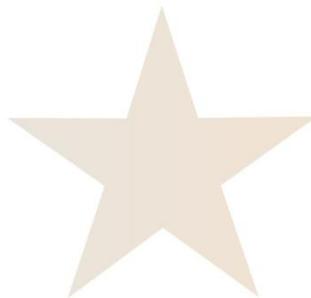


Consultation Paper

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)



Consultation Paper on 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)

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1. Responding to this Consultation

The ESAs invite comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/rationale proposed; and
- describe any alternative regulatory choices that the ESAs should consider.

Submission of responses

To submit your comments, click on the 'Send your comments' button on the consultation page on the EBA's website by 05.05.2014. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the ESAs' rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the ESAs' Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the ESAs is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the ESAs in the implementing rules adopted by their Management Board. Further information on data protection can be found under the [Legal notice section](#) of the EBA website and under the [Legal notice section](#) of the EIOPA website and under the [Legal notice section](#) of the ESMA website.

2. Executive Summary

Regulation 575/2013 (Capital Requirements Regulation—CRR) establishes that risk weights under the Standardised Approach should be based on the exposure class to which the exposure is assigned and, if applicable, its credit quality, determined by reference to the credit assessments of External Credit Assessment Institutions (ECAIs). As per Articles 136(1) and 136(3) CRR, these draft ITS specify the correspondence ('mapping') between risk weights and credit assessments (via credit quality steps) as well as the factors and benchmarks that should be taken into consideration to determine such correspondence.

The 'mapping' has to be provided for all ECAIs, defined according to Article 4(98) CRR. This includes any credit rating agency that is registered or certified in accordance with the CRA Regulation¹ or a central bank issuing credit ratings that are exempt from the application of CRA Regulation. This 'automatic' recognition process represents a substantial modification of the process applicable under the Directives 2006/48/EC and 2006/49/EC. This aims at opening the market to other undertakings different from the three main ones that already dominate the market.

The draft ITS have been elaborated on the basis of long-term and short-term default rates which constitute the main quantitative factor that characterises the risk of a credit assessment. The same Basel II benchmarks define each risk weight (or credit quality step).

The following aspects of these draft ITS represent a material contribution to the existing regulatory framework:

- Specific requirements have been established for the calculation of the default rate, which should improve the objectivity and consistency of the 'mappings'. Special attention should be paid to the minimum size of the pool that qualifies for the calculation of the default rate and to the definition of the types of default events that should be considered by the ECAI.
- In order to make the most efficient use of available quantitative information, default experience from other sources, such as external ratings of other ECAIs or credit scores produced by the ECAIs themselves, are considered in addition to the default experience stemming from rated items.
- Where neither internal nor external default data are available, an estimate of the quantitative factor is required based on the belief of the ECAI (in accordance to Article 136(2)(a) CRR) and taking into account the prudential purpose of the CRR.
- Special effort has been devoted to the implementation of the qualitative factors, as described in the explanatory boxes of these draft ITS. However, it has to be acknowledged that a full characterisation of the use of such factors is not possible given the relevance of expert judgement in the mapping process.

In order to complete the consultation process on the proposals of this paper, an addendum to this Consultation Paper will be issued containing the individual mapping tables of all ECAIs in Annex III.

¹ Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies (OJ L 302, 17.11.2009, p. 1).

3. Background and rationale

The nature of ITS under EU law

These draft ITS are produced in accordance with Article 15 of Regulation (EU) No 1093/2010 (EBA regulation). Article 15(4) of the EBA regulation stipulates that they shall be adopted by means of regulations or decisions. According to EU law, EU regulations are binding in their entirety and directly applicable in all Member States. This means that, on the date of their entry into force, they become part of the national law of the Member States and that their implementation into national law is not only unnecessary but also prohibited by EU law, except in so far as this is expressly required by them.

Shaping these rules in the form of a Regulation ensures a level playing field by preventing diverging national requirements and eases the cross-border provision of services since each time an institution wishes to take up operations in another Member State, it currently has to assess a different set of rules.

Background to these draft ITS

Use of external credit assessments in the CRR/CRDIV

Regulation (EU) No 575/2013 (Capital Requirements Regulation—CRR) allows the use of external credit assessments of ECAs to determine the credit quality that will be used to set the corresponding risk weight under the Standardised Approach (see Article 113(1) CRR). This provision is equivalent to the provisions of the Basel II framework and represents a significant enhancement in the risk-sensitivity and prudential soundness of the credit risk rules.

These draft ITS should be specially applicable by institutions where credit risk is less material, which is typically the case for less sophisticated institutions, for insignificant exposure classes, or in situations where using internal approaches would be overly burdensome. Where credit risk is material, institutions should therefore generally seek to implement internal ratings-based approaches or internal models.

Notwithstanding with the principle stated in the previous paragraph, the G-20 conclusions and the FSB principles for reducing reliance on external credit ratings should also be taken into account. Therefore, although the analysis behind the ‘mapping’ of each ECAI and its regular monitoring over time should alleviate any mechanistic overreliance of the credit risk rules on external ratings, institutions should be encouraged to use internal ratings rather than external credit ratings, even for the purpose of calculating own fund requirements as a way to reduce overreliance (on external credit ratings).

ECAIs and relevant external credit assessments

As stated in Article 135(1) CRR, external credit assessments can only be used if they have been provided by an External Credit Assessment Institution (ECAI). These draft ITS specify, for all ECAIs, the mappings that should be used for determining the own fund requirements under the Standardised Approach.

ECAIs are defined as any credit rating agency registered or certified in accordance with the CRA Regulation² or any central bank issuing credit ratings that are exempt from the application of CRA Regulation. This 'automatic' recognition process represents a substantial modification to the process applicable under the Directives 2006/48/EC and 2006/49/EC. This aims at opening the market to other undertakings different from the three main ones that already dominate the market.

ECAIs produce a wide variety of credit assessments. Although credit assessments mainly refer to the ability of the issuer to pay back traditional debt-like instruments, they may also refer to other types of instruments such as hybrid instruments, bank deposits, claims on insurance policies or shares in income funds. These draft ITS refer to credit assessments that can be used to determine the risk weight of non-securitisation exposures under the Standardised Approach. Therefore, credit assessments of covered bonds and shares in CIUs have been considered. Exposures to specific types of obligors are also allowed to be risk weighted on the basis of external credit assessments. This is the case with regard to exposures to the public sector (central/regional governments, central banks, local authorities and public sector entities), institutions (including multilateral development banks) and corporates. In all these cases, the credit assessments that comply with the definition of 'credit rating' provided in the CRA Regulation³ have been considered.

Structure of the ITS

These draft ITS serve the two mandates contained in Article 136 CRR. As per paragraph 3, the draft ITS specify the elements that should be considered to characterise the degree of risk expressed by a credit assessment of an ECAI (quantitative and qualitative factors) as well as the levels of risk that should be used to characterise each credit quality step ('benchmark'). As per paragraph 1, the draft ITS also specify the resulting mapping of each relevant credit assessment for each ECAI.

Article 136
Mapping of ECAIs' credit assessments

1. EBA, EIOPA and ESMA shall, through the Joint Committee, develop draft implementing technical standards to specify for all ECAIs, with which of the credit quality steps set out in Section 2 the relevant credit assessments of the ECAI correspond ('mapping'). Those determinations shall be objective and consistent.

...

2. When determining the mapping of credit assessments, EBA, EIOPA and ESMA shall comply with the following requirements:

(a) in order to differentiate between the relative degrees of risk expressed by each credit assessment, EBA, EIOPA and ESMA shall consider quantitative factors such as the long-term default rate associated with all items assigned the same credit assessment. For recently established ECAIs and for those that have compiled only a short record of default data, EBA, EIOPA and ESMA shall ask the

² Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies (OJ L 302, 17.11.2009, p. 1).

³ According to Article 3(1)(a), 'credit rating' means an opinion regarding the *creditworthiness* of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such instruments, issued using an established and defined ranking system of rating categories.

ECAI what it believes to be the long-term default rate associated with all items assigned the same credit assessment;

(b) in order to differentiate between the relative degrees of risk expressed by each credit assessment, EBA, EIOPA and ESMA shall consider qualitative factors such as the pool of issuers that the ECAI covers, the range of credit assessments that the ECAI assigns, each credit assessment meaning and the ECAI's definition of default;

(c) EBA, EIOPA and ESMA shall compare default rates experienced for each credit assessment of a particular ECAI and compare them with a benchmark built on the basis of default rates experienced by other ECAs on a population of issuers that present an equivalent level of credit risk;

(d) where the default rates experienced for the credit assessment of a particular ECAI are materially and systematically higher than the benchmark, EBA, EIOPA and ESMA shall assign a higher credit quality step in the credit quality assessment scale to the ECAI credit assessment;

(e) where EBA, EIOPA and ESMA have increased the associated risk weight for a specific credit assessment of a particular ECAI, and where default rates experienced for that ECAI's credit assessment are no longer materially and systematically higher than the benchmark, EBA, EIOPA and ESMA may restore the original credit quality step in the credit quality assessment scale for the ECAI credit assessment.

3. EBA, EIOPA and ESMA shall develop draft implementing technical standards to specify the quantitative factors referred to in point (a), the qualitative factors referred to in point (b) and the benchmark referred to in point (c) of paragraph 2.

...

The legal mandate is restricted to the specification of the (quantitative and qualitative) factors, the benchmark and the 'mappings'. In order to illustrate the practical implementation of the quantitative and qualitative factors and their comparison with the benchmark to arrive at each particular 'mapping', additional details have been provided in the form of recitals and explanatory boxes for consultation purposes.

Main policy options

The draft ITS have been elaborated on the basis of the regulatory framework in force prior to the entry into force of the CRR⁴, which basically relies on the international agreement reflected in the Basel II framework published in June 2004.

The default rate of the items assigned the same credit assessment constitute the main quantitative factor to measure the underlying level of risk. Both short-run and long-run default rates have been proposed. The long-run default rate should provide the basis of the mapping proposal and the short-

⁴ Annex 2 of the document 'Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework — Comprehensive Version' dated June 2006 and Part 3 of the document 'Revised Guidelines on the recognition of External Credit Assessment Institutions' dated 30 November 2010.

run default rate should indicate a weakening of the assessment standards of the ECAI that might be affecting the underlying level of risk.

Given the importance of this factor and its contribution to the objectivity and consistency of the process, the draft ITS propose that all available information be used to calculate the default rate. Therefore, in cases where default data from rated items is not sufficient, default experience stemming from other sources (such as external ratings of other ECAIs or credit scores produced by the ECAI itself) should also be considered.

In a situation where neither internal nor external default experience is available, the estimate of the default rate provided by the ECAI in accordance to Article 136(2)(a) CRR should be addressed, taking into account the prudential purpose of the CRR. This prudential principle, directly observable in the quantification of risk of internally rated exposures (see Article 179(1)(a) CRR), is considered of equal importance in the case of the quantification of risk of externally rated exposures. Failure to do this would make it very difficult to impose a conservative mapping of credit assessments where the default data showed bad performance by the ECAI. In any case, it should be made clear that qualitative factors may challenge the mapping stemming from this conservative estimate of the long-run default rate.

Another important step forward regarding the objectivity and consistency of the mapping process is the establishment of certain requirements for the calculation of the default rate. Special attention should be paid to the dependency of the required minimum size of a credit assessment on its perceived risk profile and to the definition of the types of default events that should be considered. Regarding the latter, it is worth noting two aspects. First, ECAIs use different default definitions, as reflected in the CRA Regulation⁵ and Commission Delegated Regulation (EU) No 448/2012.⁶ Therefore, the types of default events underlying the calibration of the benchmark have been proposed to ensure that the overall level of calibration of the mappings does not change with respect to the previous regulatory framework. Second, any difference in the level of strictness of an ECAI's default definition with respect to other ECAIs has a large potential to affect the level playing field since the respective mappings would not have been done under similar terms. Therefore, the types of default event considered by each ECAI should be confronted by those used to calibrate the benchmark.

The role of the qualitative factors should be more important where the default experience is less conclusive about the mapping of a rating category. For this purpose, a set of qualitative factors has been identified to challenge the information contained in the quantitative factor.

The time horizon considered in the credit rating is also a relevant factor. Given that the time horizon chosen for the calculation of the default rate is equal to 3 years, this same time horizon should be considered when default data are not available to ensure consistency across ECAIs. As a consequence, where the credit rating is based on a shorter horizon, the expected level of risk of the rating category beyond its time horizon (for example, second and third years if the time horizon of the credit rating is 12 months) should be considered to assess the level of risk of the rating category that is relevant for the mapping.

⁵ Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, Annex I, Section D, I.(2)(c)

⁶ Commission Delegated Regulation (EU) No 448/2012 of 21 March 2012 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council with regard to regulatory technical standards for the presentation of the information that credit rating agencies shall make available in a central repository established by the European Securities and Markets Authority, OJ L 140, 30.5.2012, p. 17.

Although mostly considered as an ordinal measure of risk, the meaning and range of the credit assessments of an ECAI can be particularly helpful in certain situations. For example, where the mapping of the adjacent credit assessment is already known or where the meaning already indicates a situation close to default, the mapping of a rating category can be implicitly derived from this information.

The internal relationship established by an ECAI between its different rating scales for various kinds of credit assessments (e.g. short-term credit assessments and credit assessments available for collective investment undertakings—CIUs¹) should also be helpful, especially where the credit assessments do not have the same meaning. In these cases, the internal relationship established by the ECAI between such credit assessments and the main rating scale should provide the basis for the mapping of the former, as long as the mapping of the latter is already known.

Finally, the estimate provided by the ECAI of the long-run default rate associated with its rating categories should also be considered, provided that it has been adequately justified. The relative importance of the estimate compared to the default rate calculated according to this draft ITS should depend on the amount of default information available for the rated items. When this information is sufficient, the default rates calculated according to these draft ITS should contain all relevant information and any material difference with the estimate provided by the ECAI should lead to an investigation of the source of divergence. When this information is not available, the estimate provided by the ECAI should be used as complementary information

The benchmarks proposed in these draft RTS have been chosen to maintain the overall level of capital required for externally rated exposures under the Standardised Approach. Whereas the CRD/CRR have increased the overall level of capital required for credit institutions and investment firms by different means, there are no reasons to indirectly modify the overall level of the risk weights specified under the Standardised Approach. Therefore, this Regulation proposes the same values as contained in the Basel II framework. The only difference is that a set of lower and upper bounds have been provided for the long-run default rate benchmark to acknowledge that a range of values can be compatible with each credit quality step.

4. Draft Implementing TS on the mapping of ECAIs' credit assessments under Articles 136(1) and 136(3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation-CRR)

In between the text of the draft RTS/ITS/Guidelines/advice that follows, further explanations on specific aspects of the proposed text are occasionally provided, which either offer examples or provide the rationale behind a provision, or set out specific questions for the consultation process. Where this is the case, this explanatory text appears in a framed text box.

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laying down implementing technical standards with regard to implementing technical standards on the mapping of ECAIs' credit assessments under Articles 136(1) and 136(3) of Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms

of XX Month 2014

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms¹ and in particular the third subparagraph of Article 136(1) and the third subparagraph of Article 136(3) thereof,

Whereas:

- (1) Article 136(1) of Regulation (EU) No 575/2013 requires the specification for all ECAIs, of the correspondence of the relevant credit assessments issued by an ECAI to the credit quality steps set out in Section 2 of that Regulation ('mapping'). ECAIs are credit rating agencies that are registered or certified in accordance with Regulation (EC) No 1060/2009 or a central bank issuing credit ratings which are exempt from the application of that Regulation. 'Credit assessment' is a term used under that Regulation to refer both to the 'labels' of the different categories of ratings by ECAIs (such as 'AAA'), and to assignment of one such rating to a particular item, either firm or instrument (such as 'rating of a certain instrument at AAA'). However these two concepts are distinguished with the terms 'credit rating' and 'rating category', in Articles 3(1)(a) and (h) respectively of Regulation (EC) No 1060/2009. To avoid confusion given the need to refer to these two particular concepts separately, and given that the complementarity of the two Regulations, the terminology of Regulation (EC) No 1060/2009 should be used in this Regulation, as more specific.
- (2) Given that paragraph 1 of Article 4 of Regulation (EC) No 1060/2009 permits the use of credit ratings for regulatory purposes by credit institutions and investment firms only if issued by credit rating agencies established in the Union and registered in accordance with that Regulation, the mapping of ECAIs credit assessments should cover credit assessments that comply with the definition of 'credit rating' according to Article 3(1)(a) of that Regulation. Further, given that by virtue of Article 135 of

¹ OJ L 176, 27.6.2013, p. 1.

Regulation (EU) No 575/2013, a mapping is required for all ECAIs, the definition of which includes, by virtue of Article 4(98) of that Regulation also credit ratings produced by central banks exempted from the application of Regulation (EC) No 1060/2009, the mapping of ECAIs rating categories should also cover such credit ratings as well. Furthermore, since Regulation (EU) No 575/2013 does not allow the use of credit ratings for certain asset classes (such as equity) within the Standardised Approach, only assessments for fixed-income CIUs ('collective investment undertakings') that primarily depend on the credit quality of the underlying assets should be covered by the mapping provided in this Regulation.

- (3) The mapping has the objective of assigning the appropriate risk weights of Regulation (EU) No 575/2013 to the rating categories of an ECAI. Therefore, it should be able to identify not only relative differences of risk but also the absolute levels of the risk of each rating category, ensuring appropriate levels of capital under the Standardised Approach.
- (4) Given the wide range of methodologies across ECAIs, objectivity and consistency of the mapping methodology are key aspects for ensuring a level playing field for institutions as well as fairness of treatment for ECAIs. For this reason, when elaborating rules on the use of quantitative and qualitative factors and their comparison with the benchmark, this Regulation should build on the main sources of the previous regulatory framework which had the same objectives, namely Annex 2 of the 'Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version' dated June 2006² and Part 3 of the 'Revised Guidelines on the recognition of External Credit Assessment Institutions' dated 30 November 2010³.
- (5) This Regulation takes into account that the default definitions used by ECAIs differ, as reflected in Regulation (EC) No 1060/2009 and Commission Delegated Regulation (EU) No 448/2012. In order to ensure that the overall level of the capital required to externally rated exposures is not changed, the types of default events used for the calibration of the benchmark referred to in point (c) of Article 136(2) CRR constitute the default definition proposed for this Regulation.
- (6) The mapping does not constitute the mapping on the possibility of which the European Securities and Markets Authority shall report on in accordance with Article 21(4b) of Regulation (EC) No 1060/2009 which would aim to allow investors to easily compare all credit ratings that exist with regard to a specific rated entity. The mapping should however be interpreted as the correspondence of the rating categories of an ECAI with a regulatory scale which has been defined for prudential purposes.
- (7) A different mapping should be conducted for each relevant set of rating categories ('rating scale'). When the rating scale of an ECAI is the same across exposure classes, the mapping should not differ in order to guarantee the differentiation of risk weights across exposure classes established by Regulation (EU) No 575/2013. When an ECAI

² <http://www.bis.org/publ/bcbs128.pdf>

³ <http://www.eba.europa.eu/documents/10180/15917/Revised-Guidelines-ECAIS.pdf/30eb51dc-1521-4caf-b8e8-15724dde00fc>

has several rating scales, the relationship established by the ECAI among them should be considered for the mapping.

- (8) Unsolicited ratings, as referred to in point (x) of Article 3 of Regulation (EC) No 1060/2009⁴, should be included in the mapping of an ECAI as long as these ratings can be used for regulatory purposes in accordance with Article 4(1) of Regulation 1060/2009 and the EBA has confirmed that they do not differ in quality from solicited credit ratings of this ECAI in accordance with paragraph 1 of Article 138 Regulation (EU) No 575/2013.
- (9) Quantitative factors should be used in the first place to produce an initial proposal for a mapping. Qualitative factors should be considered in a second stage to review the initial mapping proposal and amend where it is justified. This two-step approach should contribute to the objectivity of the mapping.
- (10) The default rate associated with items assigned the same rating category should be considered as the most representative quantitative factor. Ideally it should be calculated from default data corresponding to such items. However, in order to guarantee the objectivity and consistency of the mapping according to Article 136(1) of Regulation (EU) No 575/2013, where default data corresponding to these items is not available, it is appropriate to allow for an estimate of the default rate based on alternative default data, such as the default observed for comparable items rated by other ECAIs or for comparable items assigned the same credit score category as defined in point (y) of Article 3(1) of Regulation (EC) No 1060/2009. Where neither internal nor alternative default data is available, a conservative estimate of the default rate should still be calculated on the basis of the opinion of the relevant ECAI and any default evidence associated with the items assigned the same rating category for which the mapping is being performed.
- (11) The calculation of the default rate should meet some requirements in order to ensure that it is comparable across ECAIs. For example, it should be measured over a 3 year time horizon in order to allow the observation of a significant number of defaults when risk is very low and it should account for withdrawals to avoid an underestimation of risk. Also, it should not include public sector ratings given the scarcity of defaults for this type of rating.
- (12) Default rates should be calculated for each rating category to the extent possible over a long term and a short term observation period. The former should provide the basis for the mapping, whereas the latter should provide an early warning about a potential increase in the level of risk of the rating category. Where a sufficient number of credit ratings is not available, only the long run default rate should be calculated due to the high degree of uncertainty regarding the calculation of short run default rates. In this case, a warning about a potential increase in the level of risk of the rating category should be provided by the qualitative factors.

⁴ Amended by Article 1 of Regulation (EU) No 462/2013.

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- (13) The definition of default established by the ECAI to calculate the default rate associated with items assigned the same rating category is a key element of the mapping. A stricter definition of default may produce higher default rates compared to other less strict default definitions. Therefore the impact of the definition of default on the calculation of the default rate should be estimated in order to ensure a correct mapping.
- (14) When only scarce default data is available, the time horizon considered in a rating category should be taken into account for the purpose of the mapping to ensure consistency across ECAIs. For example, where a short term horizon has been chosen, some items may qualify for a particular level of risk. However, these same items may represent a significantly different level of risk if evaluated over the 3-year time horizon chosen for the calculation of the default rate. This factor should be recognised and appropriately reflected in the mapping.
- (15) The meaning of the rating category and its relative position within the rating scale should be especially helpful when there is no quantitative factor available and the mapping of adjacent rating category is known. For that purpose, credit quality steps should be characterised in terms of aspects such as the capacity of the issuer to meet its financial obligations, its sensitivity to the economic situation or its proximity to the default status.
- (16) General risk drivers of the items assigned a rating category should also be taken into account. The size and the degree of activity diversification of the items assigned a rating category should be considered as relevant indicators of their underlying risk profile.
- (17) The benchmarks of the long-run and short run default rates provided in the document 'Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version' dated June 2006, should be used in order to converge with international standards. However, more detailed rules should be provided to account for the variety of ECAIs that currently operate in the EU market and whose default rates may significantly deviate from the pattern of the international ECAIs underlying the current benchmark. More concretely, the long-run benchmark should be defined in terms of intervals to acknowledge that a range of values can be compatible with each credit quality step.
- (18) Rating categories should be initially mapped to a credit quality step based on the comparison of their long-run default rate with the long-run benchmark and the information provided by the qualitative factors.
- (19) The adequacy of the mapping should be reviewed frequently because the long-run default rate could change and become representative of a different credit quality step. To that end, recent short run default rates experienced within a rating category should be regularly confronted with their relevant short run benchmarks ('monitoring' and 'trigger' levels). A breach of the short run benchmarks for a consecutive period of two years could signal a weakening of assessment standards which could imply that the new underlying long-run default rate is representative of a less favourable credit

quality step. This signal would be more relevant where the trigger level is breached instead of the monitoring level.

- (20) The mapping tables should be regularly updated with the most recent available information and changed if necessary, particularly where the information available at the time of the existing mapping was scarce. Regarding new available ECAIs, the mapping table should be available in a timely manner in order not to affect competition in the market. Therefore revised versions of this Regulation should be published either annually, or within a reasonable time following publication by the ESMA of the registration of a new ECAI in accordance with Article 18(3) of Regulation (EC) No 1060/2009, or within a reasonable time following publication by the European Commission of the list of central banks issuing credit ratings which are exempt from the application of Regulation (EC) No 1060/2009 and which, by virtue of Article 4(98) of Regulation (EU) No 575/2013, also constitute ECAIs.
- (21) The updating of the adequacy of the quantitative and qualitative factors and the benchmark and the updating of the mapping tables constitute a revision of this Regulation, therefore it should be carried out in accordance with the process described in Articles 136(1) and 136(3) of Regulation (EU) No 575/2013 and Article 15 of Regulation (EU) No 1093/2010.
- (22) This Regulation is based on the draft implementing technical standards submitted by EBA, ESMA and EIOPA to the Commission.
- (23) EBA, ESMA and EIOPA have conducted open public consultations on the draft implementing technical standards on which this Regulation is based, analysed the potential related costs and benefits and requested the opinion of the Banking Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1093/2010; the opinion of the Securities and Markets Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1095/2010; and the opinion of the Insurance and Reinsurance Stakeholder Group established in accordance with Article 37 of Regulation (EU) No 1094/2010.

HAS ADOPTED THIS REGULATION:

TITLE I - Quantitative factors, qualitative factors and benchmark

CHAPTER 1 - Quantitative factors

Article 1 - Quantitative factors of the mapping of a rating category

The quantitative factors referred to in point (a) of Article 136(2) of Regulation (EU) No 575/2013 shall be the short run and long run default rates associated with items assigned the same rating category, as specified in Articles 2 to 7.

Explanatory text for consultation purposes

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

Section 1 - Calculation of the quantitative factors of a rating category where a sufficient number of credit ratings is available

Article 2 - Items used for the calculation of the quantitative factors of a rating category where a sufficient number of credit ratings is available

The calculation of the default rates referred to in Article 1 for each rating category shall be performed based solely on items assigned the same rating category by the ECAI for which the mapping is being performed, where they meet all of the following requirements:

- (a) they belong to the ‘Corporates’ type of rating referred to in Article 3(5) of Commission Delegated Regulation (EU) No 448/2012⁵;
- (b) they are assigned either of the following:
 - (i) a solicited credit rating;
 - (ii) an unsolicited credit rating that meets the requirements of Article 138 of Regulation (EU) No 575/2013.
- (c) they allow for the calculation of both the short run and the long run default rates as set out in Articles 3 and 4.

Article 3 - Short run default rates of a rating category where a sufficient number of credit ratings is available

1. Where a sufficient number of credit ratings is available according to Article 2, the short run default rates referred to in Article 1 shall be calculated in the manner described in paragraphs 2 to 7.

⁵ Dated 21 March 2012 supplementing Regulation (EC) No 1060/2009 of the European Parliament and of the Council with regard to regulatory technical standards for the presentation of the information that credit rating agencies shall make available in a central repository established by the European Securities and Markets Authority, OJ L140, 21.3.2012, p. 17.

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2. The short run default rates shall be measured over a 3-year time horizon.
 3. The short run default rates shall be expressed as a fraction where:
 - (a) the denominator represents the number of items assigned the same rating category present at the beginning of the time horizon referred to in paragraph 2;
 - (b) the numerator represents the number of items referred to in point (a) that have defaulted prior to the end of the time horizon referred to in paragraph 2.
 4. In order to be included in the denominator specified in point (a) of paragraph 3, items shall meet all of the following requirements:
 - (a) they shall be representative of the most recent pool of items assigned the same rating category;
 - (b) they shall be sufficiently numerous with respect to the perceived risk profile of the rating category to ensure a reliable estimate of the default rate.
 5. Items withdrawn prior to the end of the time horizon and not defaulted shall only contribute to the denominator of the short run default rates mentioned in point (a) of paragraph 3 with a weight equal to 50%. Any item for which there is evidence that it has been withdrawn prior to the occurrence of default shall be considered as defaulted item.
 6. Items shall be considered as defaulted items to be included in the numerator specified in point (b) of paragraph 3 where any of the following type of event has occurred:
 - (a) a bankruptcy filing or legal receivership that will likely cause a miss or delay in future contractually required debt service payments;
 - (b) a missed or delayed disbursement of a contractually required interest or principal payment, unless payments are made within a contractually allowed grace period;
 - (c) a distressed exchange if the offer implies the investor will receive less value than the promise of the original securities;
 - (d) the rated entity is under a significant form of regulatory supervision owing to its financial condition.
 7. The short run default rates shall be calculated for each available pool of items assigned the same rating category that exists on 1 January and 1 July of each year.

Explanatory text for consultation purposes

The requirements established for the default rate calculation reflect the criteria which are of interest for the legislator from a prudential perspective. Unlike the previous regulatory framework (Annex 2 of the document 'Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version' dated June 2006 and Part 3 of the document 'Revised Guidelines on the recognition of External Credit Assessment Institutions' dated 30 November 2010), this Regulation has opted for a more prescriptive approach and has set specific requirements regarding the calculation of the quantitative factor. The main objective is to reduce the number of differences in default rates stemming from purely methodological aspects so that only different underlying risk profiles are responsible for any difference in the default rate.

Two requirements deserve special attention. In first place, Article 4(b) provides the basis for determining the *sufficiency* of credit ratings that gives name to Section 1. According to it, the sufficiency of the number of items assigned the same rating category ('rated items') depends on the perceived risk profile of the rating category. The rule that has been used to implement this requirement requires the number of rated items to be greater or equal to the inverse of the expected long run default rate of the rating category. Where observed default data suggests that the long run default rate is expected to be close to 1%, each historical cohort should contain, at least, 100 rated items. This rule is more stringent for low-risk rating categories where the pool should be larger to provide a reliable statistical estimate. However, it cannot be applied without some necessary expert judgement. Therefore, the rules text cannot be more specific than Article 3(4)(b).

Secondly, it has been necessary to specify the types of default events that can be included in the calculation of the default rate because this typically affects the comparability of this metric across ECAIs. The required types of default event that should be considered, listed in Article 3(6), are essentially the ones used for the calibration of the benchmark in Article 15. Types of default events not included in this list should not be used for the default rate calculation and, where not all types of default events have been considered by an ECAI, the qualitative factor specified in Article 9 should be applied to the calculated default rate in order to increase the consistency of the mapping process.

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 4 - Long run default rate of a rating category where a sufficient number of credit ratings is available

1. Where a sufficient number of credit ratings is available according to Article 2, the long run default rate referred to in Article 1 shall be calculated according to paragraphs 2 to 5.
2. Where at least the most recent 20 short run default rates of a rating category have been calculated according to Article 3, the long run default rate shall be calculated as the weighted average of these short run default rates.

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3. Where less than 20 short run default rates have been calculated according to Article 3, the long run default rate shall be calculated only where those short run default rates are at least [10] and the remaining short run default rates have been estimated. In that case, the long run default rate shall be calculated as the weighted average of all these short run default rates.
 4. For the purpose of producing the weighted average referred to in paragraphs 2 and 3, the short run default rates calculated according to Article 3 shall refer to the most recent recessionary period.
 5. For the purpose of producing the weighted average referred to in paragraphs 2 and 3, the following shall apply:
 - (a) the short run default rates calculated according to Article 3 shall be weighted based on the number of items specified in point (a) of paragraph 3 of that Article;
 - (b) the estimated short run default rates shall be weighted based on the number of items specified in point (a) of paragraph 3 of that Article of the least recent short run default rate calculated according to Article 3.

The weights shall ensure an adequate representation of recessionary and non-recessionary years in a full economic cycle.

6. For the purpose of point (b) in paragraph 1, a recessionary period shall refer to a semester or more of negative growth rate of GDP in the main geographical areas of reference of the rated population.

Explanatory text for consultation purposes

The long run default rate should be initially based on the most recent 10 year period (20 semi-annual observations in January and July each year). However when a longer period is available, additional years should also form part of the long run calculation so that all relevant information is taken into account.

A long run default rate should be estimated as weighted average of short run default rates only when they refer to a recessionary period. Otherwise, the level of uncertainty would be very high and therefore no estimate would be allowed. Given the potential duration of a recessionary period, if short run default rates are not available for, at least, 5 consecutive years, it would be considered that the implicit degree of uncertainty surrounding the calculation of the long run default rate would be too high.

Short run default rates should be calculated with a six-month frequency to ensure that a weakening of the assessment standards of the ECAI is captured sufficiently in advance.

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?

Section 2 - Calculation of the quantitative factors of a rating category where a sufficient number of credit ratings is not available

Article 5 - Items used for the calculation of the quantitative factors of a rating category where a sufficient number of credit ratings is not available but a sufficient number of items assigned a different measure of creditworthiness is available

1. Where any of the requirements specified in Article 2 is not met, the long run default rate referred to in Article 1 shall be calculated based on both of the following items:
 - (a) items assigned the same rating category by the ECAI for which the mapping is being performed.
 - (b) items assigned a different measure of creditworthiness from that of Article 2 where this different measure of creditworthiness meets all of the requirements of paragraph 2;
2. For the purposes of point (b) of paragraph 1, the different measure of creditworthiness shall meet all of the following requirements:
 - (a) it has been produced by an ECAI;
 - (b) it is closely related to the credit rating for which the mapping is being performed;
 - (c) the items on which it has been assigned meet the following requirements:
 - (i) they are representative in terms of number and perceived risk profile of the items assigned the same rating category for which the mapping is being performed;
 - (ii) they allow for the calculation of the short run and long run default rates of each category of that different measure of creditworthiness as set out in Articles 3 and 4, where the term ‘rating category’ shall be understood as referring to the ‘category of that different measure of creditworthiness’.

Article 6 - Long run default rate of a rating category where a sufficient number of credit ratings is not available but a sufficient number of items assigned a different measure of creditworthiness is available

1. Where any of the requirements specified in Article 2 is not met but a sufficient number of items assigned a different measure of creditworthiness is available according to Article 5, the long run default rate referred to in Article 1 shall be calculated in one of the following ways:

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- (a) as the weighted average of the long run default rate benchmarks, as referred to in paragraph 2 of Article 15, that are associated with the related categories of the different measure of creditworthiness, where a correspondence of each category of that different measure of creditworthiness to the relevant credit quality step ('mapping') has already been set out according to this Regulation;
 - (b) as the weighted average of the long run default rates, as referred to in point (c)(ii) of paragraph 2 of Article 5, that are associated with the related categories of the different measure of creditworthiness, in all other cases.
2. For the purpose of producing the weighted average referred to in paragraph 1, the number of items assigned each related category of that different measure of creditworthiness shall be used.

Article 7 - Items used and long run default rate of a rating category where neither a sufficient number of credit ratings nor a sufficient number of items assigned a different measure of creditworthiness is available

1. Where neither a sufficient number of credit ratings as referred to in Article 2 nor a sufficient number of items assigned a different measure of creditworthiness as referred to in Article 5 is available, the calculation of the long run default rate specified in Article 1 shall be performed based on items assigned the same rating category by the ECAI for which the mapping is being performed.
2. In the case of paragraph 1, for the purpose of calculating the long run default rate referred to in Article 1, the estimate of the long run default rate specified in point (e) of Article 8 shall be complemented with the number of defaulted and non-defaulted items assigned the rating category by the ECAI for which the mapping is being performed. The prudential purposes shall be taken into account.

Explanatory text for consultation purposes

The calculation of the default rate of a rating category is considered a key step of the mapping process because it contributes to the consistency and objectivity of the process, as required by Article 136(1) CRR. The approach chosen in this Regulation tries to make the most efficient use possible of available information while incorporating an appropriate degree of careful consideration when uncertainty is higher. This does not prevent qualitative factors from challenging the initial mapping proposal based on the calculation of the default rate.

Therefore, when an ECAI does not have historical default information that is sufficiently numerous and representative of the current pool of rated items, two additional options are available for the calculation of the long run default rate under Section 2 of this Regulation.

As a first possibility, reflected in Articles 5 and 6, the level of risk of a rating category can be inferred from a different measure of creditworthiness for which observed default rates are available. This is the case, for example, of ECAIs whose rated items have also been rated by another ECAI or scored by the ECAI itself. The main additional requirement is that both the credit rating produced by the ECAI and that different measure of creditworthiness show some relationship. This should help transforming, by means of a weighted average, the default rates observed for that different measure into default rates associated with the rating categories which are being mapped.

The resulting default rate is expected to be close to the true (unknown) default rate. Therefore, in order to complement this calculation, the qualitative factor specified in Article 13 should be used. For example, in the case of credit scores being used (and not credit ratings of another ECAI), the contribution of the rating analyst in terms of discriminatory power should be recognised in the default rate of the rating category because the default curve across scoring categories will tend to show a lower level of risk differentiation.

When the first alternative is not available, the estimate of the default rate provided by the ECAI specified in Article 13 should be considered as a valid starting point for the default rate calculation of a rating category as long as it has been adequately justified. In these cases, some degree of careful considerations should be imposed to reflect the implicit uncertainty. However, this initial estimate should be updated with whatever information becomes available regarding the default experience of the rating category, what should lead to a reduction of the degree of conservatism.

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

CHAPTER 2 - Qualitative factors

Article 8 - Qualitative factors of the mapping of a rating category

The qualitative factors referred to in point (a) of Article 136(2) of Regulation (EU) 575/2013 shall be:

- (a) the definition of default considered by the ECAI, as referred to in Article 9;
- (b) the time horizon of a rating category considered by the ECAI, as referred to in Article 10;
- (c) the meaning of a rating category and its relative position within the whole range of rating categories ('rating scale') established by the ECAI, as referred to in Article 11;
- (d) the creditworthiness of the items assigned the same rating category, as referred to in Article 12;

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- (e) the estimate provided by the ECAI of the long run default rate associated with all items assigned the same rating category, pursuant to point (a) of Article 136(2) of Regulation (EU) No 575/2013, as referred to in Article 13;
 - (f) the relationship established by the ECAI ('internal mapping'), where available, between, on the one hand, the rating category which is being mapped, and, on the other hand, other rating categories produced by the same ECAI, where a correspondence of these other rating categories of the ECAI to the relevant credit quality step ('mapping') has already been set out according to this Regulation, as referred to in Article 14;
 - (g) any other relevant information that can describe the degree of risk expressed by a rating category.

Article 9 - Definition of default used by the ECAI

The type of events considered by the ECAI for the purposes of establishing whether an item is in default situation, shall be compared to those specified in paragraph 5 of Article 3 by using all available information. Where the comparison indicates that not all such types of default events have been considered by the ECAI, the quantitative factors referred to in Article 1 shall be adjusted accordingly.

Explanatory text for consultation purposes

The default definition is a key element of the mapping process, especially where sufficient default data is available. ECAs using a strict definition of default would record more default events than ECAs using a less strict definition for the same population of rated entities. Therefore, any difference in the level of strictness of the default definition has a large potential of affecting the comparability of the mappings across ECAs. For this reason, an ECA's definition of default should be assessed and adjusted if necessary.

The type of default events considered by the ECAI should then be compared to those used to build the benchmark (described in Article 3(6)). However, this might not be possible in the case of some ECAs due to the type of firms that they rate. For example, SMEs do not usually issue market debt and therefore it is not always possible to identify defaults as a consequence of missed payments of principal/interest of bonds traded in the market.

In order to address this problem, and given that bankruptcy (and similar legal proceedings) is the default trigger most commonly considered by ECAs, it is proposed that the strictness of a default definition is measured as the additional number defaults recorded by the ECAI due to a reason different from bankruptcy.

According to this measure, a reference level of strictness equal to 100% is proposed, which is based on information used to calibrate the benchmark. This level means that the number of non-bankruptcy

defaults is expected to be equal to the number of bankruptcy defaults and therefore, any default definition that leads to a different situation would have to be carefully analysed.

More specifically, the adjustment of the default rate of an ECAI would be initially proposed as follows:

- where the ECAI considers all the types of default events referred to in paragraph 6 of Article 3 or does not consider the one referred to in point (d) but only because it rates firms operating in non-regulated sectors, no adjustment of the default rate would be applied
- where the ECAI considers not only the types of default events referred to in paragraph 6 of Article 3 but also additional ones, the impact of these additional default events in the default rate should be filtered out
- where the ECAI considers only the type of default event referred to in point (a) of Article 3(6), the default rate should be increased by 100%
- where the ECAI partially considers the other types of default events referred to in points (b) to (d) of Article 3(6), the default rate should be increased by a factor between 0% and 100%.

As a second step, the following information regarding the level of strictness of the default definition should also be analysed to assess the appropriateness of the proposed adjustment factor:

- the range of types of debt considered by the ECAI to identify a default event: banking, market, commercial or tax debt
- the materiality threshold considered by the ECAI to define each type of default event (if any)
- the representativeness of the sources of data used by the ECAI to capture each type of default event

Q5. Do you agree with the proposed use of the default definition use by the ECAI as a relevant factor for the mapping? Do you agree with the proposed assessment of the comparability of the default definition of an ECAI? If not, what alternatives would you propose? Do you think that the adjustment factor depends on certain characteristics of the rated firms such as size and credit quality and if so, how can this be reflected?

Article 10 - Time horizon of a rating category

The time horizon considered by the ECAI for assigning a rating category shall provide a relevant indication of whether the level of risk of that rating category is sustainable over the time horizon specified in paragraph 2 of Article 3.

Explanatory text for consultation purposes

The time horizon for the calculation of the default rate is 3 years, as specified in Article 3(2). This may have relevant implications on credit ratings based on shorter horizons because the expected level of risk over the next 3 years will not be totally explained by the credit rating. In the case of a 12-month time horizon, for example, the expected migration of credit ratings to different rating categories during the second and third years should be considered to assess the level of risk of the rating category that is relevant for the mapping. To be noted, this factor is only relevant when default rates are not available because otherwise the expected migration would already be incorporated in the default rate calculation.

In general, where the time horizon of a rating category is shorter than 3 years this qualitative factor should be considered. Regarding the implementation, the transition probabilities (of one rating category to other rating categories) could be used as an indication of the expected level of risk during the 3-year time horizon.

Q6. Do you agree with the proposed use of the time horizon of the rating category as a relevant factor for the mapping? Do you agree with the proposed use of transition probabilities to identify the expected level of risk during the 3-year time horizon?

Article 11 - Meaning and relative position of a rating category

1. The meaning of a rating category established by the ECAI shall be defined according to the following characteristics of the capacity of financial commitments as reflected in the items assigned such rating category, being honoured, and more in particular by:
 - (a) its degree of sensitivity to the economic environment;
 - (b) its degree of proximity to the default situation.
2. The meaning of a rating category shall be compared to the one established for each credit quality step, as specified in Article 16.
3. The meaning of a rating category shall be considered in combination with its relative position within the rating scale established by the ECAI.

Explanatory text for consultation purposes

The meaning and range of rating categories established by an ECAI may provide no effective guidance regarding their (absolute) level of risk. The only exception may be those rating categories which, by definition, refer to a near-default situation. In those cases, it could be safely assumed that the corresponding credit quality step is the worst one, i.e. CQS 6.

In the other cases, this factor should be more useful when the adjacent rating category has already been mapped on the basis of other quantitative/qualitative factors. For example, where a A rating

category has been mapped to CQS2 based on its associated default rate, the AAA and AA rating categories could be mapped to CQS1 provided that the analysis concludes that their meaning is aligned with the reference set out in Article 16 for CQS1. However, where the A rating category has only been mapped to CQS2 on the basis of this factor (because BBB was CQS3 based on its associated default rate), the meaning of the AAA and AA rating categories may not necessarily be used again. Otherwise, the mapping of a single rating category could lead to the mapping of the full rating scale based only on this factor. Given that the meaning of rating categories usually reflects the relative ordering of the ECAI, the objectivity of the process would be affected.

Q7. Do you agree with the proposed use of the range and meaning of rating categories as a relevant factor for the mapping? Do you agree with the proposed restriction of this factor to adjacent rating categories?

Article 12 - Creditworthiness of items assigned the same rating category

The creditworthiness of items assigned the same rating category shall be determined by considering, at least, their size and the degree of sector and/or geographical diversification of their business activity.

Explanatory text for consultation purposes

The application of this factor is limited to those circumstances where default data are not reliable. Otherwise, the default rate should provide all necessary information to assess the level of risk of a rating category.

Where default data are not available, information about relevant risk factors (of the rated items) may provide a rough estimate of the range of possible values for the level of risk of a rating category. For example, a rating category composed mainly of small and non-diversified firms will very likely not qualify for CQS1, which underlying level of risk is representative of multinational firms present in various continents/sectors and therefore with a high resilience to adverse shocks. This does not mean that none of these firms could ever qualify for such low-risk CQS. It means, however, that unless contradicted by other relevant information, these general risk factors suggest that the mapping of such a low-risk CQS should not be proposed.

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

Article 13 - Estimate provided by the ECAI of the long run default rate associated with all items assigned the same rating category

The estimate provided by the ECAI of the long run default rate associated with all items assigned the same rating category shall be considered as long as it has been justified to the satisfaction of the Joint Committee.

Explanatory text for consultation purposes

The estimate provided by the ECAI of the long run default rate should have a limited role when sufficient default data for the rated items is available (Section 1). In these cases, the default rates should contain all relevant information and any material difference with the estimate provided by the ECAI should lead to an investigation of the source of divergence.

Where sufficient default information stems from other items, e.g. items rated by another ECAI or scored by the ECAI itself, the estimate provided by the ECAI should be used as additional information to the long run default rate calculated according to Articles 5 and 6:

- where the long run default rate has been calculated based on items rated by another ECAI, it should be specially considered when it would have led to a less favourable credit quality step.
- where the long run default rate has been calculated based on items scored by the ECAI itself, it should be considered to test whether it is compatible with the observed default rate for the pool of scored items provided that a rating distribution for such pool has been estimated.

Finally, where no sufficient default information is available, the estimate of the ECAI should be used as input for the calculation of the long run default rate of the rating category, as specified in Article 7.

Q9. Do you agree with the proposed use of the estimate provided by the ECAI of the long run default rate associated with all items assigned the same rating category as a relevant factor for the mapping? Do you agree with the proposed role played by this factor depending on the availability of default data for the rating category?

Article 14 - Internal mapping of a rating category established by the ECAI

The corresponding credit quality step of other rating categories produced by the same ECAI for which an internal mapping exists according to point (f) of Article 8 shall be used as a relevant indication of the level of risk of the rating category which is being mapped.

Explanatory text for consultation purposes

Some ECAs have different rating scales for certain types of ratings. Whenever a mapping to credit quality steps is available for one of these rating scales, the mapping of another rating scale should be mainly based on the already existing mapping and any relationship established by the ECAI among the two rating scales.

This situation typically arises with the long-term and short-term rating scales. Thus, the mapping of a short run rating category would be based on the CQS of the long run rating categories that the ECAI would typically associate with it.

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

CHAPTER 3 - Benchmark and related references

Article 15 - Benchmark

1. The benchmark referred to in point (c) of paragraph 2 of Article 136 of Regulation (EU) No 575/2013, shall be distinguished in:
 - (a) a long-run default rate benchmark for each credit quality step;
 - (b) a short-run default rate benchmark for each credit quality step.
2. The long run default rate benchmarks of each credit quality step shall be those referred to in Part 1 of Annex I.
3. The short run default rate benchmarks of each credit quality step shall be those referred to in Part 2 of Annex I.

Explanatory text for consultation purposes

The benchmark value for the long run default rate has been further specified under this Regulation. The benchmark under the previous regulatory framework only consisted of a point long run default rate, what is insufficient guidance given the wide risk profiles behind all registered and certified ECAIs operating in the EU. Also, the wide variation of default rates due to the recent recession has had a significant impact on the long run default rates. Therefore, the specification of upper and lower bounds for the value of the long run default rate acceptable within each credit quality step should mean very useful guidance.

The short run benchmarks remain the same as under the previous regulatory framework. They should continue to alert of a weakening of assessment standards by the ECAI that is leading to a worsening of the credit quality of the rating category. To that end, the following mechanic should be applied.

Automatic identification of a weakening of assessment standards based on the short run default rate

An observed sequence of short run default rates may represent a weakening of assessment standards if the following conditions are met:

1. The default rate is materially higher than the benchmark.

A default rate of a rating category should be considered as materially higher than the benchmark if the lower limit of the confidence interval corresponding to the default rate is higher than the short run benchmark. This condition should provide sufficient evidence that the observed value is not due to sampling variation.

The following confidence interval should be used:

$$CI: DR_t^{mod} \pm Z_{95\%} * \sqrt{\frac{DR_t^{mod} * (1 - DR_t^{mod})}{N_t^{mod}}}$$

where:

DR_t^{mod} is the modified observed short run default rate of period t (by adding 2 defaults and 2 non-defaults)

N_t^{mod} is the modified size of the pool of period t (by adding 2 defaults and 2 non-defaults)

$Z_{95\%}$ is the 95%-percentile of the Normal distribution (i.e. 1.96)

2. The default rate is systematically higher than the benchmark.

A default rate of a rating category should be considered as systematically higher than the benchmark if it has been materially higher than the benchmark for, at least, two consecutive years.

3. The increase in the default rate is not temporary.

An increase in the default rate of a rating category should be considered as temporary when it is due to an exogenous shock such as a natural disaster. Likewise, a material and systematic breach of the benchmark level by several ECAs simultaneously may indicate a temporary market change or exogenous shock as opposed to a loosening of credit standards.

In either scenario, the ECA's rating categories should be monitored in order to ensure that the higher default experience is not the result of a loosening of credit risk assessment standards.

As an automatic rule that may help as a warning alert, the default rate of a rating category should be compared with the one of the next less favourable rating category. If the upper bound of its 95%-confidence interval is higher than the lower bound for the next less favourable rating category, this should indicate that a weakening of the assessment standards is likely to have occurred.

**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?**

The reference meaning of a rating category that shall correspond to each credit quality step shall be that referred to in Annex II.

TITLE II - Mapping tables

Article 17 - Mapping tables

The correspondence of the rating categories of each ECAI with the credit quality steps set out in Section 2, Chapter 2, Title II, Part Three of Regulation (EU) No 575/2013 ('mapping') shall be that set out in Annex III.

TITLE III - Final provisions

Article 18 - Final provision

This Regulation shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels,

For the Commission
The President

On behalf of the President

[Position]

ANNEX I - Benchmarks

Part 1- Long-run benchmark

| Credit Quality Step | Long run benchmark | |
|----------------------------|---------------------------|--------------------|
| | Lower bound | Upper bound |
| 1 | 0.00% | 0.16% |
| 2 | 0.17% | 0.54% |
| 3 | 0.55% | 2.39% |
| 4 | 2.40% | 10.99% |
| 5 | 11.00% | 26.49% |
| 6 | 26.50% | 100.00% |

Part 2- Short run benchmarks

| Credit Quality Step | Short run benchmarks | |
|----------------------------|-----------------------------|----------------------|
| | Monitoring level | Trigger level |
| 1 | 0.80% | 1.20% |
| 2 | 1.00% | 1.30% |
| 3 | 2.40% | 3.00% |
| 4 | 11.00% | 12.40% |
| 5 | 28.60% | 35.00% |
| 6 | not applicable | not applicable |

ANNEX II - Other references

Reference meaning of a rating category for each Credit Quality Step

| Credit Quality Step | Meaning of the rating category |
|----------------------------|---|
| 1 | The rated entity has extremely/very strong capacity to meet its financial commitments and is subject to minimal/very low credit risk. |
| 2 | The rated entity has strong capacity to meet its financial commitments and is subject to low credit risk but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than rated entities in CQS 1. |
| 3 | The rated entity has adequate capacity to meet its financial commitments and is subject to moderate credit risk. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the rated entity to meet its financial commitments. |
| 4 | The rated entity has the capacity to meet its financial commitments but is subject to substantial credit risk. It faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions, which could lead to the rated entity's inadequate capacity to meet its financial commitments. |
| 5 | The rated entity has the capacity to meet its financial commitments but is subject to high credit risk. Adverse business, financial, or economic conditions will likely impair the rated entity's capacity or willingness to meet its financial commitments |
| 6 | The rated entity is currently vulnerable or highly vulnerable and is subject to very high credit risk, including in or very near to default. It is dependent upon favourable business, financial, and economic conditions to meet its financial commitments. |

ANNEX III - Mapping tables

[The individual mapping tables will be made available as an addendum to this Consultation Paper during the course of the consultation period]

5. Accompanying documents

5.1 Draft Cost-Benefit Analysis/Impact Assessment

Problem definition

1. The CRD permits the use of external ratings for determining the own fund requirements where credit risk is less material, such as the case of less sophisticated institutions, insignificant exposure classes or the unduly burdensome implementation of internal approaches. To make it possible, a correspondence ('mapping') between the credit assessments of an ECAI and the credit quality steps of the Standardised Approach set out in the CRR needs to be established.
2. In order to reduce the foreclosure of a market already dominated by three undertakings, Article 4(98) CRR automatically recognises credit rating agencies registered or certified in accordance with Regulation (EC) No 1060/2009 as external credit assessment institutions (ECAIs). This means that 'mappings' should be made available for all existing credit rating agencies that conduct their activities in accordance with the principles of integrity, transparency, responsibility and good governance set out in that Regulation. As an exception, 'mappings' should also be made available for central banks producing ratings that are not subject to that Regulation.

Objectives

3. To promote consistency in the way that the 'mappings' are determined, the Council and the European Parliament mandated the Joint Committee to draft the quantitative and qualitative factors that should be considered to differentiate between the relative degrees of risk expressed by each credit assessment of a particular ECAI, as well as the benchmarks against which these factors should be compared. Additionally, the Council and the European Parliament mandated the Joint Committee to specify the 'mappings' for all ECAIs in accordance with Article 136 CRR.
4. This ITS will contribute to a common understanding among institutions and the EU's national competent authorities about the methodology that the Joint Committee should use to specify the 'mappings'. Given that the mappings of any ECAI will be equally applicable in all EU Member States, this ITS will also contribute to ensure a high level of harmonisation and consistent practice in this area and contribute to achieving the objectives in the CRR of enhancing the risk sensitivity of the credit risk rules.
5. Finally, the analysis performed to arrive at each individual mapping and its regular monitoring over time should mitigate any mechanistic overreliance of the credit risk rules on external ratings. This is one of the objectives of the CRD derived from the G-20 conclusions and the FSB principles for Reducing Reliance on external credit ratings.

Technical options considered

6. This section explains the rationale behind the most relevant choices that the Joint Committee has made when designing the ITS proposals.

Quantitative factors

7. **Selection of the default rate.** Among the factors considered to measure the degree of risk underlying the credit assessment of an ECAI, traditional risk metrics such as the default rate and the loss upon default rate have been considered.
8. In order to decide between the two metrics, factors such as the availability of information, consistency with the definition of the credit assessment and continuity with the previous regulatory framework have been considered. Regarding the availability of information to measure them, the default rate is a better option. Whereas all ECAIs record information about their defaulted rated entities (for back-testing purposes, mainly), they usually do not keep a database of the effective losses borne by investors in defaulted instruments. Regarding the definition of the credit assessments, most ECAIs provide opinions on the ability of the rated entity to meet the financial obligations derived from the instrument. Losses upon default are usually excluded from such credit opinion. Finally, the Basel text that served as a basis both for the previous regulatory framework (Directive 2006/48/EC) and the CRD4/CRR is based on the default rate, which should help to ensure a smooth transition to the rules derived from this Regulation.
9. **Long-run and short-run default rates.** Both short-run and long-run default rates have been proposed to characterise the level of risk underlying each credit assessment. Each one has a specific role and therefore both of them are equally necessary. The long-run default rate of a credit assessment should provide the basis of the mapping proposal under the quantitative framework. This role cannot be played by the short-run default rate because it may be affected by temporary shocks that do not reflect the true underlying level of risk of the credit assessment and/or induce cyclicity in the capital requirement. Instead, the role of the short-run default rate of a credit assessment should be to provide an early warning of a weakening of the assessment standards of the ECAI that might be affecting the level of risk of the items currently assigned to that credit assessment.
10. The exclusion of any of these two metrics would not allow a complete characterisation of the level of risk underlying a credit assessment and therefore have been included in this ITS. The choice of the long-run default rate is consistent with the Basel text.
11. **Use of all available default data to calculate the default rate.** The calculation of default rates is considered a key step of the mapping process because it contributes to the objectivity and consistency of the process, as required by Article 136(1) CRR. A set of requirements has been established in this ITS for when sufficient default data are not available. When default data are not sufficient, Article 136(2) CRR establishes that the ECAI should be consulted on the long-run default rate associated with a credit assessment. In order to promote objectivity and consistency in this process, this ITS specifies which information should be used by the Joint Committee to conclude on the final level of the long-run default rate.
12. As a first choice, the level of risk of a credit assessment can be inferred from the long-run default rate associated with an (sufficiently correlated) alternative measure of creditworthiness, such as the rating provided by another ECAI or a score provided by the ECAI itself. Under this option, the

alternative measure of creditworthiness can be considered as a proxy for the default rate of the credit assessment. Although this implies that expert judgement still needs to be exercised, the degree of uncertainty regarding the default rate estimate should be significantly smaller compared to a situation where the default rate is purely based on a qualitative statement. Therefore, the use of the default rates associated with an alternative measure of creditworthiness should be considered for the mapping of a credit assessment.

13. When the long-run default rate of a valid alternative measure of creditworthiness is not available, the estimate of the default rate provided by the ECAI should be addressed with an appropriate degree of careful consideration in order to reflect the implicit uncertainty. This principle, directly applicable in the quantification of risk of internally rated exposures (see Article 179(1)(a) CRR), is considered of equal importance in the case of the quantification of risk of externally rated exposures. Failure to do this would make it very difficult to impose a conservative mapping of credit assessments where the default data showed a bad performance by the ECAI. In any case, it should be made clear that qualitative factors may challenge the mapping stemming from this conservative estimate of the long-run default rate.

14. Requirements for the calculation of the default rate. The default rate can be calculated in multiple ways. The options proposed in this ITS reflect the criteria that are of interest from a prudential perspective, as explained in the paragraphs below.

15. It is proposed that the time horizon of the default rate be equal to three years. From a practical perspective, this allows the observation of a larger number of defaults in low-risk credit assessments. A one-year horizon would hardly allow the observation of defaults in these categories and therefore would be less useful for the purpose of the mapping. From a prudential perspective, it reflects a reasonable period of time during which credit losses would be borne given the illiquidity of many credit assets to which the external rating would apply (e.g. bank loans). If a one-year horizon were chosen, the potential for future downgrades should, in any case, be taken into account to ensure that the appropriate amount of capital is set aside. Finally, the calculation of default rates over a three-year horizon reduces the range of values in the case of dynamic rating systems which mitigate the cyclicity of the capital requirement.

16. It is proposed that the size of the pool of rated items be sufficiently numerous. It has not been possible to specify a strict rule because the risk profile of the credit assessment, which should be part of such rule, is not known *a priori*. Therefore, a less strict rule is proposed based on the perceived risk profile of the credit assessment so that the required size of the pool is larger for low-risk credit assessments. More concretely, it is proposed that the size of a pool be considered as sufficiently large if it is at least equal to the inverse of the 'expected' long-run default rate. For example, where the 'expected' long-run default rate is 1%, each historical pool should contain at least 100 rated items. This requirement should provide the necessary degree of comfort regarding the certainty surrounding the default rates used for the mapping.

17. The contribution of withdrawn ratings is also addressed in this ITS. It is acknowledged that they provide some evidence of the default behaviour of a credit assessment. However, such evidence

should be less conclusive than the case of credit assessments that have been observed for the whole three-year period because it cannot be guaranteed that a default has not taken place after withdrawal. In order not to affect those rating businesses where withdrawals are more frequently observed, no weighting is applied as long as the default behaviour has been observed after the credit assessment has been withdrawn (so that a complete three-year horizon has been completed).

18. Finally, the required types of default event are essentially the ones considered in the calibration of the benchmark values, which are based on the Basel text in order to ensure continuity with the mappings produced under the previous regulatory framework (Directive 2006/48/EC). A different choice of default events might have led to a different overall level of capital for externally rated exposures and would have also been difficult to observe by ECAs since they typically have no access to this information. This would have been the case, for example, with the default definition stated in Article 178 CRR.

19. Not all the requirements regarding the calculation of the default rate specified in these ITS were contained in the previous regulatory framework. The reason for such a prescriptive approach is the reduction in the number of differences in default rates stemming from purely methodological aspects. The consequence should be that only different true underlying risk profiles are responsible for any observed difference in the default rates of the ECAs.

Qualitative factors

20. **Definition of default.** The definition of default is a key element of the mapping process, especially where sufficiently numerous default data are available. Any difference in the level of strictness of an ECA's default definition with respect to other ECAs has a large potential to affect the level playing field since the respective mappings would not have been done under similar terms. Therefore the comparability of an ECA's definition of default should be assessed.

21. These ITS propose that the comparison is based on the bankruptcy (and similar legal proceedings) rate. This information is generally available to all ECAs and can be used to characterise the degree of strictness of a default definition as the increase in the number of default events in comparison with respect to the number of observed bankruptcies. Any other comparison based on a set of default events that are not generally observed for most ECAs would be very difficult to implement and the degree of uncertainty implied in the comparison would be very large.

22. **Time horizon of the credit assessment.** The choice of the three-year horizon to calculate the default rate implies that the risk reflected in any credit assessment should, at least, cover this period. Therefore, a qualitative factor should be applied every time the credit assessment is based on a shorter time horizon and the default rate is not available. Failure to do so would increase the potential for capital underestimation. For example, in the case of a rating system that only focuses on the forthcoming 12 months, if downgrades were expected during the second and third years, this should be considered to assess the level of risk that is relevant for the mapping.

23. **Estimate provided by the ECAI of the long-run default rate.** In order to ensure objectivity and consistency in the mapping process, the default rate should be calculated for any credit assessment. Where sufficient default data are not available, the estimate of the default rate is subject to a higher degree of uncertainty even if it has been produced by the ECAI itself. This may directly affect the consistency and objectivity of the mapping. Therefore, it is proposed that this estimate be taken into account with an appropriate degree of careful consideration to reflect the implicit uncertainty.

24. **Relationship between the credit assessments of an ECAI.** The CRR stipulates that a mapping should be established for all relevant credit assessments. This means that all exposures for which the CRR requires the calculation of capital to be based on external ratings should be mapped to the relevant credit quality steps. In many cases, the main rating scale of the ECAI will cover most of these exposures. For example, a credit assessment by an ECAI will typically have the same meaning if it refers either to corporate, sovereign or institutions' exposures and therefore it should be mapped to the same credit quality step.

25. However, the credit assessments of certain exposures have different meanings and therefore need separate mappings. This is the case, for example, for short-term credit assessments and credit assessments available for CIUs. In these cases, the internal relationship established by the ECAI between such credit assessments and the main rating scale should provide the basis for the mapping of the former, as long as the mapping of the latter is already known.

26. Alternatively, a different set of benchmarks could be proposed for these other credit assessments (i.e. short term, CIUs etc.). However, it has been considered that the mappings of a single ECAI would be more consistent if they were based instead on the internal relationship described in the previous paragraph.

Benchmarks

27. The benchmarks proposed under this Regulation have been chosen to maintain the overall level of capital required to externally rated exposures under the Standardised Approach. Whereas the CRD/CRR have increased the overall level of capital required to credit institutions and investment firms by different means, there is no reason to indirectly modify the overall level of the risk weights specified under the Standardised Approach. Therefore, the same values as contained in the Basel II text are proposed under this Regulation.

28. **Benchmark for the long-run default rate.** The benchmark for the long-run default rate has been further specified under this Regulation with respect to the one contained in the Basel II text. The Basel benchmark only consists of a point long-run default rate. However, it has been acknowledged that a wider range of values can be compatible with each credit quality step. Under one option, the Basel values have been considered as potential upper bounds of such ranges. A preliminary comparison of the new mappings with the ones existing under the previous regulatory framework has indicated that a significant number of changes would have taken place, which contradicts the objective stated in the previous paragraph.

29. As second option, the upper bounds of the long-run default rate reflect the values beyond which the Basel benchmark of the next less favourable credit quality step is more likely to be the true underlying default probability. For example, it is more likely that a 0.16% default rate comes from a pool of items whose true default probability is equal to 0.10% (Basel long-run reference of CQS1) rather than 0.25% (Basel long-run reference of CQS2). Similarly, it is more likely that a 0.17% default rate comes from a pool of items whose true default probability is equal to 0.25% (Basel long-run reference of CQS2) rather than 0.10% (Basel long-run reference of CQS1)¹.

30. This result has been modified for CQS 3 and CQS 4, where a lower threshold has been chosen instead, namely the short-run benchmark. The reason is that it would have been very difficult to justify that a credit assessment for which the long-run default rate is higher than the short-run benchmark only breaches the monitoring level in the short-run on a temporary basis.

31. In addition to the reasons provided above, the framework described in the Basel II text is very much dependent on the observed variation of default rates of the international ECAIs operating at the moment it was designed. The current market situation reflects a wide range of business models and methodologies among ECAIs that lead to very different degrees of cyclical variation in the observed default rates. For instance, depending on the country of residence of the rated entities or the rating philosophy of the ECAI, the cyclical variation of a default rate could be hardly appreciated. A steady short-run default rate slightly below the level of 0.80% is not meant to be mapped to CQS 3, as it could be interpreted from the Basel II text. To avoid these sorts of situations, the long-run default rate has been further specified as described above.

32. **Benchmark for the short-run default rate.** The short-run benchmarks remain the same as the Basel II text. They should continue to indicate a weakening of assessment standards by the ECAI, leading to the credit quality of the credit assessment becoming worse.

Impact of the proposals

33. The use of external ratings for capital requirements under the Standardised Approach is not new in the prudential regulation of credit institutions. However, the fact that the mappings have to be reviewed (or newly provided in the case of some ECAIs) will mean that the two main types of stakeholders are directly affected.

34. On the one hand, credit institutions subject to the CRR will be affected by the mappings established according to these draft ITS. Since the mappings constitute an element of the calculation of capital requirements under the Standardised Approach, the main impact of this Regulation on credit institutions will be regarding the actual level of capital that they are required to hold for externally rated positions.

¹ The default rate has been assumed to be binomially distributed independent of defaults. If correlation is introduced, the resulting thresholds would be lower than the ones proposed in the ITS, which would increase the overall level of the risk weights.

35. On the other hand, ECAs, as defined in Article 4(98) CRR, will also be impacted by these proposals, given that they will have to provide all necessary information for the mappings to be completed. In this case, the indirect costs derived from this situation will represent the main impact of these draft ITS.

Direct compliance costs

36. The costs derived from compliance with this Regulation basically affect credit rating agencies for which a mapping has to be provided. When assessing the level of risk behind each credit assessment, the corresponding ECA is best placed to provide all necessary relevant information, therefore they bear the main costs of compliance with this Regulation. For this reason, the Joint Committee has made all efforts to limit the burden on the ECAs as much as possible. For example, the calculation of quantitative factors for those ECAs that have sufficient default data in CEREP (ESMA's central repository of credit ratings) has been carried out centrally by the Joint Committee.

37. However, it is acknowledged that smaller ECAs, where the amount of default information is scarce, are required to make use of any type of default evidence that could help to quantify the level of risk behind their rating categories. In this case, the Joint Committee has also tried to limit the burden as much as possible. For example, CEREP has been used whenever possible to capture any default evidence that could be used for the purpose of the mapping (as is the case, for example, with items rated by a smaller ECA and an ECA with larger amounts of default data).

38. For credit institutions, the costs of complying with this Regulation are negligible since the individual mapping tables for each ECA will be made publicly available and are easily incorporated into the calculation process for capital requirements.

Indirect capital costs

39. The costs, defined in terms of capital requirements under the Standardised Approach, derived from the specification of new individual mapping tables will be entirely met by the credit institutions.

The impact will be assessed once the individual mapping tables of all ECAs contained in Annex III of Section 4 are available.

Benefits

40. The methodology presented in these draft ITS will ensure complete harmonisation of the mapping of credit assessments to the corresponding credit quality steps across Member States. This will allow the calculation of capital requirements for externally rated exposures under the Standardised Approach to be the same across all institutions within the EU, which should be the main feature of that Approach.

41. Also, as suggested in paragraph 5 of this Section, the analysis performed to arrive at each individual mapping and its regular monitoring over time should mitigate any mechanistic overreliance of the credit risk rules on external ratings, which is one of the objectives of the CRD

derived from the G-20 conclusions and the FSB principles for Reducing Reliance on external credit ratings.

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?

5.2 Overview of questions for Consultation

- Q1. Do you agree with the proposed selection of quantitative factors to differentiate between the different levels of risk in each rating category?
- Q2. Do you agree with the proposed definition of *sufficient* for the number of credit ratings and the rest of the requirements imposed for the calculation of the short-run default rate when a sufficient number of credit ratings is available?
- Q3. Do you agree with the proposed requirements imposed for the calculation of the long-run default rate when a sufficient number of credit ratings is available?
- Q4. Do you agree with the proposed options to calculate the quantitative factors when a sufficient number of credit ratings is not available?
- Q5. Do you agree with the proposed use of the default definition used by the ECAI as a relevant factor for the mapping? Do you agree with the proposed assessment of the comparability of the default definition of an ECAI? If not, what alternatives would you propose? Do you think that the adjustment factor depends on certain characteristics of the rated firms such as size and credit quality and if so, how can this be reflected?
- Q6. Do you agree with the proposed use of the time horizon of the rating category as a relevant factor for the mapping? Do you agree with the proposed use of transition probabilities to identify the expected level of risk during the three-year horizon?
- Q7. Do you agree with the proposed use of the range and meaning of credit assessments as a relevant factor for the mapping? Do you agree with the proposed restriction of this factor to adjacent rating categories?
- Q8. Do you agree with the proposed use of the risk profile of a credit assessment as a relevant factor for the mapping?
- Q9. Do you agree with the proposed use of the estimate provided by the ECAI for the long-run default rate associated with all items assigned the same rating category as a relevant factor for the mapping? Do you agree with the proposed role played by this factor depending on the availability of default data for the rating category?
- Q10. Do you agree with the proposed use of the internal mapping of a rating category established by the ECAI?

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- 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?
- Q12. Do you agree with the 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?