Recognition of External Credit Assessment Institutions

I. Introduction

1. Under certain approaches for the calculation of credit risk within the Basel capital framework, banks are required to use credit assessments provided by external credit assessment institutions ("ECAIs"), recognized by national supervisors for the purposes of regulatory capital calculation, to determine the risk-weights of the banks' credit exposures. The relevant approaches are the Standardized Approach for the calculation of credit risk in respect of non-securitization exposures and both the Standardized Approach and Ratings-based Approach for the calculation of credit risk in respect of securitization exposures.

2. National supervisors are responsible for determining on a continuous basis whether an ECAI meets the requisite criteria for recognition. These criteria are listed in paragraph 91 of the paper "International Convergence of Capital Measurement and Capital Standards – A Revised Framework (Comprehensive Version)" issued by the Basel Committee in June 2006 ("Basel II") as revised by paragraph 120 of the paper "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" issued by the Basel Committee in December 2010 ("Basel III"). If a national supervisor determines that an ECAI meets the recognition criteria, banks incorporated in the supervisor's jurisdiction can use the ECAI's credit assessments for the calculation of their regulatory capital requirements under the Basel capital framework.

3. This paper sets out the HKMA's approach to the recognition of ECAIs for the purposes of the Banking (Capital) Rules ("B(C)R"), which serve to implement the Basel capital framework in Hong Kong. The paper is structured as follows:

   - the interpretation and application of the criteria for assessing whether an ECAI is eligible – Section II;

   - the approach to mapping ECAIs' credit assessments to risk-weights under–

     (i) the Standardized (Credit Risk) Approach ("STC approach") for non-securitization exposures, and
     (ii) the Standardized (Securitization) Approach ("STC(S) approach") and Ratings-based Method ("RBM") (equivalent to the Ratings-based Approach under Basel II) for securitization exposures booked in the banking book or trading book – Section III;

   - the application process and the information required to support an application for recognition – Section IV; and

- the guidelines applicable to Authorized Institutions ("AIs") with respect to the nomination of ECAIs for the purpose of determining risk-weights of AIs' exposures – Section V.

4. In developing this paper, we have drawn on the relevant policy proposals of other supervisory authorities and the revised Code of Conduct Fundamentals for Credit Rating Agencies ("IOSCO CRA Code") issued by the International Organization of Securities Commissions ("IOSCO") in May 2008. Moreover, we have also had regard to the current practices of certain international credit rating agencies.

II. Recognition criteria

5. The key objective of the recognition criteria is the identification of ECAIs that produce credit assessments of sufficiently high quality, consistency and robustness to be used by banks for regulatory capital calculation.

6. For this purpose, the HKMA will take into account the criteria set out below in determining the eligibility of an ECAI.

7. Regulation

> *All credit rating agencies whose ratings are used for regulatory purposes should be subject to a regulatory oversight regime that includes registration. The regulatory oversight regime should be established by end 2009 and should be consistent with the IOSCO Code of Conduct Fundamentals.*
>
> *(G20 Declaration on Strengthening the Financial System, London Summit, 2 April 2009)*

The ECAI must be subject to effective supervision on an ongoing basis by the Securities and Futures Commission in Hong Kong or subject to effective supervision or oversight on an ongoing basis by a competent overseas regulatory authority which has adopted a regulatory regime consistent with the IOSCO CRA Code and incorporating a registration system for ECAIs.

8. Code of Conduct

> *National supervisors should refer to the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies when determining ECAI eligibility.*
>
> *(Basel III, paragraph 120, page 52)*

The ECAI must adopt and adhere to a code of conduct that is consistent with the IOSCO CRA Code.

9. Objectivity

> *The methodology for assigning credit assessments must be rigorous, systematic, and subject to some form of validation based on historical experience. Moreover, assessments must be subject to ongoing review and responsive to changes in financial condition. Before being recognized by supervisors, an assessment methodology for each market segment, including rigorous backtesting, must have been established for at least one year and preferably three years.*
>
> *(Basel II, paragraph 91, page 27)*

9.1 The objectivity of an ECAI's methodology will be assessed against the following criteria:

(a) The ECAI must use rigorous, systematic assessment methodologies to ensure the issue of credible and reliable credit assessments.

(b) The assessment methodologies must be documented, incorporate all factors relevant in determining an entity's creditworthiness, and have been established for each market segment (e.g. sovereigns, corporates and structured products) in respect of which the ECAI intends to seek recognition. Before being recognized by the HKMA, the core assessment methodology for each market segment, including the back-testing methodology, must have been established for at least one year and preferably three years.

(c) The assessment methodologies of the ECAI should be based on both qualitative and quantitative approaches.

(d) The ECAI must have established and put into operation arrangements to ensure that all credit assessments are based on analyses performed in accordance with its established assessment methodologies and the methodologies are applied accurately and consistently. For example, the ECAI is expected to have in place a rating committee to make rating decisions and an internal audit function (or a function that plays a similar role and carries out similar tasks) to assess the compliance of the ECAI with its internal policies.

(e) The ECAI must have established and put into operation procedures to ensure that its credit assessments are reviewed on an ongoing basis and updated in a timely manner, particularly on the occurrence of material events, including significant sector or issue-specific events.

(f) The ECAI should have a mechanism to review its methodologies and procedures to adapt them to the changing environment. This would include changes in the risk characteristics of the market segments or products (and of the underlying assets in the case of structured products) in relation to which, or in respect of which, it issues credit assessments. The mechanism should include the establishment and implementation of a rigorous and formal review function (preferably independent of the business lines that are principally responsible for assigning credit assessments) responsible for periodically reviewing the methodologies and models, and significant changes to the methodologies and models, the ECAI uses.

(g) The ECAI should demonstrate that its assessment methodologies are subject to robust, quantitative back-testing (e.g. default studies, rating accuracy tests or transition matrices), using at least 12 months back-data. Procedures should be in place to ensure that systematic rating errors revealed by back-testing and/or ongoing review will be corrected by revising the assessment methodologies.

10. Independence

An ECAI should be independent and should not be subject to political or economic pressures that may influence the rating. The assessment process should be as free as possible from any constraints that could arise in situations where the composition of the board of directors or the shareholder structure of the assessment institution may be seen as creating a conflict of interest.

(Basel II, paragraph 91, page 28)

10.1 The independence of an ECAI will be assessed on the basis of the following criteria:

(a) Ownership - the ownership of the ECAI and the composition of its Board of Directors should not have the potential to jeopardize the objectivity of the rating process.

(b) Organizational structure - the ECAI should structure its businesses to ensure that credit assessments are based on thorough analysis, performed and approved by independent and relevant persons within its organizational structure. The ECAI may achieve this by—

(i) requiring that all rating decisions are made by a rating committee, composed of qualified and experienced individuals, in accordance with the ECAI's established criteria and methodology;

(ii) the presence of an internal audit function (or a similar function) to carry out independent review of the adequacy of policies and procedures for safeguarding the independence of the rating process and compliance with these policies and procedures; and

(iii) separating its credit assessment business and ancillary services[1] both operationally and legally from any of its other businesses that may present conflicts of interest.

(c) Corporate governance - the ECAI should have in place high standards of corporate governance that safeguard the independence of its credit assessments and promote integrity. This can be demonstrated by—

(i) the adoption and adherence to a code of conduct in line with market standards and internationally recognized principles (including primarily the IOSCO CRA Code), and the public disclosure of such code; and

(ii) the existence of mechanisms to identify, prevent, manage and eliminate actual and potential conflicts of interest (including through appropriate staff compensation arrangements) and adequate safeguards to ensure that the ECAI's credit assessments are independent from external pressure (whether from major clients, issuers, governments or political bodies) and that the relationship between its staff and the assessed entities is regularly monitored.

(d) Financial resources - the ECAI must be financially viable so that it can operate free from economic and political pressures exerted by its owners/shareholders, assessed entities or other external parties that may potentially have incentives to influence the ECAI's credit assessments (e.g. governments or political bodies). In meeting this requirement, the ECAI needs to demonstrate that its financial viability does not depend upon a few clients.

[1] The ECAI should define what it considers to be an ancillary service and why it cannot reasonably be considered to have the potential to give rise to any conflict of interest with the ECAI's credit assessment business.

11. International access / Transparency

> *The individual assessments, the key elements underlining the assessments and whether the issuer participated in the assessment process should be publicly available on a non-selective basis, unless they are private assessments. In addition, the general procedures, methodologies and assumptions for arriving at assessments used by the ECAI should be publicly available.*
>
> *(Basel III, paragraph 120, page 52)*

11.1 An ECAI's individual credit assessments, the key elements underlying the assessments and information on whether the issuers concerned participated in the assessment process must be publicly available on a non-selective basis, unless an assessment is a private assessment.

11.2 The general procedures, methodologies and assumptions employed by the ECAI for the formulation of its credit assessments should be publicly available.

Requirements specific to credit assessments for securitization exposures

11.3 If recognition is sought for credit assessments of securitization exposures, the credit assessments, procedures, methodologies and assumptions, and the key elements underlying the assessments must be publicly available on a non-selective basis and free of charge[2]. In other words, a credit assessment must be published in an accessible form and included in the ECAI's transition matrix in order to be eligible for the purposes of risk-weighting securitization exposures. Moreover, loss and cash-flow analysis as well as the sensitivity of credit assessments to changes in the underlying assumptions should be publicly available.

12. Disclosure

> *An ECAI should disclose the following information: its code of conduct; the general nature of its compensation arrangements with assessed entities; its assessment methodologies, including the definition of default, the time horizon, and the meaning of each rating; the actual default rates experienced in each assessment category; and the transitions of the assessments, e.g. the likelihood of AA ratings becoming A over time.*
>
> *(Basel III, paragraph 120, page 53)*

[2] Where the credit assessments are not provided free of charge, the ECAI should provide an adequate justification, in its own publicly available Code of Conduct, in accordance with the 'comply or explain' standard within the IOSCO CRA Code.

12.1 To enable users to evaluate its credit assessments, an ECAI should make public the following information:

(a) the assessment methodologies, including timely disclosure of any material changes in the methodologies;

(b) the meaning of each credit assessment category, including how credit assessments of structured finance products are differentiated from the credit assessments of traditional corporate bonds;

(c) the definition of default, the time horizon within which a default is considered and, where appropriate, the measure of the loss given a default;

(d) the actual default rates experienced in each credit assessment category;

(e) the transition matrices (i.e. the transitions of credit assessments over time, e.g. the likelihood of AA ratings becoming A ratings over time);

(f) whether a credit assessment is solicited or unsolicited (and the definition of unsolicited credit assessment);

(g) its code of conduct; and

(h) the general nature of its compensation arrangements with assessed entities.

13. Resources

An ECAI should have sufficient resources to carry out high quality credit assessments. These resources should allow for substantial ongoing contact with senior and operational levels within the entities assessed in order to add value to the credit assessments. Such assessments should be based on methodologies combining qualitative and quantitative approaches.

(Basel II, paragraph 91, page 28)

13.1 An ECAI should have sufficient financial and human resources to carry out high quality credit assessments. The ECAI must demonstrate that—

(a) it is financially sound and has the capability to recruit and retain competent staff and invest in necessary technological infrastructure to ensure speedy acquisition and processing of data/information and timely release of reliable and credible credit assessments;

(b) it has established recruitment and training policies to ensure that its

professional analytical staff possess the necessary experience and skills to carry out credit assessments thoroughly and competently based on methodologies that combine both qualitative and quantitative approaches;

(c) the size of its body of professional analytical staff is sufficient to allow the use of established procedures to ensure credible, reliable and consistent assessments and ongoing contact with the assessed entities as a routine component of the surveillance process; and

(d) it has the expertise in assessing securitization, if recognition of its credit assessments of securitization exposures is sought.

14. Credibility

To some extent, credibility is derived from the criteria above. In addition, the reliance on an ECAI's external credit assessments by independent parties (investors, insurers, trading partners) is evidence of the credibility of the assessments of an ECAI. The credibility of an ECAI is also underpinned by the existence of internal procedures to prevent the misuse of confidential information. In order to be eligible for recognition, an ECAI does not have to assess firms in more than one country.

(Basel II, paragraph 91, page 28)

14.1 Credibility will be assessed according to factors such as the following:

(a) the extent to which the ECAI meets criteria 7 to 13;

(b) the number of years of experience of the ECAI in relation to the market segment or product for which recognition is sought;

(c) the market share of the ECAI, particularly in the market in which the ECAI is operating and where recognition is sought;

(d) the degree of acceptance by predominant users in the market (i.e. issuers, investors, bankers, insurers and securities traders);

(e) the existence of internal procedures to prevent misuse or unauthorised disclosure of confidential information; and

(f) whether there is any pricing of financial products or instruments based on the ECAI's credit assessments.

14.2 An ECAI does not need to assess entities in more than one country to be eligible for recognition.

15. Credit assessments for collective investment schemes

15.1 Credit assessments of credit exposures to collective investment schemes (as defined under the B(C)R) by an eligible ECAI can be used under the STC approach—

(a) provided that the assessments depend primarily on the credit quality of the assets held by the schemes concerned; and

(b) where the assessments are assigned to fixed-income collective investment schemes (e.g. money market funds and bond funds).

16. Unsolicited credit assessments

16.1 Unsolicited credit assessments will be treated the same as solicited credit assessments if the ECAI can demonstrate that—

(a) it has policies and procedures in place to ensure that the methodologies used for unsolicited assessments will not be less stringent than those for solicited assessments and that the ECAI does not differentiate between unsolicited and solicited assessments in its credit judgements; and

(b) it clearly identifies those assessments that are unsolicited.

16.2 In considering whether to accept an ECAI's unsolicited credit assessments, the HKMA may request the ECAI concerned to provide statistical evidence of changes in unsolicited credit assessments or changes in status of credit assessments from unsolicited to solicited and to explain such changes so as to demonstrate that it has not used unsolicited credit assessments to put pressure on entities to obtain solicited credit assessments. If the HKMA becomes aware of an ECAI using unsolicited credit assessments to put pressure on entities to obtain solicited credit assessments, the HKMA will consider whether it is appropriate to continue recognizing the ECAI for regulatory capital calculation purposes.

III. <u>Mapping process</u>

17. The HKMA will assign a risk-weight to each of the credit assessment categories of an eligible ECAI based on a systematic mapping to the risk-weights available under the STC approach, STC(S) approach and RBM, unless there is evidence that a higher risk-weight is warranted. In doing so, the HKMA will consider a variety of qualitative and quantitative factors to differentiate between the relative degrees of risk expressed by different credit

assessment categories. Quantitative parameters may help to promote a more consistent mapping of credit assessment categories into the available risk-weights.

18. Quantitative factors

Credit assessments for non-securitization exposures under the STC approach

18.1 As recommended by the Basel Committee, the HKMA will evaluate the cumulative default rate ("CDR") associated with all issues assigned the same credit assessment by an ECAI to help determine the appropriate risk-weight to which each of the ECAI's credit assessment categories should be mapped.

18.2 For the purposes of paragraph 18.1, the HKMA will evaluate the three-year CDR associated with each credit assessment category of the ECAI. This is the sum of all defaults that have occurred in a given three-year period for all rated items belonging to the same credit assessment category. Two measures of the three-year CDR will be used:

(a) the ten-year average of the three-year CDR[3] for evaluation of the long-run default experience over time; and

(b) the most recent three-year CDR for evaluation of the most recent default experience.

18.3 Both of the measures under paragraphs 18.2 provided by the ECAI will be compared to the aggregate default experience of other international ECAIs as described in paragraphs 18.4 to 18.8 below.

18.4 The ten-year average of the three-year CDR of a particular credit assessment category of the ECAI will be compared with the corresponding "long-run reference three-year CDR" (set out in Table 2 of Annex 2 of Basel II) based on the Basel Committee's observations of the default experience reported by major rating agencies internationally.

18.5 Recognizing that the ten-year average of an ECAI's particular credit assessment category would not match exactly the corresponding long-run reference three-year CDR, Basel II provided national supervisors with two benchmarks, namely the "monitoring" level benchmark and the "trigger" level benchmark, to assist them in assessing whether an ECAI's CDR falls within an acceptable range for a credit assessment category to qualify for a particular risk-weight.

[3] In 2002, for example, the average of the three-year CDRs for issuers assigned to each rating grade ("the cohort") would be calculated for each of the ten years 1990-1999.

18.6 The HKMA adopts the Basel Committee's two benchmarks for CDR (i.e. Table 3 of Annex 2 in Basel II) in its mapping process. Specifically, the HKMA will compare the two most recent three-year CDRs provided by the ECAI to each of the two benchmarks for CDR and determine the mapping in accordance with paragraphs 18.7 and 18.8 below.

18.7 Exceeding the "monitoring" level benchmark implies that an ECAI's current default experience for a particular credit assessment category is markedly higher than international default experience. Although credit assessments under the credit assessment category would generally still be considered eligible for the associated risk-weight, the HKMA will consult the relevant ECAI to understand why the default experience appears to be significantly worse. If it is determined that the higher default experience is attributable to weaker assessment standards, a higher risk-weight may be assigned to the credit assessment category concerned.

18.8 Exceeding the "trigger" level benchmark implies that an ECAI's default experience for a particular credit assessment category is considerably above the international default experience. Thus, there is a presumption that the ECAI's assessment standards are either too weak or are not applied appropriately. If the observed three-year CDR exceeds the trigger level in two consecutive years, the HKMA will map the credit assessment category to a higher risk-weight, unless the HKMA is satisfied that the higher observed CDR is not attributable to weaker assessment standards.

18.9 For recently established ECAIs and those that have compiled only a short record of default data, the HKMA may ask the ECAI concerned for its two most recent CDRs and its estimate of the ten-year average of the three-year CDR for each of its credit assessment categories. The HKMA will review the ECAI's CDRs on the basis of the availability of data and the methodology used by the ECAI in comparison with those used to calculate the benchmarks and take into account relevant qualitative factors (e.g. those set out in paragraph 19) to determine whether any adjustments to the mapping of the ECAI are needed.

18.10 The HKMA may also compare the default rates for the credit assessment categories of an ECAI seeking recognition with those of other major ECAIs to see if there is a general trend of higher default rates during a particular period and take this factor into account in the mapping process. This kind of comparison is particularly relevant to ECAIs that concentrate in rating regional entities and to periods of economic downturn during which the average default rates may be higher than the benchmarks developed by the Basel Committee.

Credit assessments for securitization exposures under the STC(S) approach and RBM

18.11 If and to the extent that there is insufficient historical default data to construct

the above-mentioned CDR benchmarks for securitization exposures, the HKMA will take into account other quantitative factors including default rates and loss rates for each of the credit assessment categories of an ECAI, relative to those of the international credit rating agencies, in mapping securitization credit assessments to risk-weights.

19. Qualitative factors

19.1 The measures of CDRs are the basis of the mapping process. They play an important role in ensuring consistency of treatment in respect of the credit assessments of different ECAIs and in differentiating the relative degree of risk expressed by each credit assessment in the mapping process. However, the mapping process should also take into account qualitative factors which influence the comparability of an ECAI's CDRs with the benchmark CDRs, particularly when the assessment methodologies of the ECAI concerned are different from those of the international rating agencies, upon the basis of which the Basel Committee constructed its benchmarks.

19.2 The quantitative assessment may need to be adjusted for differences in qualitative factors such as the following:

(a) the definition of default and the variables used to weight default events. An ECAI may use a more or less stringent definition than that used in the international benchmark, which may result in the ECAI's CDRs being overstated or understated. Similarly, the choice of variables for weighting default events may have an impact on the results;

(b) the treatment of "censored obligors" (i.e. issuers whose credit assessments are withdrawn by an ECAI) in the default rate calculation. Assessments can be withdrawn for a number of reasons such as all the rated debt of an issuer having matured or an issuer having been acquired by another company. The inclusion of "censored obligors" in the default rate calculation during the observation period will likely produce downwardly biased default rate estimates;

(c) the "meaning" of each credit assessment category, i.e. the substance of the opinion represented by a particular credit assessment category. An ECAI's credit assessment may measure the "probability of default" of a rated instrument or the "expected loss" in the event of default. The difference in the "meaning" may result in apparent performance discrepancies between ECAIs;

(d) the pool of issuers covered (which may be static or periodically adjusted);

(e) the range of credit assessment categories assigned by the ECAI;

(f) the dynamic properties and characteristics of the rating system or methodology (e.g. a "point-in-time" rating system or a "through the cycle" system); and

(g) the geographical coverage, i.e. the use of regional or global data.

19.3 Qualitative factors are particularly important to the mapping of credit assessments of securitization exposures, given the lessons learned from the global financial crisis. Quantitative data alone are unlikely to be conclusive with respect to the performance of securitization credit assessments. Therefore, the HKMA will need to take into account qualitative factors in the mapping process. These factors include market information, such as the credit spreads of securitization exposures assigned with equivalent credit assessments by different ECAIs, which might be indicative as to whether other market participants take a similar or diverse view on the credit-worthiness reflected by the credit assessments. Differences in the rating definitions and methodologies between an ECAI and its peers may also be informative for the mapping process.

IV. <u>Application process</u>

20. Applicant

20.1 An application for recognition of an ECAI may be initiated by the HKMA, by an AI intending to use the ECAI's credit assessments for the purposes of its regulatory capital calculation, or by the ECAI itself.

20.2 Where an AI proposes to use the credit assessments of an ECAI for regulatory capital calculation purposes, it should inform the HKMA of its proposal and provide the necessary information to the HKMA to enable the HKMA to undertake the preliminary study outlined below. In considering whether to invite the relevant ECAI to apply for recognition, the HKMA will conduct a preliminary study to evaluate the following:

(a) the size of the portfolio of exposures, relative to the AI's total credit exposures, in respect of which the ECAI's credit assessments are intended to be used and the impact on the AI's capital adequacy ratio if the ECAI is recognized;

(b) evidence that the AI has policies and procedures in place to ensure that there are adequate internal credit assessments of the exposures concerned without undue or mechanical reliance on the ECAI's credit assessments;

(c) whether the ECAI is subject to supervision or oversight by a regulatory authority which has adopted a regulatory regime consistent with the IOSCO CRA Code and incorporating a registration system for ECAIs;

(d) whether, for the purposes of regulatory capital calculation, the ECAI has been recognized by another banking supervisor, which imposes prudential standards (covering minimum regulatory capital requirements and capital calculations) consistent with international norms;

(e) market acceptance of the ECAI's credit assessments;

(f) the extent of adherence by the ECAI to the IOSCO CRA Code; and

(g) the extent of public disclosure of the general procedures, methodologies and assumptions for arriving at credit assessments, the transition matrices, the default studies, the compensation arrangements with assessed entities, the financial information and the code of conduct of the ECAI, and the ease of access to the information.

The preliminary study is intended to ensure that only those applications that have a reasonable prospect of approval will be considered.

20.3 In considering an application, the HKMA would first wish to establish whether the ECAI concerned has already been recognized by another supervisor and, if so, to consider whether the HKMA could rely on the recognition of such other supervisor (see paragraph 22.1 below for details on the "indirect recognition" approach adopted by the HKMA).

20.4 When an application is initiated by an ECAI, the ECAI should demonstrate that at least one AI intends to use its credit assessments for the purpose of assigning risk-weights in the calculation of regulatory capital. This requirement is meant to ensure that only applications in respect of ECAIs whose credit assessments will genuinely be used for the purposes of regulatory capital calculation will be considered.

20.5 Irrespective of which party initiates an application for recognition, the application should be supported by all relevant information deemed necessary for the purpose of assessing compliance with the criteria for recognition. The Annex sets out an indicative list of information required to be submitted to support an application for recognition. The list in the Annex is however non-exhaustive. The application should also be supported by evidence that the credit assessments will be used by at least one AI for risk-weighting purposes under the Basel capital framework.

21. Group-level application for recognition

21.1 For ECAIs that have subsidiaries in different countries, the HKMA may accept application for recognition on a group basis, provided that the ECAI can demonstrate that each of the subsidiaries for which it seeks recognition adheres to the same group-wide policies, procedures and practices. In such cases, there is no need for each of the subsidiaries of the ECAI to make a separate application.

21.2 However, if any of the ECAI's subsidiaries adopt policies, procedures and practices that are materially different from those of the group, a separate application should be made in respect of that subsidiary and separate recognition will be considered by the HKMA. If the subsidiary is a newly formed subsidiary, the assessment methodology adopted must have been established for at least one year.

22. Indirect recognition

22.1 Where the HKMA is satisfied that another supervisor has developed recognition criteria and processes that are in line with those of the HKMA (developed on the basis of Basel II and III), the HKMA may recognize an ECAI based on the recognition given to that ECAI by that other supervisor without carrying out its own assessment of the ECAI's compliance with the recognition criteria (i.e. indirect recognition). The use of this indirect recognition approach should enhance the efficiency of the HKMA in the recognition process and reduce the compliance burden faced by ECAIs seeking recognition in more than one jurisdiction. The indirect recognition approach will be particularly useful in circumstances where an AI intends to use the credit assessments of an ECAI, which is domestic to an overseas jurisdiction, for credit exposures booked in its overseas branch in that jurisdiction.

23. Segmented recognition

23.1 The Basel capital framework allows for the credit assessments of ECAIs to be recognized on a limited basis, e.g. by type of claim or by jurisdiction. It appears that ECAIs generally categorize assessed entities/exposures into the following three broad asset classes or market segments: structured finance (including securitization), public finance (including sovereign and municipalities) and commercial entities (including banks, investment firms and insurance companies).

23.2 An ECAI only needs to submit a single application for recognition in respect of different market segments or products. However, it will need to provide separate information when assessment methodologies, procedures, or information required for analysis differ by market segments and/or by

products.

23.3 An ECAI (or an AI, if the application is initiated by the AI) should specify in its application the purpose of the recognition, i.e. the types of exposure and the calculation approaches under the B(C)R for which the ECAI's credit assessments are intended to be used.

24. Ongoing recognition

24.1 Under Basel III, national supervisors should ensure that the ECAIs recognized by them continue to meet the recognition criteria and that the ECAIs' methodologies and credit assessments remain appropriate over time and through changes in market conditions. To discharge its ongoing review responsibility, the HKMA will—

(a) verify that ECAIs continue to have procedures in place to ensure that their credit assessments remain appropriate over different time periods and market conditions, including that—

(i) their credit assessments are reviewed at least annually, and revised in response to changes in financial conditions; and

(ii) their credit assessments are subject to back-testing on an annual basis;

(b) require ECAIs to inform the HKMA as soon as reasonably practicable of any significant event potentially having an impact on their compliance with any of the recognition criteria, including—

(i) material changes in the methodology they use for assigning credit assessments, including changes that alter a significant number of credit assessments or potentially prompt the need for a change in mapping;

(ii) significant changes in ownership or organizational structure and material deterioration in financial positions; and

(iii) disciplinary / supervisory actions taken against them by any of their regulators or supervisors, or any adverse changes in their licensing or authorisation or registration status with their regulators or supervisors, or any withdrawal of their recognition for regulatory capital adequacy calculation purposes by any supervisory or regulatory authority; and

(c) review the continuing eligibility of an ECAI if it comes to the HKMA's

attention that there is possible non-compliance with any of the recognition criteria by the ECAI or a marked deterioration in the performance and/or market acceptance of the ECAI.

24.2 The HKMA will, in withdrawing recognition of any eligible ECAI that ceases to comply with the recognition criteria, have regard to the impact of such a decision on AIs and the relevant considerations and decisions of other regulatory authorities that have also recognized the ECAI concerned for the purposes of their capital adequacy regimes. Before a decision to derecognize is made, the HKMA will first notify the ECAI concerned in writing of its intention to withdraw the recognition, identifying the recognition criteria with which the HKMA considers the ECAI no longer complies. The ECAI concerned will be invited to make written representations to the HKMA within a reasonable period of time after being so notified. Where representations are made by the ECAI, the HKMA will take them into account in deciding whether to derecognize the ECAI.

V. Guidelines applicable to authorized institutions with respect to the nomination of external credit assessment institutions

25. For the purpose of using ECAI credit assessments to derive risk-weights for sovereign exposures, public sector entity exposures, bank exposures, securities firm exposures, corporate exposures or collective investment scheme exposures under the STC approach or for securitization exposures under the STC(S) approach and RBM (each class of exposures being referred to as an "ECAI ratings based portfolio" in the following paragraphs), an AI should satisfy all of the following requirements:

(a) an AI shall nominate, for each ECAI ratings based portfolio, at least one ECAI ("the nominated ECAI") whose credit assessments the AI will use for deriving the risk-weights for exposures in that ECAI ratings based portfolio, The ECAI concerned must be able to provide a reasonable coverage for the exposures in terms of the types of obligor and the geographical regions in which the exposures arise or may need to be enforced, having regard to other ECAIs that have already been recognized by the HKMA;

(b) an AI should notify the HKMA of its nominated ECAIs and the ECAI ratings based portfolios to which the credit assessments of each of the nominated ECAIs will be applied;

(c) an AI should use the credit assessments of the nominated ECAIs within the ECAI ratings based portfolios consistently for both risk-weighting and risk management purposes, and seek the consent of the HKMA on any subsequent changes to the nomination (e.g. the addition or removal

of a nominated ECAI in respect of an ECAI ratings based portfolio or any change in the scope of application of a nominated ECAI's credit assessments); and

(d) an AI should treat an exposure or the obligor of an exposure in an ECAI ratings based portfolio as "unrated" for risk-weighting purposes if the exposure or obligor does not have a credit assessment assigned to it by an ECAI nominated by the AI for that portfolio.

26. The above requirements aim to ensure that AIs use the credit assessments of their nominated ECAIs consistently and to avoid any possible cherry-picking of credit assessments provided by different ECAIs or any arbitrary change of the use of ECAIs.

27. In selecting ECAIs to be nominated, AIs should pay special attention to the criterion of "reasonable coverage". AIs should ensure that their nominations are made in such a way as to ensure that significant exposures within their external ratings based portfolios are covered by at least one of the ECAIs recognized by the HKMA. For example, if an AI has significant exposures to issuers in a particular country and these issuers are only rated by a domestic ECAI which is recognized by the HKMA, the AI should include such ECAI as one of its nominated ECAIs for the purpose of determining the risk-weights for its exposures to issuers in that country.

28. The HKMA may give recognition to a particular ECAI for its credit assessments with respect to a particular market segment or geographical region only. In such case, AIs should not use credit assessments assigned by the ECAI to an obligor or exposure that is outside the scope of the HKMA's recognition in risk-weighting their exposures.

29. If an AI intends to use a credit assessment issued by a nominated ECAI to risk-weight a credit risk exposure, the credit assessment must take into account and reflect the entire amount of the credit risk exposure with regard to all payments owed to the AI. For example, if the AI is owed both principal and interest, the credit assessment must fully take into account and reflect the credit risk associated with timely payment of both principal and interest.

Hong Kong Monetary Authority
September 2013

Annex

List of information required for recognizing an ECAI

1. An ECAI's application for recognition should contain the information set out in the following paragraphs, which seek evidence that the ECAI meets each of the recognition criteria and information to facilitate the HKMA's mapping process. It is envisaged that much of the information required from ECAIs will already be contained in existing documents and that ECAIs should be readily able to provide concise answers. However, some additional information may be required to address individual institution-specific issues identified in the recognition process.

Regulation

2. A list of supervisory authorities supervising or charged with oversight of the ECAI and a brief description of each of the authorities' regulatory framework for credit rating agencies.

Code of conduct

3. A copy of the ECAI's code of conduct, and of the ECAI's self-certification of compliance with the code and of the code's adherence to the IOSCO CRA Code, and where there are any deviations from the IOSCO CRA Code, an explanation for the deviations.

Objectivity

4. A high level description of the ECAI's credit assessment methodologies and processes, which should include—

   - how the methodologies are determined, implemented, reviewed and changed;

   - a description of the process in place to ensure consistent application of the assessment methodologies across all credit assessments, in particular the role of rating committees and the guidelines governing them, the extent of input from assessed entities and the access to non-public information; and

   - a description of quantitative inputs (e.g. key variables, data sources, assumptions and quantitative techniques used, extent of input from assessed entities) and qualitative inputs (e.g. regarding the strategy and business plans of the assessed entities).

5. If the ECAI employs different methodologies for different market segments,

and/or products (particularly for structured products), separate explanation should be provided for each market segment or product in respect of which the ECAI intends to seek recognition from the HKMA.

6. Details on back-testing including—

- a description of the methodology used by the ECAI to verify the accuracy of its rating systems;
- the latest back-testing results and conclusions; and
- a description of the process in place to ensure that systematic errors in credit assessments highlighted by back-testing will be addressed by changes in assessment methodologies.

Independence

7. A brief description of the ownership and organizational structure of the ECAI including—

- the country of incorporation and year of establishment;
- an overview of the group structure of the ECAI showing its holding company and subsidiaries, if any;
- a list of shareholders who hold, directly or indirectly, more than a 10% interest or more than 10% of the voting rights in the ECAI and the composition of the board of directors of the ECAI; and
- a copy of the organization structure chart.

8. A description of the procedures to ensure fair and objective credit assessments, i.e. mechanisms to identify, prevent, manage and eliminate actual or potential conflicts of interest. These include—

- a summary of the arrangements for separating credit assessment business and ancillary services from other businesses of the organization;
- disclosure of any credit assessments on any of the ECAI's shareholders or any entities in a group of which the ECAI is a member, and a description of the policies and procedures that have been implemented to ensure the fairness and objectivity of the credit assessments produced in such cases;
- self-certification that the remuneration policy and arrangements in respect of staff involved in the rating process do not affect the production of

independent and objective credit assessments; and

- self-certification of a existence of an effective internal audit function (or a function that plays similar role and carries out similar tasks) to ensure that internal policies and procedures are adequate and followed – including details of remit, independence, resources and power.

International access/Transparency/Disclosure

9. Evidence that the ECAI has publicly disclosed sufficient information on a non-selective basis (except in relation to private assessments), including—

   - the general assessment procedures, methodologies and assumptions employed by the ECAI;
   - individual credit assessments and the types of credit assessment, i.e. solicited or unsolicited, structured finance product ratings or traditional bond ratings;
   - the key elements underlying individual assessments and whether the issuer concerned participated in the assessment process;
   - default studies and transition matrices;
   - the ECAI's code of conduct; and
   - the general nature of the compensation arrangements with assessed entities.

10. Where the ECAI wants to seek recognition from the HKMA for the purposes of risk-weighting securitization exposures, evidence that—

    - the information mentioned in paragraph 9 in respect of securitization exposures is publicly available on a non-selective basis and free of charge[4]; and
    - the information on loss and cash-flow analysis and sensitivity of credit assessments to changes in the underlying assumptions is publicly available.

11. Evidence that modifications to methodologies and rating actions are made known to the public as soon as possible.

12. Evidence of efforts to facilitate public access, such as the use of public websites, creating helpdesks, providing free publications and giving public presentations.

[4] If the information is not provided free of charge, evidence that an adequate justification is provided in the ECAI's code of conduct.

Resources

13. Financial information demonstrating the financial soundness of the ECAI, such as—

- evidence that the ECAI's income does not depend on a few major clients (N.B. the ECAI is not required to disclose the names of the clients for confidentiality reasons);
- financial statements for the last three years; and
- letter of support from the parent entity (if applicable).

14. Expertise of staff

- Self-certification that key staff possess requisite skills and experience to carry out credit assessment thoroughly and competently.
- A brief description of the recruitment and training policy to demonstrate that staff with appropriate skills and experience are being recruited and their skills are maintained or improved over time through an adequate training programme.

Credibility

15. Evidence demonstrating wide market acceptance of the ECAI's credit assessments in relation to the market segment / product for which recognition is sought, such as—

- years of experience in rating the market segment / product concerned;
- the estimated market shares of the ECAI (with breakdown by market segment / product and geographic location, if possible);
- statistical evidence which demonstrates market acceptance of the ECAI's credit assessments;
- evidence that the market uses the credit assessments of the ECAI as the basis for pricing financial products or instruments;
- authorities that have recognized the ECAI's credit assessments including their names and the purposes of the recognition; and
- a list of countries where the ECAI is active.

16. Evidence of internal procedures or safeguards to prevent the misuse of information by staff.

Mapping

17. Information that will facilitate the mapping process, such as—

- the two most recent three-year CDRs for each credit assessment category;
- the ten-year average of three-year CDRs for each credit assessment category (if not available, the ECAI's estimate of the long term default rate for each credit assessment category);
- the definition of default;
- a description of the methodology to calculate the CDRs, including:

  (i) the selection of the pool (static versus dynamic/adjusted); and

  (ii) the weighting mechanism for the aggregation of defaults;
- the statistical significance of the default rates;
- the meaning of the credit assessment categories and the range of credit assessments that the ECAI assigns;
- the target probability of default, if used, for each individual credit assessment category;
- the internal mapping of the ECAI's short term assessments to long term assessments
- transition matrices;
- geographic coverage; and
- dynamic characteristics of the credit assessment methodology (point-in-time or through the cycle).

18. Additional information for mapping of credit assessments for securitization exposures:

- the definition of default / impairment; and
- the performance data for credit assessments including default / impairment

rates and loss data over time for each credit assessment category if transition matrices and three-year CDRs are not available due to insufficient data.