



**Financial Services
Commission**

Guidance Notes
Capital Requirements Directive
ECAIs

Issued : 18 December 2007
Re-issued: 10 March 2008





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Introduction

1. This Guidance Note applies to all locally incorporated credit institutions and investment firms for the purposes of the Capital Adequacy Directive, comprising Directive 2006/48/EC and Directive 2006/49/EC which have been implemented in Gibraltar via the Banking (Capital Adequacy of Credit Institutions) Regulations, and Financial Services (Capital Adequacy of Investment Firms) Regulations. The aim of the Guidance Note is to supplement the Regulations and other guidance notes in setting the standards for recognition of External Credit Assessment Institutions (ECAIs).
2. Under the various guidance notes published, in relation to the implementation of the Capital Requirements Directive, firms adopting certain approaches for their regulatory capital calculations may use external credit assessments to risk weight their exposures, provided that these assessments have been recognised as eligible for that purpose by the competent supervisory authorities. The recognition is granted only if the competent authorities judge the ECAI to meet the recognition criteria laid down in the Capital Requirements Directive.
3. ECAI recognition for capital purposes does not in any way constitute a form of regulation of ECAIs or a form of licensing of rating agencies.

Further guidance on the use of ECAIs refer to the guidance note on credit risk.

Recognising ECAIS

4. An ECAI can be recognised by providing an information pack to the Commission (please see section below for further guidance) it will then be subject to on-going review. A list of recognised ECAIs will be published on the Commission's website.
5. In accordance with Regulation 31(3) of the Financial Services (Capital Adequacy of Credit Institutions) Regulations the Commission shall recognise an ECAI which has been approved by the competent authority of an EEA State, without carrying on its own evaluation process. This means that if an ECAI has been recognised as eligible by the competent authority of another Member State, the Commission may also recognise it.
6. Where a firm proposes to use the credit assessments and ratings issued by member states, it must notify the Commission of the name of the ECAI and details of which member state it is recognised by and may only then use these in its credit risk reporting in the format at Appendix A..

Criteria for recognition

7. The Commission suggests that participants seeking recognition should prepare their information packs in line with the 'Common Basis Application Pack' referred to in the Committee of European Banking Supervisors (CEBS) CP07. CEBS guidelines on ECAIs called 'Guidelines on the Recognition of External Credit Assessment Institutions' may be found on the CEBS website: <http://www.c-ebs.org/>.
8. The object of recognition will entail the Commission verifying that the methodology for assigning credit assessments is rigorous, systematic, continuous and subject to validation based on historical experience.
9. The Commission shall verify that the methodology is free from external political influences or constraints, and from economic pressures that may influence the credit assessment. Independence of the ECAI's methodology shall be assessed according to factors such as the following-



- 9.1. ownership and organisation structure of the ECAI;
 - 9.2. financial resources of the ECAI;
 - 9.3. staffing and expertise of the ECAI; and
 - 9.4. corporate governance of the ECAI.
10. As part of its ongoing review the Commission shall verify that ECAI's credit assessments are subject to ongoing review and shall be responsive to changes in the financial conditions. Such review shall take place after all significant events and at least annually.
 11. Before any approval, the Commission shall verify that the assessment methodology for each market segment is established according to standards such as the following-
 - 11.1. the back-testing must be established for at least one year;
 - 11.2. the regularity of the review process by the ECAI must be monitored by the Commission; and
 - 11.3. the Commission shall be able to receive from the ECAI the extent of its contacts with the senior management of the entities which it rates.
 12. The Commission shall request to be promptly informed by ECAIs of any material changes in the methodology they use for assigning credit assessments.
 13. The Commission shall take the necessary measures to assure that the principles of the methodology employed by the ECAI for the formulation of its credit assessments are publicly available as to allow all potential users to decide whether they are derived in a reasonable way.

Individual Credit Assessments

14. The Commission shall verify that ECAIs' individual credit assessments are recognised in the market as credible and reliable by the users of such credit assessments.
15. Credibility shall be assessed by the Commission according to factors such as the following-
 - 15.1. market share of the ECAI;
 - 15.2. revenues generated by the ECAI, and more in general financial resources of the ECAI;
 - 15.3. whether there is any pricing on the basis of the rating; and
 - 15.4. at least two credit institutions use the ECAI's individual credit assessment for bond issuing or assessing credit risks.
16. The Commission shall verify that individual credit assessments are accessible at equivalent terms at least to all credit institutions having a legitimate interest in these individual credit assessments.
17. In particular, the Commission shall verify that individual credit assessments are available to non-domestic parties on equivalent terms as to domestic credit institutions having a legitimate interest in these individual credit assessments.

Mapping

18. In order to differentiate between the relative degrees of risk expressed by each credit assessment, the Commission 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, the Commission shall ask the ECAI what it believes to be the long-term default rate associated with all items assigned the same credit assessment.
19. In order to differentiate between the relative degrees of risk expressed by each credit assessment, the Commission 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.
20. The Commission 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 ECAIs on a population of issuers that the competent authorities believes to present an equivalent level of credit risk.
21. If the Commission believes that the default rates experienced for the credit assessment of a particular ECAI are materially and systematically higher than the benchmark, the Commission shall assign a higher credit quality step in the credit quality assessment scale to the ECAI credit assessment.
22. When the Commission has increased the associated risk weight for a specific credit assessment of a particular ECAI, if the ECAI demonstrates that the default rates experienced for its credit assessment are no longer materially and systematically higher than the benchmark, competent authorities may decide to restore the original credit quality step in the credit quality assessment scale for the ECAI credit assessment.

Use of ECAIs' credit assessments for the determination of risk weights

23. A firm may nominate one or more approved ECAIs to be used for the determination of risk weights to be assigned to asset and off-balance sheet items.
24. A firm which decides to use the credit assessments produced by an approved ECAI for a certain class of items must use those credit assessments consistently for all exposures belonging to that class.
25. A firm which decides to use the credit assessments produced by an approved ECAI must use them in a continuous and consistent way over time.
26. A firm can only use ECAIs credit assessments that take into account all amounts both in principal and in interest owed to it.
27. If only one credit assessment is available from a nominated ECAI for a rated item, that credit assessment shall be used to determine the risk weight for that item.
28. If two credit assessments are available from nominated ECAIs and the two correspond to different risk weights for a rated item, the higher risk weight shall be assigned.
29. If more than two credit assessments are available from nominated ECAIs for a rated item, the two assessments generating the two lowest risk weights shall be referred to. If the two lowest risk weights are different, the higher risk weight shall be assigned. If the two lowest risk weights are the same, that risk weight shall be assigned.



Issuers and Issuer credit assessments

30. Where a credit assessment exists for a specific issuing program or facility to which the item constituting the exposure belongs, this credit assessment shall be used to determine the risk weight to be assigned to that item.
31. Where no directly applicable credit assessment exists for a certain item, but a credit assessment exists for a specific issuing program or facility to which the item constituting the exposure does not belong or a general credit assessment exists for the issuer, then that credit assessment shall be used if it produces a higher risk weight than would otherwise be the case or if it produces a lower risk weight and the exposure in question ranks *pari passu* or senior in all respects to the specific issuing program or facility or to senior unsecured exposures of that issuer, as relevant.
32. Credit assessments for issuers within a corporate group cannot be used as credit assessment of another issuer within the same corporate group.

Long-term and short-term credit assessments

33. Short-term credit assessments shall only be used for short-term asset and off-balance sheet items constituting exposures to institutions and corporates.
34. Any short-term credit assessment shall only apply to the item the short-term credit assessment refers to, and it shall not be used to derive risk weights for any other item.
35. Notwithstanding paragraph 34, if a short-term rated facility is assigned a 150% risk weight, then all unrated unsecured exposures on that obligor whether short-term or long-term shall also be assigned a 150% risk weight.
36. Notwithstanding paragraph 34, if a short-term rated facility is assigned a 50% risk weight, no unrated short-term exposure shall be assigned a risk weight lower than 100%.

Domestic and foreign currency items

37. A credit assessment that refers to an item denominated in the obligor's domestic currency cannot be used to derive a risk weight for another exposure on that same obligor that is denominated in a foreign currency.
38. Notwithstanding paragraph 37, when an exposure arises through a credit institution's participation in a loan that has been extended by a Multilateral Development Bank whose preferred creditor status is recognised in the market, the Commissioner may allow the credit assessment on the obligors' domestic currency item to be used for risk weighting purposes.



Appendix A

Name of Credit Exposure	Name of ECAI to be used	Member State where recognised	Risk mapping rating	Equivalent ECAI credit rating