EUROPEAN CENTRAL BANK

EUROSYSTEM

ACCEPTANCE CRITERIA FOR THIRD-PARTY RATING TOOLS WITHIN THE EUROSYSTEM CREDIT ASSESSMENT FRAMEWORK

I INTRODUCTION

The Eurosystem credit assessment framework (ECAF) defines the procedures, rules and techniques which ensure that the Eurosystem requirement of high credit standards is met for all eligible assets. The ECAF builds on credit assessment information from four sources, one of which is third-party rating tools (RTs). The details of ECAF have been published in section 6.3 of the September 2006 update of the publication "The implementation of monetary policy in the euro area – General documentation on Eurosystem monetary policy instruments and procedures" (hereafter referred to as the "General Documentation"). Acceptance criteria for third-party rating tools are outlined in section 6.4.3 ("Acceptance criteria for credit assessment systems"), whereby footnote 39 on page 47 announces that details of the acceptance criteria are listed on the ECB's website. This document contains the relevant specifications.

Third-party rating tools (RTs) refer to a credit assessment source that consists of third-party applications which rate obligors using, among other relevant information, audited annual accounts. Within ECAF, these tools have to be operated by the RT providers. Counterparties wishing to use a specific RT for ECAF purposes have to submit a request to their home NCB using the appropriate template provided by the Eurosystem, complemented by additional documentation of the RT as specified in the application form.[1] As stated in the General Documentation, the Eurosystem decides on the acceptance of any proposed RT to be used as a credit assessment system within ECAF. The acceptance decision is based upon the evaluation of the compliance with the acceptance criteria set by the Eurosystem. The proposed acceptance evaluation follows general ECAF principles and comprises relevant components of the

ECAI and the internal ratings-based (IRB) endorsement following the procedures foreseen under the new capital adequacy framework (Basel II)[2] or the EU Capital Requirements Directive (CRD)[3] respectively and tailored to RT specifics.

This document follows up on the announcement in the General Documentation to publish the acceptance criteria for RTs on the ECB's website.

2 PROPOSED ACCEPTANCE PROCEDURE

The following procedure is foreseen:

– If a counterparty intends to use an RT for ECAF purposes, it needs to submit a request to its NCB using a template provided by the Eurosystem. It has to declare that it intends to use this RT to a significant extent, should it be judged eligible by the ECB. Furthermore, it will be one of the counterparty's obligations to have clarified in advance procedural issues with the RT provider when submitting a request for approval. The counterparty will have to confirm in the application form that the RT provider has been informed about the requested RT acceptance within ECAF and that it is willing to support it and to cooperate continuously with the Eurosystem in an

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1 See template in the annex to this document.
2 See the Basel Committee on Banking Supervision's "International Convergence of Capital Measurement and Capital Standards: A Revised Framework", June 2004.
3 The CRD comprises Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (OJ L177 of 30 June 2006, page 1) and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) (OJ L177 of 30 June 2006, page 201).

appropriate manner by providing required information. Part of the request template will be for the contact address of the RT provider at which the Eurosystem can directly obtain any additional information needed at any stage.

– The Eurosystem, and in particular the relevant NCB of the country for which the RT is considered and the ECB, analyse the request within four months. After receiving a valid and complete request, the Eurosystem directly contacts the provider of the RT to get any sort of additional information that is required to conduct the necessary validation analysis.

– The decision to accept a certain RT is taken by the Governing Council of the ECB.

– An RT is always accepted per jurisdiction. If an RT has been accepted for a certain country, an additional identical request from another counterparty for using the same RT is approved directly by the NCB in question.

– The decision is communicated to the requesting counterparty as soon as possible. Moreover, the Eurosystem will publish a list of eligible RTs. Therefore, the ECB and NCBs will make available on their respective websites the relevant information concerning the RTs that have already been accepted in a certain country.

– An RT is accepted without a specified time horizon. However, the Eurosystem reserves the right to revoke the acceptance of an RT at any time, if the RT provider fails to comply with the requirements to ensure the high credit quality standards of the Eurosystem, in particular to cooperate continuously by providing all the required information (e.g. for the performance monitoring as described in section 6.3.5 of the General Documentation) as otherwise an essential precondition for eligibility would no longer be assured.

– The information which has to be provided by a requesting counterparty will differentiate between the cases of already accepted and not yet accepted RTs (acceptance being always specific to a jurisdiction). Obviously, the amount of information to be provided in case of a not yet accepted RT would be substantially higher than in the case of an RT which is already listed as eligible in a certain country.

– The Eurosystem reserves the right to visit the RT provider with a view to assessing the compliance of the RT with the acceptance criteria over time.

3 ACCEPTANCE CRITERIA

The following differentiation between RT criteria and criteria concerning the RT provider, though reasonable and practical most times, will in some cases be more of an academic nature. What will finally count for the endorsement of an RT is the overall assessment of the RT and its provider.

3.1 ACCEPTANCE CRITERIA FOR RATING TOOLS

The Eurosystem requires the following minimum standards for RTs:

1) *Objectivity of the methodology:* The methodology for assigning ratings shall be systematic, continuous, rigorous, and subject to validation (primarily based on historical experience by means of systematic backtesting).

2) The *input* required for the rating tool with respect to most enterprises must be readily available to banks. In addition to other reasonable and valid information that helps to increase its discriminatory powers, the RT ought to use audited annual accounts that comply with local accounting standards.

3) The RT must *produce a one-year probability of default*, following the definition of a default event given in the EU Capital Requirements Directive (CRD) in line with the requirements of section 6.3.1 of the General Documentation. The credit assessment has to produce an overall assessment for the issuer and not of a specific credit claim or debt instrument.

4) The RT should ideally *cover a wide range of euro area countries*. Nevertheless, for regional operators, ample coverage within at least one euro area country may suffice. Coverage, of course, has to be in line with the general requirement that data used for model-building purposes need to be representative. Compliance with this requirement will be checked in the RT validation process.

5) The methodology used ought to be extensively documented and the *documentation* easily available to the users or assessors of the RT. The same applies to any possible future updates or amendments. Also, validation concepts, procedures and results associated with the RT must be made available to the Eurosystem for assessment purposes.

6) The *model should be primarily mechanical*. Furthermore, assessments of RTs should, in principle, not be overruled – in the sense of ex post changes to given model results – as that would make such rating assessments discretionary in character. If at all, the individual cases must be treated, documented and justified in a very strict manner.

7) The *procedures for the collection of data*, their transmission to the RT provider and their incorporation into the rating tool must be documented in detail.

3.2 ACCEPTANCE CRITERIA FOR RATING TOOL PROVIDERS

The Eurosystem requires the fulfilment of the following minimum standards by RT providers.

1) *Independence of the provider*: The provider must be economically independent from the rated entities and not be linked to the RT clients. Details of the ownership structure and organisational structure of the RT provider should be made available (including major shareholders and major subsidiaries).

2) *Transparency/international access:* Ratings ought to be available to all parties with a direct interest. Direct interest is understood as the interest of those counterparties that use the credit assessments for their banking business and as the interest of the Eurosystem (i.e. basically, the NCBs that use the credit assessments in the context of accepting collateral).

3) *Sufficient resources*: The RT provider has to have sufficient resources in order to carry out high quality credit assessments in a timely manner. Resources refer to economic and technical resources, know-how and an adequate number of qualified staff.

4) *Credibility*: Reliance by third parties on the rating tool output is evidence of credibility and should flow naturally from compliance with the aforementioned requirements. A track record in the rating business would be useful and enhance the market credibility of the provider. The provider must have a diversified customer base and should supply a representative list of clients. Market share details should be made available.

5) *Internal governance:* A minimum level of internal governance standards reflecting internationally accepted governance practices must be met by the RT provider.

6) *Assumption of ad hoc notification responsibilities*: Once the risk assessment for an obligor has been provided to the client, the rating tool provider's responsibility for ad hoc notification is limited to informing all parties involved of any changes in status (in the current context, downgrades are of primary importance).

7) *Minimum frequency of regular rating updates*: The RT provider must ensure that the ratings provided are updated at least once every year, fulfilling two timeliness requirements:

   • *Timeliness of the credit assessment*: The credit assessment of an issuer or debtor should be conducted whenever material information on the debtor becomes available, but at least once per calendar year.

   • *Timeliness of underlying data*: The credit assessment should be conducted with the most recent available financial and non-financial information. The financial statements data are deemed valid only if they are delivered within 12 months of the closing date of the debtor's last financial year.

8) The RT provider has to set up and maintain the necessary infrastructure for carrying out the monitoring tasks with reference to the static pool. In general, the RT provider has to cooperate in the procedures as defined by the Eurosystem in section 6.3.5 of the General Documentation.

4 CONCEPTUAL DETAILS OF THE ACCEPTANCE PROCESS

In the following, further conceptual details on the RT acceptance process to be carried out by the Eurosystem are provided. Overall, the evaluation of RTs will aim at assuring the Eurosystem of the high quality standards which credit assessment systems have to fulfil within ECAF. The main issues to be addressed in further detail are, first, the methodology and the modelling techniques applied by the third-party RT. The second decisive factor in determining tool quality will be the input data used for estimating and calibrating the model(s). And thirdly, the analysis of RT validation procedures and validation results of model outputs will conclude the evaluation cycle. High quality standards have to be guaranteed in all of these areas in order to yield risk parameters which adequately reflect the risk profile of the collateral submitted to the Eurosystem.

4.1 METHODOLOGY: RATING SYSTEMS AND RISK QUANTIFICATION

The conceptual evaluation of an RT request carried out by the Eurosystem will cover an analysis of the rating assignment methodology, the logic of the obligor rating system, and its ability to provide meaningful differentiation of risk. In principle, a variety of different rating assignment methodologies can be used to assign obligor grades. In the case of a third-party RT, one can expect that statistical models will be mainly used for the assignment of rating grades. The assumptions underlying the respective RT model shall be presented in detail.

The assessment of the RT methodology will focus on the following issues:

– methods used for assigning rating grades (carrying out risk differentiation);

– methods used for PD estimation;

– compliance of the definition of default used in calibrating the PD with the definition of default underlying ECAF;

– systematic approaches for the detection of any deficiencies in the estimation system that will need to be corrected by the RT provider (this covers the inclusion of feedback in the form of validation results on the accuracy and predictive ability of estimated PDs); and

– in case the RT directly assigns obligor-specific PD estimates, all of the issues related to the assessment of this assignment methodology apply; where an RT uses direct estimates of risk parameters, these may be seen as the outputs of grades on a continuous rating scale.

Third-party RT providers have to document the development and fundamentals of their models and of the validation process in a way that permits third parties to gain a detailed understanding thereof and to assess whether the model is performing adequately on a client-specific basis.

4.2 DATA

DATA ACCURACY, COMPLETENESS AND APPROPRIATENESS

Data used as inputs for the third-party RT need to be accurate, complete and appropriate. In the current context, these terms will be understood as follows:

Accurate refers to the degree of confidence that can be placed in the data inputs. Data must be sufficiently accurate to avoid material distortion of the outcome.

Complete means that the databases provide comprehensive information (i.e. all relevant information required for all relevant variables). While missing data for some fields or records may be inevitable, one should attempt to minimise their occurrence and aim to reduce them over time.

Appropriate means that data do not cause biases in parameter estimates which make them unfit for the intended purpose.

DATA QUALITY STANDARDS

RT providers should define standards for ensuring data quality and should strive to improve these standards over time. They should measure performance against these standards and should work on an ongoing basis to ensure that the data are of high enough quality. This could include reviewing the structure of input data to identify outliers or implausible values, changes from previous periods, and the amount of missing data. The review should also indicate whether the integrity of data is being maintained. Regular reconciliation against accounting data could provide an additional quality check (e.g. cross-checks between input data and other items of accounting data, or checks considering alternative sources of accounting data, etc.).

There should be minimum checks including a periodic review by an independent party (e.g. external auditors or the Eurosystem) to confirm that data are accurate, complete and appropriate.

The RT provider is expected to have data directories in place. These directories should contain clear definitions of data items used. Furthermore, database documentation with database descriptions should be available documenting the soundness of the databases used for the third-party RT implementation.

In addition, the Eurosystem retains the right to have carried out by the RT provider ad hoc sample drawings from the data provided by counterparties.

4.3 VALIDATION

In the context of rating systems, the term "validation" encompasses a range of processes and activities that contribute to an assessment of whether ratings adequately differentiate risk and whether estimates of risk parameters (e.g. PD) appropriately characterise the relevant aspects of risk. In the course of the RT approval, the Eurosystem will assess the RT provider's validation concept and validation results evaluating the risk differentiation and PD estimation methodologies. In doing so, the Eurosystem will adhere to the following six general principles on validation established by the Basel Committee.[4]

4 "Update on the work of the Accord Implementation Group related to the validation under the Basel II framework", Basel Committee, January 2005.

Validation is fundamentally about assessing the predictive ability of an RT provider's risk estimates. Rating systems should effectively discriminate risk (i.e. credits with lower ratings should have a higher risk of default) and calibrate risk (i.e. they should accurately quantify the risk of loss). If the processes that are used in assigning risk estimates are not accurate, then the risk estimates may fail to be sufficiently predictive. Consequently, validation should focus on assessing the forward-looking accuracy of the risk estimates, the processes for assigning those estimates, and the oversight and control procedures that are in place to ensure that the forward-looking accuracy of these estimates is preserved on an ongoing basis.

The RT provider has primary responsibility for validation. The Eurosystem does not have the primary responsibility for validating the rating systems. Rather, the RT provider has the primary role and consequently must validate its rating systems and demonstrate how it arrived at its risk estimates. The Eurosystem, on the other hand, should assess these validation processes and outcomes.

Validation is an iterative process. The design of the validation process, of course, does not remain forever unchanged once the initial evaluation of the RT has been carried out by the Eurosystem. Rather, RT providers periodically refine their validation tools in response to changing market and operating conditions. The Eurosystem and the RT providers will need to engage in an iterative dialogue on the strengths and weaknesses of the systems.

There is no single validation method. While some validation tools (e.g. backtesting or benchmarking) may prove especially useful, there is no universal tool that can be used for all portfolios in all banks. Backtesting, for example, may prove difficult for portfolios where there is a low level of historical defaults. In addition, the underlying philosophy of the rating system must be well understood and taken properly into account when determining which validation tools and techniques should be applied for assessing the accuracy and stability of a rating system.

Validation should encompass both quantitative and qualitative elements. While validation could be thought of as a purely technical/ mathematical exercise in which statistical techniques are used to compare actual outcomes with estimates (and such technical tools may indeed play a critical role in evaluations under some circumstances), focusing solely on comparisons between predictions and outcomes is likely to be insufficient. In assessing the overall performance of a rating system, it is also important to assess the components of the rating system (data, models, etc.) as well as the structures and processes underlying the rating system. This should include an assessment of controls, documentation, and other relevant qualitative factors.

Validation processes and outcomes should be subject to independent review. It is important that validation processes and results should be reviewed for integrity by parties within the organisation that are independent of those responsible for the design and implementation of the validation process. This independent review can be accomplished using a variety of structural means; one possibility might be for the internal audit function to take over this task.

VALIDATION TOOLS

The validation process of the RT provider must ensure that the requirements stated below are met on an ongoing basis:

– estimations have to be accurate and consistent;

– backtesting[5] and benchmarking[6] of the risk quantification for each grade must take place at regular intervals;

5 Backtesting is performance checking of the rating system estimates by comparing realised risk parameters with estimated risk parameters.
6 Benchmarking consists of comparing the outputs of the reviewed rating systems with the outputs of other rating systems with external information.

–   consistency of methods and data through time has to be ensured and changes in methods and data have to be documented; and

–   unexpected changes in economic conditions have to be taken into account.

ANNEX: EUROSYSTEM APPLICATION FORM - INFORMATION REQUIREMENTS RELATING TO COUNTERPARTIES AND RT PROVIDERS

REQUEST FOR THIRD-PARTY RATING TOOL ACCEPTANCE[1]

1.   Credit assessment source: Third-party rating tool (RT)

2.   From: [Name of counterparty]

3.   To: [Name of home central bank]

4.   Frequency:[2]
     [For initial endorsement or for ad hoc request due to changes in methodology or coverage]

REQUESTED INFORMATION

5.   Name of counterparty: [Name of counterparty]

6.   MFI ID: [MFI ID of counterparty]

7.   Country (or countries) to be covered by RT: [List of country names]

8.   Exposure category to be covered:
                               [Details on the exposure category to be covered by the RT]

9.   Co-endorsing and monitoring institution(s):
                          [List name(s) of co-endorsing and monitoring institution(s)]

THIRD-PARTY RATING TOOL (RT)

10. RT: [Name of the RT (product name)]

11. Model coverage:

     Geographical: [List the countries covered by the RT]

     Class of debtors:
                     [Specify the coverage in terms of sectors of economic activity covered by the RT]

     Minimum/maximum turnover of entities rated: [Specify the requested range of turnover]

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7   Brackets indicate that the counterparty or third-party rating tool provider have to fill in the requested information.
8   A request for RT acceptance must be filed by the counterparty when it applies for acceptance of a certain RT for ECAF purposes for the first time and subsequently each time material changes occur with respect to the RT (e.g. methodology, database, etc.), the RT provider, the counterparty specifics or the collateral submission policy (e.g. intended submission of previously not submitted exposure categories as collateral).

12.   Definitions:

Definition of default: [Specify the default definition underlying the RT]

Probability of default: [Specify the probability of default definition underlying the RT]

13.   Model description:[9]
          [Provide a detailed description of the RT including at least the following points:
    a)   general description of methodology underlying the RT, econometric model;
    b)   data and information sources;
    c)   data input;
    d)   frequency of rating updates;
    e)   classification of the rating buckets (RBs);
    f)   brief description of the risk associated with each RB;
    g)   one-year PD estimate assigned to each RB;
    h)   number of rated obligors per RB at the date of last PD update;
    i)   cumulative default rates for the last three years for each RB;
    j)   simplified transition matrix for the last year; and
    k)   overruling: frequency of occurrence, general handling.]

14.   Model validation (should cover at least):[10]
          [Provide a detailed description of the RT model validation process covering at least the
                                                                                  following aspects:
    a)   validation concept;
    b)   regular validation procedures;
    c)   validation results (including backtesting);
    d)   results for particular consideration of the respective country for which endorsement
         is requested; and
    e)   results for particular consideration of the exposure categories which the counterparty
         plans to pledge as collateral.]

15.   RBs envisaged as eligible:
          [Indicate the RBs which according to your interpretation comply with the Eurosystem
                                                                        credit quality threshold]

RT PROVIDER

16.   RT provider's name, address, contact details:
                  [Please indicate the name of the RT provider together with all contact details]

17.   Information on the RT provider:[11]
    a)   Organisation (group structure: affiliation <--> organisational independence):
              [Describe legal structure and specificities under which the RT provider operates]]

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9   If appropriate, the counterparties need not submit all of the requested details themselves, but may refer the Eurosystem to the RT
    provider for purposes of obtaining this information directly.
10 See footnote 9.
11 See footnote 9.

b)   Economic independence:
[Detail the degree of independence in terms of financial means and decision-making power the RT provider enjoys]

c)   Resources (i.e. economic and technical resources as well as know-how):
[Specify the resources along the lines indicated]

18.   First year of RT provision:
[Indicate the date of first endorsement of the RT in case the current application relates to an ad hoc request]

19.   Number of customers:[12]
[Indicate the number of customers structured according to regional relevance to the RT provider's business]

20.   Yearly turnover:[13]
[Indicate the figure structured according to regional relevance to the RT provider's business]

21.   Was the RT provider's agreement obtained for the endorsement of its RT for ECAF purposes?[14]

[yes or no]

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12 See footnote 9.
13 See footnote 9.
14 The RT provider must have declared its willingness to support the RT acceptance and to cooperate with the Eurosystem in an appropriate manner. The requirement of cooperation extends from the acceptance phase to the operating phase (including monitoring).