To

Basel 3.1 Hub
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

Submitted via email to Prudential.Consultation@hmtreasury.gov.uk

Date: March 31st, 2023

Reference: Implementation of the Basel 3.1 standards – Consultation dated November 2022

Dear Prudential Regulation Authority,

With reference to the above consultation, we are pleased to hereby submit the views of our association. Our response focuses solely on questions relative to Credit Ratings raised in your consultation. This response complements our views already expressed in our response to the HM Treasury consultation on the Basel implementation in the United Kingdom, which we submitted end of January 2023.

Question 3: Do you have any comments on the PRA's proposed approach to the use of external credit ratings and the proposed due diligence requirements?

In §3.15 of the consultation paper, the PRA proposes "that firms would use the credit ratings of their nominated external credit assessment institutions (ECAIs) consistently for all types of exposures, for risk management and risk-weighting purposes".

This proposed approach departs from the current practice where banks nominate ECAIs separately for different exposures. For instance, we observe that banks may nominate certain ECAIs for sovereign exposures while they may use other or more agencies for structured finance exposures. Banks therefore currently use ECAIs selectively for different exposure classes. Furthermore, requiring banks to use ECAIs consistently for all exposures would result in prohibiting the IRB approach.

This proposed approach will result in cementing the oligopolistic nature of the rating market as banks will nominate only the dominant ECAIs having a wide coverage across all exposure classes. Banks will be reluctant to nominate new or specialized credit rating agencies as ECAIs since these may

potentially move into new exposure classes over time and banks would be required to use these new assessments without the possibility to first observe the activity of these ECAIs.

In § 3.18 of the consultation paper, the PRA proposes that "in cases where external credit ratings are used for risk-weighting purposes, due diligence should be used to assess whether the risk weight applied is appropriate and prudent. If the due diligence assessment suggests an exposure has higher risk characteristics than implied by the risk weight assigned to the relevant CQS of an exposure, the firm would assign the risk weight of a CQS at least one higher than the CQS indicated by the counterparty's external credit rating. This requirement is applicable to exposures to corporates, institutions, and covered bonds"

While this proposal is based on the internationally agreed Basel III Reform, we believe that this approach is opposed to two key principles. First, banks are mandated to use nominated ECAI ratings consistently for all exposures in an asset class – requiring banks to carry out a due-diligence on each and every ECAI rating goes against the principle of consistent use of these ratings.

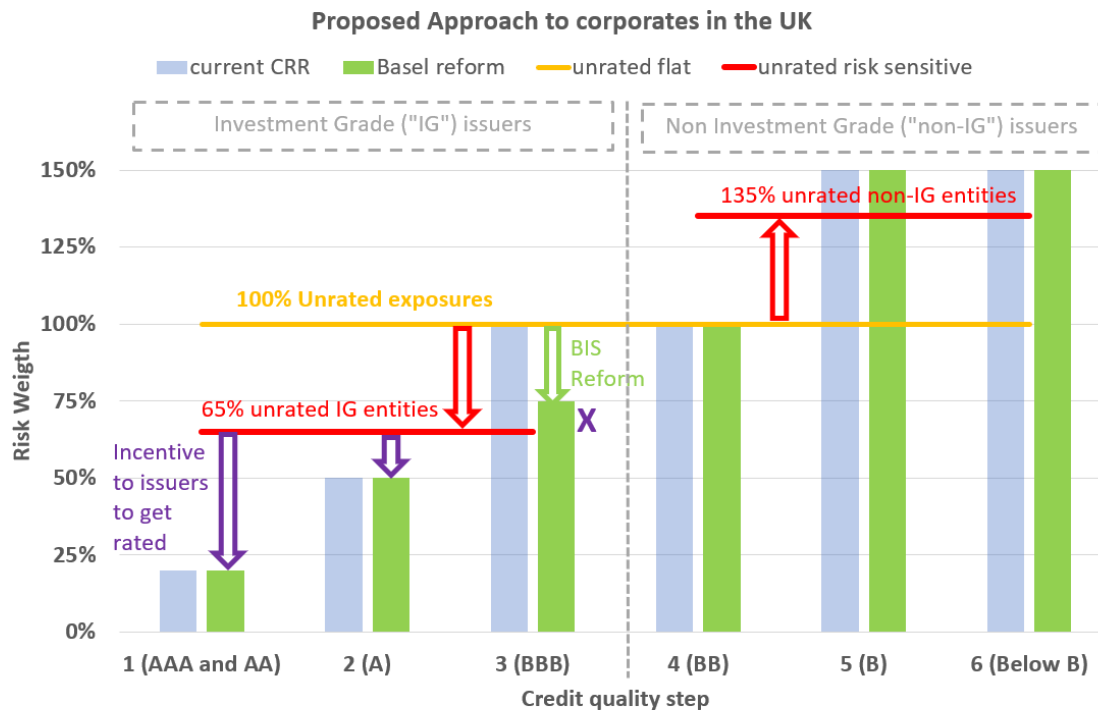
Second, in the context of the output floor, ECAI ratings act as a back-stop to internal ratings. In case the due-diligence would imply the need to assign a high risk weight, the output floor could no longer be used consistently across banks to compare capital requirements.

Furthermore, given the concern of excess variability of risk weighted assets based on internal models, we believe that it is highly unlikely that the due-diligence requirements will result in higher risk weights being applied. This due-diligence requirement is therefore a burden to banks with only limited tangible results.

Finally, the proposal clearly states that the due-diligence requirement should only apply to corporates, institutions and covered banks. The proposal therefore excludes the important asset classes of sovereign ratings, sub-sovereign ratings and public sector entities. There is no explanation given why these sovereign assets should be exempted from the due-diligence requirement – the underlying assumption is to safeguard these assets from increased capital requirements. This is an undue preferential treatment compared to banks or corporates, who equally contribute to the well-functioning of the economy and therefore should not be disadvantaged.

Question 8: Do you have any comments on the PRA's proposed approach for exposures to unrated corporates? Do you have any evidence – quantitative or qualitative – to support your comments, particularly in respect of the proposed 135% risk-weight for Non-IG exposures?

The graph below summarizes the PRA's proposals regarding corporate exposures:



In line with the Basel 3 reform, the PRA proposes to reduce the risk weight of Credit Quality Step 3 (usually corresponding to the BBB rating category) from 100% to 75%. We welcome that the PRA follow suits on the Basel 3 reform since BBB rated entities have far lower probabilities of default than BB rated entities who continue to have a risk weight of 100%. We further think that this change contributes to increased risk sensitivity of the prudential framework and to a better allocation of banks capital requirements.

With regard to unrated corporates, the PRA proposes two different approaches:

- A flat risk weight of 100% for all unrated corporate exposures or
- A risk sensitive approach distinguishing between investment grade and non-investment grade issuers – the former benefiting of a reduced risk weight of 65% and the later of an increased risk weight of 135%.

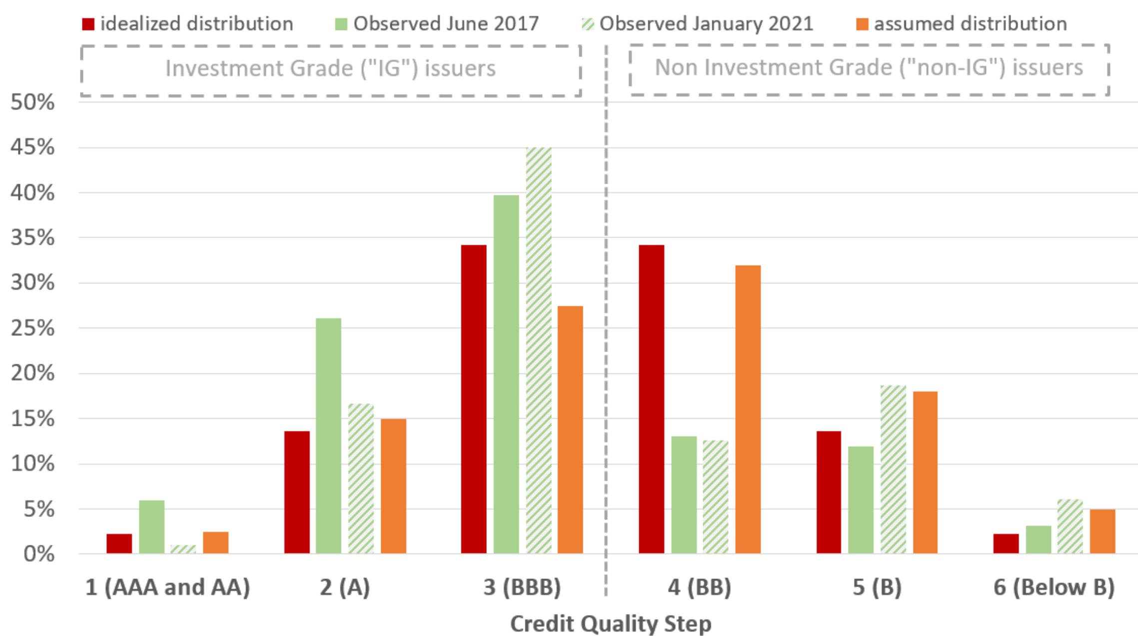
We welcome the PRAs proposed risk sensitive approach to unrated corporates since it provides for some degree of risk sensitivity reflecting different probabilities of default across the corporate landscape.

In terms of impact on rating coverage, we assume a mixed reaction by issuers largely depending on their credit quality:

- Highly rated corporates (rating categories from AAA to A) have clearly an incentive to request a rating since capital requirements to banks can only decrease and thereby funding costs to issuers will improve.
- With regard BBB issuers, the picture is less clear. Given that the proposed 65% risk weight for unrated IG entities is below the 75% of BBB rated entities, these entities may be reluctant to request an external rating. It may therefore be appropriate to change the 65% risk weight for unrated IG entities to 75% to match the risk weight of BBB rated entities.

- For BB issuers, the incentives for a rating are rather limited since the capital requirements to banks will remain the same (at 100%) whether they are rated or not. Additionally, cost of the rating need to be considered: issuers regularly complain about the high fees charged by the Dominant CRAs (S&P, Moody's and Fitch) using the "everybody-pays model" further disincentivizing issuers to request a rating. We draw to the attention of issuers that smaller agencies usually charge far lower rating fees, thereby modifying the assessment: the additional rating costs may be compensated by an increased funding base of issuers and potentially improved funding terms through the access to the capital market.
- Low credit quality issuers (B rating category and below) don't have any incentive to request a rating as this can only drive up the risk weight applied and thereby funding costs.

A further consideration is linked to the bank's choice with regard to the approach used on unrated corporates: will they use the flat 100% risk weight or rather the proposed risk sensitive approach? Assuming a normal distribution of issuers across the whole credit quality range, the outcome should be the same resulting at around 100% for all issuers. But, when considering all corporate exposures beyond Corporate SMEs, we assume that the non-IG range outweighs the IG range (see graph next page). In such a case, the risk sensitive approach would lead to an average risk weight above 100%. Taking into account the costs to bank to distinguish between IG and non-IG issuers, we believe that banks will opt for the easier route and consistently apply the 100% risk weight to all unrated corporates.

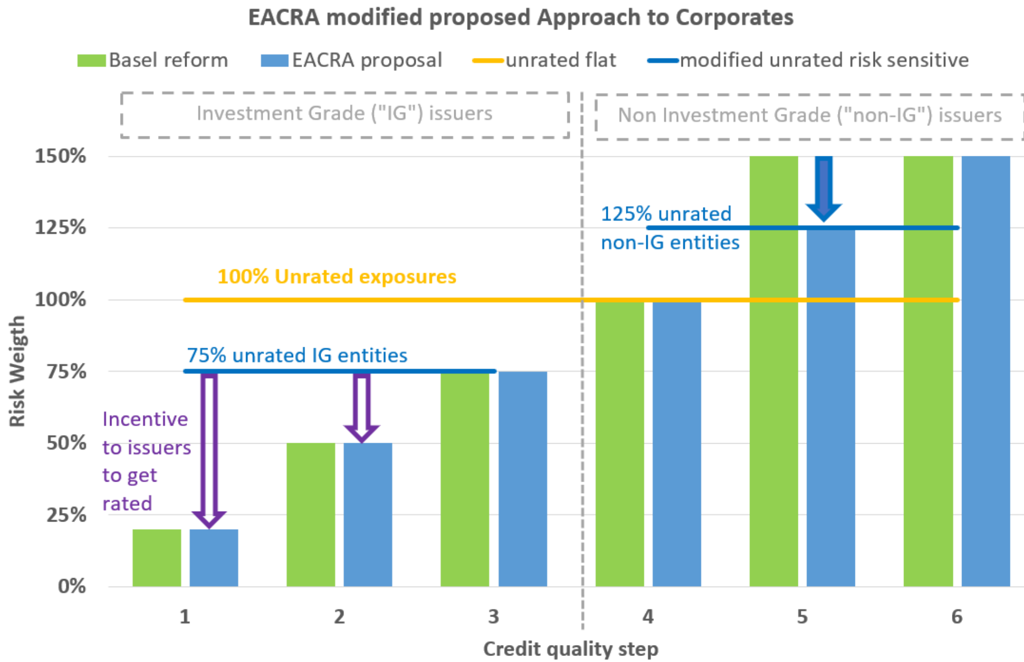


Sources: for June 2017, ESMAs Central Repository of Ratings (CEREP) database and own calculations. For January 2021, FCA Credit Rating Statistics - Central Repository Statistics (CERES) and own calculations. Assumed distribution is based on the benchmarks observed in France, Italy, Spain and Germany for all Corporates (including Medium and Small Corporates).

Based on the above analysis, we hereby submit to your consideration an alternative approach consisting of the following 2 modifications:

- Change the risk weight of Credit Quality Step 5 (associated with B rating category) from currently 150% to 125% and
- Modify the risk sensitive approach to unrated corporates using 75% for unrated IG entities and 125% for unrated non-IG entities.

The graph below illustrates this approach:



The change of the risk weight of BB entities is an extension of the Basel III reform by using different risk weights for each credit quality step thereby further enhancing the risk sensitivity of the overall framework.

The change of the risk sensitive unrated approach tackles the issues identified in the discussion above for both issuers and banks. In this case, banks will rather opt for the risk sensitive approach to unrated corporates since average risk weight will stand slightly below 100%. For nearly all issuers (except the lowest credit quality in CQS 6) incentives to request an external rating will be on the table and it will result in an overall increased rating coverage over time.

In terms of impact on risk weighted assets and thereby capital requirements to banks, we find the following results for a mixed portfolio of corporate exposures (covering rated and unrated entities):

Risk Weighted Issuers	Current CRR	Basel Reform and flat RW for unrated	Basel Reform and risk sensitive for unrated	Basel reform and modified risk sensitive approach to unrated	our combined proposal
Normal distribution	95,93%	93,36%	95,89%	92,16%	91,65%
Assumed distribution	95,95%	93,89%	99,38%	95,21%	94,54%

Source: own calculations. Includes assumptions on differing rating coverage for each credit quality step

As can be seen from the table, our combined proposal leads to risk weighted issuers at approximately the same level as under the current legislative framework (CRR).

EACRA
EUROPEAN ASSOCIATION OF CREDIT RATING AGENCIES

On Section 9 – Output Floor

With respect to section 9 of the consultation paper on the "output floor", we would welcome if your institution clarifies which ECAIs should be used for the calculation of the output floor since the consultation paper is silent on this issue.

We see two alternative approaches: 1) banks may specifically nominate ECAIs for the calculation of the output floor or 2) banks may use all ECAIs for this purpose.

The first option primarily targets banks using Internal Models to derive risk weighted assets. Such banks do not nominate ECAIs for the calculation of risk weighted assets.

The second option targets all banks (IM banks and SA banks). By using all ECAIs for the calculation of the output floor, such banks may have additional ECAI ratings available and thereby potentially reduce the number of unrated exposures.

In our view, the second option is the preferred one as it incentivizes banks to familiarize with all ECAIs on the market. This may contribute to more competition in the market over time.

We thank you for your kind attention and remain at your disposal for any clarification or additional information.

About EACRA

The European Association of Credit Rating Agencies (EACRA), set up in November 2009 and registered in Paris, was established to act as a platform for cooperation for EU-based Credit Rating Agencies (CRAs). Our mission is to support and facilitate the compliance of CRAs with regulatory requirements through effective communication, cross-border know how, and the promotion of best practices. In addition, EACRA seeks to promote Credit Ratings and the interests of CRAs across Europe, as well as enhance the financial community and general public's understanding of Credit Ratings.