EACRA
EUROPEAN ASSOCIATION OF CREDIT RATING AGENCIES

To

HM Treasury
Prudential Banking Team
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London SW1A 2HQ
United Kingdom
Submitted via email to Prudential.Consultation@hmtreasury.gov.uk

Date: January 31st, 2023

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

Dear HM Treasury,

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. We shall also respond to the PRAs consultation on the Basel implementation in the United Kingdom, which raises additional questions relative to credit ratings and ECAIs.

7: do you agree that the CRAR broadly aligns with the Basel 3.1 standards and further changes are not required?

While we believe that the CRA Regulation clearly aligns to the Basel expectations on ECAIs regarding independence and objectivity of the assessments, we suggest the following 3 clarifications to CRAR:

- No public disclosure of initial review / preliminary ratings on corporates,
- Amend Article 8d to make the use of a small CRA mandatory in case 2 or more CRAs are contracted,
- Review the definition of unsolicited ratings.

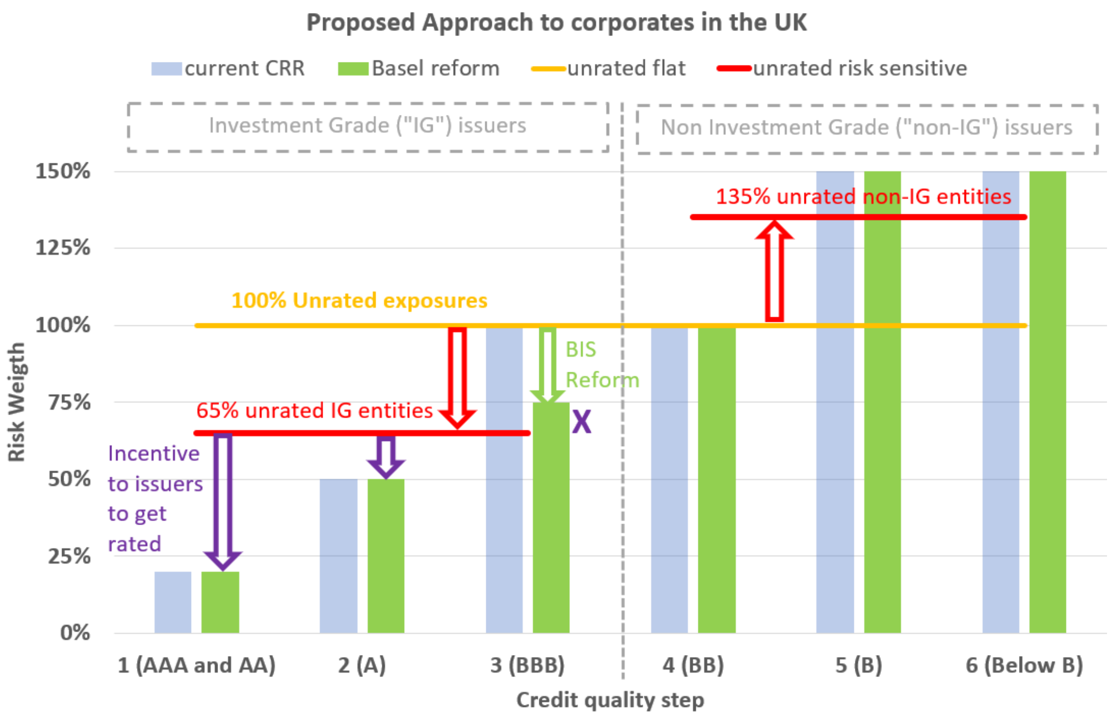
With respect to the disclosure of initial reviews (Annex I Section D Part I point 6 of CRAR), CRAs are currently required to disclose this information on their website. Given the goal of a wide rating coverage of non-financial corporates, we do believe that this requirement inhibits the development of this market. The vast majority of non-financial corporates are currently unrated and are most likely not familiar with the concept of external ratings. Corporates may therefore wish to receive a preliminary assessment of their credit quality before going public with a rating. Requiring CRAs to publicly disclose whether they have produced such a preliminary assessment may raise expectations from potential investors on an upcoming rating – if the issuer does not follow suit with a public rating, investors will likely assume that the issuer is of lower credit quality. In order to break this vicious cycle, we propose that CRAs should only notify the Financial Conduct Authority as regulator of CRAs in the UK on such initial reviews / preliminary ratings.

In order to enhance competition on the rating market, the amendment of CRAR in 2013 included the new provision in Article 8d that issuers should consider appointing a small CRA (having less than 10% market share measured against revenues) in case they mandate 2 or more agencies. This provision is only voluntary and has not modified the oligopolistic nature of the rating market. We recommend making the appointment of a small CRA mandatory as this will result in more competition in the market, lower rating fees to issuers and overall higher financial stability.

While Article 3 (1) (x) defines an unsolicited rating as a “credit rating assigned by a credit rating agency other than upon request”, the interpretation by ESMA in a Q&A document is that the request should come from the issuer itself. We do believe that this interpretation strongly limits the scope of solicited ratings since investors may equally request a rating (so called investor-solicited ratings). In view of the target of a wide rating coverage of corporates, we believe that investor-pays ratings may play an important role going forward.

12. Will the PRA’s proposed approach to Basel 3.1 – and the impact this has on funding costs for unrated corporates – provide sufficient additional incentive for firms who would previously not have taken out a credit rating to now do so?

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:

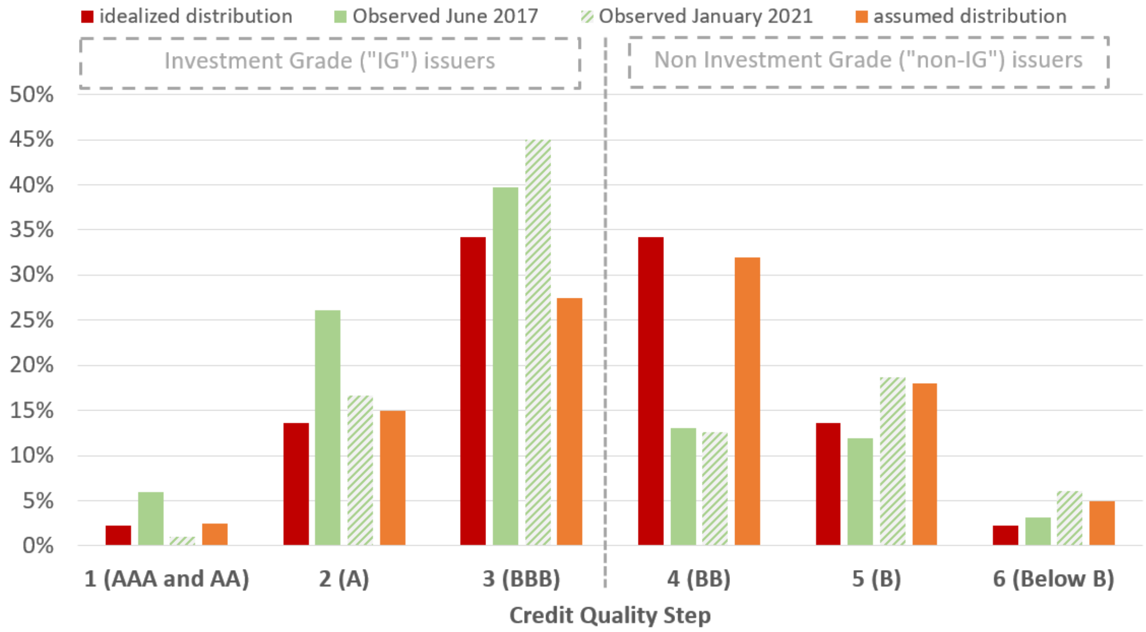
- A flat risk weight of 100% for all unrated corporate exposures or
- A risk sensitive approach distinguishing between investment grade and non-investment grade issuers – the former benefiting of a reduced risk weight of 65% and the later of an increased risk weight of 135%.

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.



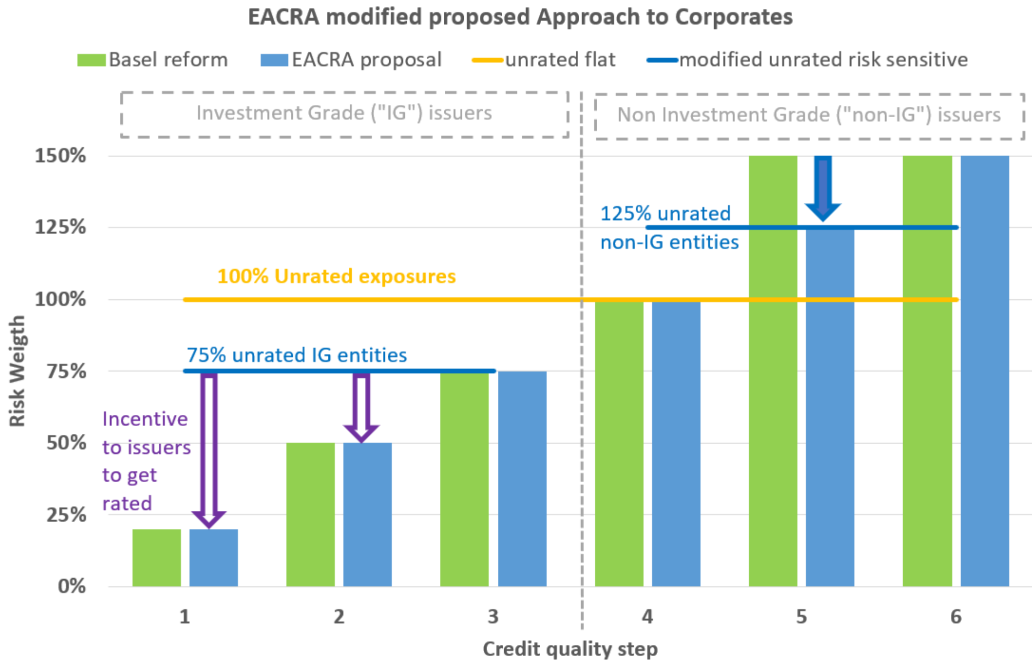
Sources: for June 2017, ESMAs Central Repository of Ratings (CEREP) database and own calculations. For January 2021, FCA Credit Rating Statistics - Central Repository Statistics (CERES) and own calculations. Assumed distribution is based on the benchmarks observed in France, Italy, Spain and Germany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

13. If not, are there alternative models that HM Treasury should consider to mitigate industry concerns regarding unrated corporates?

In view of our response to question 12 above, 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).

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.