

Information requirements for external credit assessment institutions for recognition purposes

1) Introduction

- a) In terms of section 85A of the Banks Act 94 of 1990 (the Act), banks may only use the ratings of eligible external credit assessment institutions (ECAIs) in the calculation of their minimum required capital and reserve funds.
- b) Section 85A of the Act further stipulates that rating agencies and export credit agencies need the prior approval of the Registrar of Banks (the Registrar) to act as eligible institutions.
- c) In addition, regulation 51(2) of the Regulations relating to Banks (the Regulations) contains minimum requirements that rating agencies have to comply with before approval to act as an 'eligible institution' will be granted by the Registrar.

2) Application process

- a) The Bank Supervision Department's (BSD) approach to ECAI recognition aims to balance the need for adequate prudential standards for the purposes of recognition, and limiting the compliance and informational burden on ECAIs. The BSD believes that much of the information required from ECAIs will already be contained in existing documents and that ECAIs would be readily able to provide concise answers. However, ECAIs should note that the BSD may ask for further information and possibly for meetings in certain areas should this prove necessary to clarify an ECAI's eligibility.
- b) It is advisable for ECAIs to put forward one submission covering their application for recognition in various different product segments. It is not necessary for ECAIs' submissions to repeat all the information listed below for each separate product application.
- c) In areas where group-wide information is required (e.g. on company finances or organisational structure) or where group-wide policies are applied across an ECAI's entire rating universe, ECAIs will need to submit the required information only once in a consolidated document, and make reference to such information in each individual product application.
- d) Separate information need only be provided for different product applications in those areas where procedures or information differ by product. For example, if ECAIs adopt different methodologies for rating different products, then the applications for the individual product segments would each need to describe their own relevant methodologies. Similarly, if data samples permit, ECAIs might consider submitting product-specific information concerning matters such as back-testing, among others.

- e) The recognition requirements are set out hereunder and highlight the information that will be required to enable the BSD to assess compliance with the requirements.

3) Information requirements

a) Objectivity of methodology

- i) In assessing ECAs, the BSD will be looking for evidence of processes that ensure that ECA methodologies are well-founded, rigorous, systematic and objective.
- ii) ECAs will need to demonstrate the following:
 - (1) That the mechanisms that ensure pre-defined methodological processes are applied consistently in the formulation of all ratings.
 - (2) That their rating methodologies are subject to robust, quantitative back-testing.

b) The ratings process

- i) ECAs need to provide the BSD with information requirements and reasonable assurance by way of demonstrating that it is in compliance with the items listed hereunder:
 - (1) A description of the core rating process for each market segment in which recognition is being sought (although duplicate information will not be required in areas where common ECA-wide procedures are followed in all product segments).
 - (2) A description of how policy concerning rating methodology is determined, implemented and changed.
 - (3) An overview of the rating process followed in each market segment.
 - (4) A high-level description of the quantitative aspects of the rating process (e.g. the key variables, data sources, assumptions and quantitative techniques used).
 - (5) A high-level description of the qualitative aspects (e.g. the role of and guidelines governing ratings committees, the scope for rating alterations by analysts or other means).
 - (6) Information relating to the following product classes:
 - (a) Structured products: The different methodologies used for different products.
 - (b) Other product classes: ECAs will need to provide a summary of the major differences in rating different sectors within the same market segment (e.g. any major differences in the methodology for rating mining companies and retail corporates).
 - (7) Reference to, and a summary of, other technical research used in forming a methodology.
 - (8) Details on the extent of input from rated entities.

- (9) A description of internal compliance mechanisms adopted to ensure a consistent application of ratings methodologies across all ratings.
- (10) Information on rating reviews (e.g. regularity, data updates and level of input from rated entities).

c) Back-testing

- i) ECAs need to demonstrate that their rating methodologies are subject to quantitative back-testing (e.g. default studies, rating accuracy tests and transition matrices).
- ii) ECAs will also need to show that such back-testing confirms the robustness and consistency of their rating methodologies over time and different product segments, and that procedures are in place to ensure that systematic rating errors highlighted by back-testing will be incorporated into rating methodologies.
- iii) This will require information including:
 - (1) A description of the methodology used by the ECA to verify its ratings, including key assumptions made and data used.
 - (2) Details of the results and conclusions generated by such analysis using at least 12 months' back data.
 - (3) Details about mechanisms that allow systematic errors in ratings to feed back into potential changes in the ratings method.

d) Independence of methodology

- i) ECAs need to demonstrate the following:
 - (1) That their ratings are objective and are not influenced by financial considerations and internal or external political pressures.
 - (2) That their staff members are sufficiently equipped to make fully informed, objective decisions.

e) Organisation structure and corporate governance

- i) ECAs need to demonstrate organisational structures that minimise the scope for external influence on ratings. ECAs will need to demonstrate that their corporate governance structures ensure that they act with integrity and maintain ratings independence. In this respect, ECAs will need to submit information such as:
 - (1) A summary of executive committee arrangements including composition, remit and accountability of committee, and details of any involvement from external (group) controllers.
 - (2) A summary of arrangements for separating rating and non-rating parts of their organisation.
 - (3) A summary of arrangements for, and independence of, credit policy and credit-rating committees.

- (4) Self-certification of the internal audit function in ensuring that internal policies are followed, including details of remit, independence, resources and power.
- (5) Adherence to a code of conduct that is similar in emphasis to that proposed by the International Organisation of Securities Commissions.

f) Ownership of ratings business

- i) ECAs need to demonstrate that their controllers do not exert pressures that jeopardise the objectivity of the ratings process.
- ii) ECAs need to disclose if they issue ratings for public or private controllers, including:
 - (1) A summary of major shareholders (parental interests or external investors with more than 10 per cent of voting rights).
 - (2) A summary of any ownership or direct influence from the public sector or trade associations.
 - (3) Disclosure of whether ECAs issue ratings for such entities.
 - (4) An explanation of how procedures aimed at managing conflict of interests in this area and ensuring that fair and objective ratings are produced in such cases, with reference to their submission concerning organisational structure and corporate governance.

g) Financial resources

- i) ECAs need to demonstrate that they are financially viable. Where possible, this should involve the submission of financial information (e.g. income statements, financial resources, income and expenditure forecasts), demonstrating the financial standing of the rating business as an individual entity.
- ii) However, where this is not possible, ECAs need to provide other information demonstrating the financial viability of the ratings business such as information about the financial position of the wider business group, the importance of the ratings business within that group, and the likelihood of parental support for the ratings business.
- iii) ECAs will also need to demonstrate that their financial viability does not depend on certain key clients, who may by virtue of this dependence be able to unduly influence rating assessments. In demonstrating this ECAs will need to:
 - (1) Disclose, on a no-names basis, the number of situations in which revenue earned from major clients accounts for a significant share (≥ 5 per cent of the ECAs total revenue).
 - (2) Provide evidence of procedures that are aimed at ensuring that fair and objective ratings are produced in such cases as part of the submission concerning organisational structure and corporate governance.

h) Staffing expertise and training

- i) ECALs need to demonstrate that key personnel have the skills and experience necessary to perform the roles required. This will involve ECALs providing the following information (some of which may be subject to peer-group analysis and benchmarking, if appropriate):
 - (1) Self-certification and evidence that key staff possess the requisite skills levels.
 - (2) Information on recruitment policies at different staffing levels.
 - (3) Statistics on the number of analysts per rating in each product segment.
 - (4) Statistics on the number of years' rating experience per employee.
 - (5) Self-certification and evidence that the ECAL's training programme is of the quality, regularity, staff attendance and relevance that are needed to ensure ongoing analyst quality.

i) Transparency of methodology

- i) ECALs are required to demonstrate that:
 - (1) Access to information about their methodologies for all potential users to be able to make decisions about the appropriateness of such techniques and the ratings are produced, is adequate.
 - (2) Their rating methodologies and additional technical information are available to all interested parties via public Internet access and other means, and its description is thorough yet simplified.
 - (3) Details are and will be provided of material changes to such methodologies and are made available to the public through their website as soon as reasonably possible.
 - (4) Details of other ways in which ECALs seek to make methodologies transparent will be provided, for example through helpdesks, public presentations and other publications.

j) Transparency of ratings

- i) ECALs are required to demonstrate that all potential users of their ratings for regulatory capital purposes, both domestic and non-domestic parties, have equal and timely access to such ratings.
- ii) ECALs that do not charge for access to their ratings will need to demonstrate that a full list of ratings is publicly available via public access (e.g. on the Internet), and that such ratings lists are updated as soon as a rating is issued or altered.
- iii) ECALs that only permit subscribers access to ratings will need to demonstrate, for example through policy statements, that a full list of ratings is available equally to all subscribers (possibly through the Internet) and that such rating lists are updated as soon as a rating is issued or altered.

- iv) All ECAIs are required to adhere to a code of conduct or internal procedures preventing analysts from verbally providing key customers or subscribers with early information about the nature and timing of future rating actions.

k) Credibility and market acceptance of ratings

- i) The BSD does not propose to determine whether ECAIs' individual credit assessments are recognised in the market and credible and reliable by the end user of such credit assessment, since it believes that many of the aspects of market credibility are reflected in other criteria such as independence and objectivity. The BSD will therefore not undertake specific reviews relating to matters such as market share, revenues generated and pricing as it does not wish to create entry barriers.
- ii) Consequently, the information that the BSD will request in this area will be a list of institutions that potentially propose to use an ECAIs ratings for regulatory capital purposes, on the assumption that the ECAI has gained recognition. This is in line with the BSD's view that its interaction with the ratings market should be limited purely to the recognition of ECAIs for regulatory capital purposes.

4) Ongoing review

- a) The BSD will need to undertake ongoing assessments of ECAIs that have received recognition by the BSD to ensure that ECAI methodologies and ratings remain acceptable.
- b) ECAIs that have received recognition by the BSD will be required to:
 - i) Inform the BSD of significant changes in their rating methodologies.
 - ii) Inform the BSD immediately of material changes that could prompt the need for a change in mapping, and provide a summary list of other methodological changes on an annual basis.
 - iii) Immediately notify the BSD of material changes in any other recognition criteria, for example changes in ownership, a major deterioration in financial position and a change in arrangements concerning rating committees or internal audit.
 - iv) Demonstrate that their ratings are reviewed on at least an annual basis, and that there is review in response to major changes in financial conditions. This will include a description of the methodology that is used for back-testing and a summary of results.
 - v) Inform the BSD of instances where back-testing reveals a material change in rating accuracy or rating consistency. ECAIs will be expected to explain the reason for such changes, and demonstrate that, where necessary, the results of the ratings review trigger changes in methodology.