



Information requirement for external credit assessment institutions for recognition purposes

1. Introduction

- 1.1. Section 85A(1) of the Banks Act 94 of 1990 (Banks Act) stipulates that no bank or controlling company may, in the calculation of its minimum required regulatory capital and reserve funds, take into account a credit assessment of any external credit assessment institution (ECAI) or export credit agency unless the relevant ECAI or export credit agency has obtained prior written approval of the Prudential Authority (PA) to act as an eligible institution.
- 1.2. Section 85A(2) of the Banks Act further stipulates that any ECAI or export credit agency that wishes to be authorised as an eligible institution may apply to the PA for authorisation.
- 1.3. In addition, regulation 51 of the Regulations relating to Banks (the Regulations) contains the minimum requirements that the ECAI or export credit agency must comply with before approval is granted by the PA.

2. The application process

- 2.1. The PA's approach to ECAI recognition aims to balance the need for adequate prudential requirements for the purposes of recognition with the need to limit the compliance and informational burden on ECAs. ECAs should also note that the PA may ask for additional information and may request meetings should this prove necessary to determine an ECAI's eligibility.
- 2.2. It is advisable for ECAs not to duplicate or repeat all the information listed below for each separate product application. In areas where Group-wide information is required (e.g. on company finances or organisational structure), ECAs will need to submit the required information only once in a consolidated document and then only make reference to such information in each individual product segments application.

- 2.3. Separate information need only be provided for different product applications in those areas where procedures or information differ by product. For example, if an ECAI adopts different methodologies for rating different products, the relevant methodologies would need to be described for each product segment. Similarly, if data samples permit, ECAIs might consider submitting product-specific information concerning matters such as back-testing, among other things.
- 2.4. The ECAI application requirements are set out in section 3 below. They highlight the information that will be required to enable the PA to assess compliance with the requirements.

3. Information required

3.1. The ratings process

3.1.1. The ECAI is expected to share the following:

- a) an overview of the core ratings process followed in each market segment;
- b) a high-level description of the quantitative aspects of the ratings process (e.g. the key variables, data sources, assumptions and quantitative techniques used);
- c) a description of how ratings methodologies are determined, implemented and changed;
- d) a high-level description of the qualitative aspects of the ratings process (e.g. the role of and guidelines governing ratings committees as well as the scope for rating alterations by analysts or other means);
- e) information relating to the following product classes:
 - i. structured products – the different methodologies used for different products; and
 - ii. other product classes – a summary description 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);

- f) reference to, and a summary of, the technical research used in forming a methodology;
- g) details on the input provided by rated entities;
- h) a description of the internal compliance mechanisms adopted to ensure a consistent application of ratings methodologies across all ratings; and
- i) information on rating reviews (e.g. regularity, data updates and the level of input from rated entities).

3.2. Back-testing

3.2.1. The ECAI will need to demonstrate that its ratings methodologies are subject to quantitative back-testing (e.g. default studies, rating accuracy tests and transition matrices). It will also need to show that such back-testing confirms the robustness and consistency of its ratings methodologies over time, and that procedures are in place to ensure that any systematic rating errors highlighted by back-testing will be incorporated in its ratings methodologies.

3.2.2. This will require information on the following:

- a) a description of the methodology used by the ECAI to verify its ratings, including the key assumptions made and the data used;
- b) details of the results and conclusions generated by such analysis using at least 12 months of back data; and
- c) details about the mechanisms that allow any systematic errors in ratings to feed back into potential changes in the ratings method.

3.3. Independence of methodology

3.3.1. The ECAI needs to demonstrate the following:

- a) that its ratings are objective and are not influenced by the financial considerations of the ECAI;
- b) that its ratings are free from any political and/or economic pressure that may influence a particular rating;
- c) that its ratings are appropriately responsive to any changes in the financial conditions of the rated entity and its exposure to a risk of loss;
- d) that its staff members are sufficiently equipped to make fully informed, objective decisions;
- e) that its rating methodologies and models undergo a rigorous and systematic validation process that involves its Internal Audit function; and
- f) that its relevant ratings business and the processes related thereto are operationally, legally and, where practicable, physically and appropriately separated from its other businesses, processes, and analysts.

3.4. Organisational structure and corporate governance

3.4.1. The ECAI will need to demonstrate that its organisational structure minimises the scope for external influence on ratings.

3.4.2. The ECAI will also need to demonstrate that its corporate governance structures ensure that it acts with integrity and maintains ratings independence. In this regard, the ECAI will need to submit information such as:

- a) a summary of the Executive Committee arrangements, including its composition, remit and accountability, as well as the details of any involvement from external (Group) controllers;
- b) a summary of the arrangements separating the rating and non-rating business units of the organisation;
- c) a summary of the arrangements for (and the independence of) the Credit Policy Committee and the Credit Rating Committee;

- d) assurance by the Internal Audit function that internal policies are followed, including the details of the remit, resources and independence which do not create any actual or potential conflict of interest; and
- e) adherence to a code of conduct that is similar in emphasis to that proposed by the International Organisation of Securities Commissions (IOSCO)¹.

3.5. Ownership of the ratings business

3.5.1. The ECAI needs to demonstrate that its controlling company or major shareholders do not impose pressures that may jeopardise the objectivity of the ratings process.

3.5.2. The ECAI will need to disclose if it issues ratings for public or private controllers, including:

- a) a list of its major shareholders (parental interests or external investors with more than 10% of the voting rights);
- b) a summary of any ownership or direct influence from the public sector or trade associations;
- c) disclosure of whether the ECAI issues ratings for such entities; and
- d) an explanation of how the procedures aimed at managing conflicts of interest and ensuring fair and objective ratings are produced in such cases, with reference to its submission concerning organisational structure and corporate governance.

3.6. Financial resources

3.6.1. The ECAI will need to demonstrate that it is financially viable. Where possible, this should involve the submission of financial information (e.g. income statements, financial resources, and income and expenditure forecasts), demonstrating the financial standing of the ratings business as an individual entity.

3.6.2. However, where this is not possible, the ECAI will need to provide other information demonstrating the financial viability of the ratings business, such as information

¹ <https://www.iosco.org>

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.

3.6.3. The ECAI will also need to demonstrate that its financial viability does not depend upon certain key clients who may thereby be able to unduly influence its rating assessments. In demonstrating this, the ECAI will need to:

- a) submit the information related to previously rated entities where the ECAI received 10% or more of its annual revenue from a single client;
- b) submit documentation relating to instances where the ECAI received any compensation unrelated to its credit rating services from a rated entity, obligor, originator, lead underwriter or arranger; and
- c) provide evidence of procedures that are aimed at ensuring that fair and objective ratings are produced as part of the submission concerning organisational structure and corporate governance.

3.6.4. Upon approval, ECAs will be expected to disclose the required information noted in (a) and (b) above in a relevant credit rating report or in such other medium or manner as may be specified in writing by the PA.

3.7. Staffing expertise and training

3.7.1. The ECAI will need to demonstrate that it has sufficient resources and that the key staff possess the requisite skills levels to carry out high-quality credit assessments. This will involve the ECAI providing the following information (some of which may be subject to peer group analysis and benchmarking, if appropriate):

- a) information on the recruitment policies at different staffing levels;
- b) statistics on the number of analysts per rating in each product segment;
- c) statistics on the average number of years of rating experience per employee; and
- d) self-certification and evidence that the ECAI's training programme is of quality, regularity, staff attendance and relevance, all of which are needed to ensure ongoing analyst quality.

4. Ongoing Review

- 4.1. The PA will undertake ongoing assessments of ECAs that have obtained the prior written approval of the PA to act as an eligible institution to ensure that the ECAs continuously meet their eligibility criteria contemplated in regulation 51 of the Regulations.
- 4.2. ECAs that have obtained the prior written approval of the PA to act as an eligible institution will be required to:
- a) inform the PA of significant changes in their rating methodologies;
 - b) inform the PA 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;
 - c) immediately notify the PA 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;
 - d) demonstrate that their ratings are reviewed on at least an annual basis and that there is a 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 the results; and
 - e) inform the PA of instances where back-testing reveals a material change in rating accuracy or rating consistency. Eligible ECAs 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.

The above list is not exhaustive, and the PA may request additional information.