II Regional Conference Public Sector – Private Sector
The New Basel Accord. Work Progress:
The Use of External Credit Assessment Institutions (ECAI) Policy Options
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Introduction

I am not sure I am happy to be here or not, to discuss an aspect of Basel II for which there has been a lot of criticism -- the use of External Credit Assessment Institutions (ECAIs). But it beats being in Ottawa, where we broke records recently for cold temperatures. And Antonio is here to answer the tough questions.

As you may know, the Basel Committee met in mid-January and decisions were taken to allow continued progress toward Basel II, with mid-2004 still being the goal.

We are pleased to see the warm reaction to various changes made by the Basel Committee to CP3 over recent months. At the October meeting in Madrid, the Committee responded to a major concern regarding whether capital charges for credit risk should be based on unexpected loss and expected loss, by dropping the expected loss component. At the mid-January meeting, we responded to major industry concerns about securitization. Over the course of many meetings we have tried to assess and deal with a great many issues and for the most part the response has been positive.

But there are still criticisms. One long-standing criticism has been directed at the use of ECAIs in the standardized approach for credit risk, with some saying that the "whole approach should be scrapped".

Today I want to deal with the major points that have been raised regarding the downsides of using ECAIs, and the Committee's response to this difficult issue.

Concerns Raised Regarding use of ECAIs

Point one: It has been said that it is unwise to rely on the credit rating agencies to determine risk weights under the standardized approach, as there is no regulation of these agencies, and there are questions about their competence, independence, and motives. It has been suggested that Basel II will make problems identified with rating agencies even worse – that eligible ECAIs will have the Basel seal of approval.

Response: The Basel Committee has given a lot of consideration to this issue.

I think we would all agree that it makes sense to move from Basel I's rigid system to a more risk-sensitive system. The question is how to do this. Despite shortcomings, ratings continue to be the best available measure. The standardised approach uses a broad range of risk weights as a method of distinguishing credit risk. They are intended to be more indicative of degrees of credit worthiness. While not perfect the Committee still believes it is an improvement, for example, from the existing OECD "club rule".

So rather than dropping the approach, we focused on safeguards. In particular, the Committee spent a lot of time developing ECAI eligibility criteria. Some of the most meaningful criteria we developed are those that include a number of output-related measures, such as the requirement for an ECAI to disclose the actual default rates experienced in each assessment category, as well as the transitions of assessments (the likelihood of AA ratings becoming A over time).

Will Basel II exacerbate concerns about ratings agencies? Instead of agreeing with this statement, as some have, another way of looking at it is that, due to the increasing use of ratings, rating agencies will focus even more attention on their procedures, disclosure, and reputations. This will be to the benefit of the market place. Greater reliance on ECAIs can lead to even greater responsibility on the part of ratings agencies.

Point 2: Rating Agencies do not have a great track record with respect to sovereigns and, in addition, the standardized approach links the rating of a bank with the rating of its sovereign, which could favor weak banks operating in strong jurisdictions.

Response: I think we can all agree that Basel I's club rule, whereby all OECD countries are risk weighted at 0, has little risk sensitivity and is also unfair to many countries. Basel II has to be better for non-OECD countries as it provides more opportunity for their quality to be recognized in the marketplace.

I would also note that sovereigns often borrow from major international banks, which will typically be on the advanced internal ratings based approach, where external ratings are not as relevant. All sovereigns, whether rated or not, will have the opportunity for their quality to be recognized, which is an improvement. If a sovereign borrows from one of its own banks in its own currency, the exposure will be risk weighted at zero.

In recognition of the light market penetration of the major rating agencies the Committee has incorporated the recognition of country risk scores assigned by Export Credit Agencies (ECAs). Banks may use the risk scores published by individual ECAs recognized by national supervisors or the consensus risk scores published by the OECD in the "Arrangement on Guidelines for Officially Supported Export Credits". This will allow for greater ratings coverage for sovereign exposures.

As for the decision to link the credit rating of a bank with the credit rating of the sovereign, this is simply a continuation of the current practice under the 1988 Basel Accord. The principle applied being no bank can be better rated than its sovereign where it is incorporated and it treats all domestic institutions on the same plane. Since it was noted that this method does not take full advantage of the market information to distinguish credit quality of banks a second option is available to Supervisors to apply a risk weight associated with the external rating of the bank.

Point 3: Unrated banks and corporations carry a lower risk weight than that assigned to banks and corporations with a rating below B-. This creates an incentive for weak entities not to get a rating.

Response: This point focuses on one side of the argument – the weak entity that gets an advantage by not being rated. Very few commentators focus on the very high quality entity that does not have rating. Should such high quality entities be assigned a higher risk weighting simply because they are unrated? That would also have elicited considerable comment as well.

The Committee decided on balance that it would be better to place all unrated entities in the 100% bucket. While some might say that low quality credits might benefit as a result, it is important to note that supervisors are expected to be aware of the quality of loan portfolios and this may mean adding to minimum required capital generated by pillar 1. So weak unrated entities should not benefit if supervisors and banks are doing their job, and high quality entities should not be hurt simply because they don't have a rating.

To be clear, Basel II does not delegate responsibility of standardized banks, and their supervisors, to rating agencies. In addition, the various QIS exercises have demonstrated that only a small portion of bank exposures are actually rated and to substantially change current risk weights would have an undesired impact on the overall capital levels.

Point 4: Small and medium enterprises are typically unrated. There is a lack of clear definitions allowing people to distinguish between small and medium enterprises and retail loans.

Response: The Committee has created a retail category that includes SME , as defined for standardised banks that will attract a 75% risk weight. SMEs are typically not rated so this is beneficial to SMEs that would under the current Accord receive a 100% risk weight.

It has been noted that in some countries there is a much higher correlation in the probability of SMEs running into trouble than in more diverse economies. If this is a widespread view in a region, the regional supervisors could make it clear that the SME risk weights will be 100% and the experience will be monitored to see if a lower rate is justified in the future. Alternatively, effective use of Pillar 2 to ensure that a 75% risk weight does not give inappropriate reductions in capital for SME portfolios that have sector or regional concentrations is an option. Countries must adapt the minimum requirements of the Accord to their circumstances.

Conclusion

In conclusion, much of the comment on Basel II – including use of ECAIs -- focuses on pillar 1. But the marked improvement in risk management and controls for banks that is envisaged by Pillar 2, as well as the increased transparency implied by pillar 3, are

incredibly important - -some have even said they are more important. Think about it - - for the first time in history the Basel Committee members themselves are discussing, through the Accord Implementation Group, how they are sizing up banks and supervising. This discussion is very different from agreeing on formulas and risk weights. It is in this area where real progress will be made to strengthen financial institutions and systems.