Moody's Investors Service

May 30, 2001

Comment on the Second Consultative Package of the New Basel Capital Accord

Moody's broadly supports the proposals contained in the second consultative package of the New Basel Capital Accord (the New Accord) and commends the Basel Committee on Banking Supervision (the Committee) for its efforts. The New Accord is composed of three mutually reinforcing pillars: minimum capital requirements, a supervisory review process and the effective use of market discipline.

Our comments are focused primarily on the first pillar, minimum capital requirements. We believe that these requirements will promote greater efficiency and stability in the international financial markets by expanding the range of risks subject to systematic measurement, by refining the risk weights applied to bank assets, and by rewarding greater sophistication in risk management practices.

Under the New Accord, minimum capital charges for a bank will be assessed according to its exposure to credit risk, market risk and operational risk. The Committee has provided two alternative methods for calculating the regulatory capital required to offset credit risk. The Internal Ratings-Based (IRB) Approach is to be used by financially sophisticated banks, while the Standardised Approach to Credit Risk is available for those banks that are as yet unable to implement internal methods for credit risk assessment.

It is clear that third-party ratings can play a useful role in defining risk buckets under the Standardized Approach, and we understand the benefits for regulators of using such inputs to the risk-measurement process. However, there may be unintended consequences arising from such regulatory use of ratings.

In particular, the use of ratings within a regulatory regime could erode rating agency objectivity as a result of regulatory influence and rating shopping. While the systemic benefits arising from the use of ratings in regulation may outweigh such risks, we would suggest that any such regime should seek to mitigate these risks where possible. In particular, there is a risk that the national ECAI recognition process could be used to reward and punish rating agencies for their ratings. Ideally, we would argue for a centralized, global process housed within the Committee. Failing that, we would request that the Committee establish clear and fair recognition criteria that emphasize the quality of an ECAI's ratings. Quality measures should include an analysis of the *outputs* of the

ratings process – based on default studies and transition matrices – rather than relying only on inputs, such as practices and rating methodologies. Such measures would contribute to maintaining the independence and objectivity of ECAI's and the integrity of the risk measurement process established by the New Accord.

We would also like to encourage uniform standards for an ECAI's objectivity, independence, international access/transparency, disclosure, resources, and credibility. Public availability of ratings is an important component of transparency, especially when combined with the publication of an historical record of defaults, by rating category and time horizon, and publication of transition matrices.

We further encourage supervisors to become conversant with the various rating systems used by an ECAI to indicate risk. For example, potential ECAIs may publish foreign currency ratings, local currency ratings, financial strength ratings and national scale ratings. Although each rating system is designed to meet the needs of market participants, supervisory needs may differ.

Although the Committee recommends that eligible ECAIs designate certain ratings as unsolicited, we have concerns regarding the proposed definition. Today, it is standard practice among established credit ratings agencies to offer issuers an opportunity to meet with their analysts, and in most cases, issuers take advantage of the opportunity. However, the frequency of contact, as well as the utility of the information disclosed, varies from one issuer to another. In some cases, management chooses to disclose only information that is available in the public domain. Therefore, we would appreciate a clarification of the type of relationship that warrants an "unsolicited" designation.

Finally, Moody's commends the Committee's efforts to reduce incentives that favor "rating shopping." Recognition of the second highest rating, when multiple ratings are assigned, represents a balanced response to the problems of rating shopping because incentives for inappropriate practice are diminished.

We thank the Committee for providing an opportunity to respond to its latest proposal. We look forward to an open and active discussion – one through which we contribute to the success of the Basel process.