Comment of Companhia Portuguesa de Rating, S.A. on "Strengthening the resilience of the banking sector – consultative document"

1. Introduction

Following the replies given by Companhia Portuguesa de Rating, S.A. (CPR) to the consultative papers on the revision of capital requirements applicable to credit institutions (CIs) and securities firms (SFs) at international level in general, and in the European Union in particular (Basel II consultative documents), CPR agrees on the whole with the main objectives of this revision of those rules through the document "Strengthening the resilience of the banking sector – consultative document" (the Document).

However, we would like to put forward a few suggestions regarding changes that could be introduced in the Document in the area of the use of ratings, which would improve it and pre-empt the need for its early or frequent revision, an inconvenient for all parties concerned. For systematisation purposes, we have opted in some cases for repeating our previous comments when there were no significant changes, but we insist that these aspects are, from our point of view, very relevant.

2. Many negative incentives from the use of external ratings under Basel II rules

Differentiated Treatment of Central Government Risk, CIs, SFs, Local Authorities, Public Sector Entities (PSEs) and Corporates,

Preferential Treatment of Unrated Assets,

Treatment Based on Central Government Risk,

Non Differentiated or Excessively Differentiated Treatment Between Different Rating Levels and

Differentiated Treatment According to Original Maturity of the Claim

On top of the negative incentives arising from the use of external ratings to determine regulatory capital requirements identified by the Committee (paragraphs 179 to 182 of the Document), CPR already called the attention to several other similar negative incentives in

Basel II rules.

Present Basel II rules have a different treatment for claims of CIs and SFs on Central Governments, CIs, SFs, Local Authorities, PSEs and corporates. From the standpoint of a rating agency (CPR included) there is no reason why the ratings assigned to these three categories of issuers should not be directly and fully comparable amongst them, both in terms of the risk of default and in terms of recoverability in case of default. Hence it is CPR's opinion that such differentiation between different categories of issuers should not exist.

In addition, such differentiation could lead to the arbitrage of risk premia, causing the misrepresentation of the entities that appear as façade issuers as a way of obtaining funds for the true issuers (e.g. Central Governments requesting loans to support CIs, SFs, Local Authorities, PSEs and corporates, or else CIs, SFs, Local Autorities and PSEs requesting loans to support corporates), and in turn leading to an increase in the credit risk of Central Governments and CIs, SFs, Local Authorities and PSEs entering this type of arbitrage (just think about what happened in Iceland).

Note also that it is currently the general opinion amongst rating agencies that, in the specific case of the Economic and Monetary Union (EMU), a given issuer (CI, SF, Local Authority, PSE or corporate) may have a lower credit risk (i.e., a better rating) than the Member State where that issuer is incorporated, though it cannot, in principle, have a lower credit risk than that of the European Central Bank / European System of Central Banks (ECB / ESCB), the entity with monetary powers in the referred geographical area (and which for this purpose must be considered as the true "sovereign"), as used to be the case of CIs, SFs, Local Authorities, PSEs and corporates in a given region (a Portuguese city, for instance) relative to that region and the State where that region was included. To be more specific, before Portugal joined the EMU, a company registered in Lisbon could have a higher rating than the Lisbon municipal authority but not higher than that of the Portuguese Republic. This methodological aspect should be taken into account when defining "Central Government", which, in the case of EMU Member States , and for this purpose, should be the ECB / ESCB and not the respective Member State.

Under the standardised approach, present Basel II rules impose the following risk weights for the various claims, according to the ratings assigned:

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Credit quality step	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	Below B-	Unrated
Central Government (1)	0%	20%	50%	100%	100%	150%	100% (2)
CIs, SFs, Local Authorities and PSEs – Option 1 (3) (4)	20%	50%	100%	100%	100%	150%	< or = to 100% (2)
CIs, SFs, Local Authorities and PSEs – Option 2 (4)(5)	20%	50% (6)	50% (6)	100% (6)	100% (6)	150%	50% (2) (6)
Corporates	20%	50%	100%	100%	150%	150%	100% (2)(7)(8)

(1) At national discretion a lower risk weight may be applied to banks' exposures to their Central Government of incorporation, denominated in domestic currency and funded in that currency.

(2) Or 150%, if the issuer's short-term rating implies a short term risk weight of 100%.

(3) Risk weight based on the risk weight of the Central Government where the CI, SF, Local Authority or PSE is incorporated or established.

(4) At national discretion claims on domestic Local Authorities may be treated as claims on the Central Government in whose jurisdiction the Local Authorities are established. At national discretion PSEs may be treated according to either option or be given a 100% weight. No CI of SF may have a lower risk weight than that of the Central Government of its incorporation.

(5) Risk weighting based on the rating of the CI, SF, Local Authority and PSE.

(6) Claims with an original maturity of 3 months or less would be assigned a risk weight one category more favourable than that assigned to long-term claims of the same CI or SF, this rule not applying to PSEs.

(7) Or higher, at the discretion of supervisory authorities, according to the overall default experience in their jurisdiction.

(8) No unrated company may be assigned a lower risk weight than that assigned to the Central Government of its incorporation.

These rules have deserved from CPR the following comments and suggestions, which were not previously considered, and that we feel should be reconsidered:

- Behind the establishment of the same or lower risk weights for unrated claims as for claims with low ratings, we perceive the intention of not penalising CIs, SFs, Governments, Local Authorities and PSEs of countries as the ones of the European Union, where the rating activity was a few years ago not much divulged and widespread. However, this choice:

  - only helps perpetuate the backwardness of such countries, insofar as it encourages the non-disclosure of ratings below BBB- (in the case of Central Government risk), below AA- (in the case of CIs, SFs, Local Governments and PSEs – option 2) and below A- (in the case of risk of CIs, SFs, Local Authorities and PSEs - option 1, and of corporates); this becomes particularly serious when a 50% risk weight is assigned to the unrated liabilities of CIs, SFs, Local Authorities and PSEs – option 2, where it is preferable not to be rated than to have a BB+ rating, and the same may happen (starting with a BBB+ rating) when a risk weight of less than 100% is applied to the unrated liabilities of CIs, SFs, Local Authorities and PSEs – option 1; hence, in this specific case, CPR suggests that the risk weight for unrated issuers and issues in CIs, SFs, Local Authorities and PSEs – options 1 and 2, be set at at least 100%, as is the case for Central Government risk and the risk of unrated corporates.

  - encourages concentration of credit in higher risk claims as a way of boosting profitability out of the same level of capital, in so far as the credit risk /default rises exponentially with the rating's deterioration, and hence inevitably affects the solvency of these countries' CIs and SFs and the strength of their financial systems (doesn't this sound familiar nowadays?).

  It is therefore CPR's opinion that the alternative should be to penalise unrated claims, or at least to risk-weight them by the highest weight established for the lowest rated claims. This may be done either by:

  a) rising the risk weight for unrated claims to a minimum of 150% in all cases; or

  b) reducing the risk weight for higher risk rated claims to a maximum that would be equal to the risk weight used for the same category of unrated claims, as a way of encouraging the widespread practice of rating claims.

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This is actually the spirit behind the rules already existent for short-term claims, and therefore it is not clear why the same rationale was not followed in the initial Basel II rules for medium and long-term claims.

If this approach cannot be adopted immediately, at least the referred approach of not penalising right away unrated issuers should be viewed and clarified as being temporary, and a deadline of, say, two years be established, after which unrated claims would be penalised, or at least risk-weighted using the same weight established for the lowest-rated claims, as a way of encouraging the widespread practice of rating claims.

This is actually the approach implicit in Basel II rules concerning the treatment of capital requirements to cover securitisation exposures, which establishes a risk weight of 350% for exposures with credit quality between BB+ and BB- and deduction from capital (i.e., a risk weight of 1250%) for credit quality below BB- (medium and long term) or A-3 (short term) or unrated short or medium and long-term exposures - these risk weights being much higher than those used for claims with an immediately lower risk (respectively 100%, 350% and 100%).

Moreover, the dissemination of the rating activity as a way of ensuring the transparency and development of financial markets in countries less advanced in this area should be promoted through legal and/or regulatory channels, as has been happening for a long time and in a widespread manner in the United States of America, and to a lesser extent in other markets (France, for instance). In Portugal and in other countries of the EMU any steps taken in this direction were still quite timid.

- Basel II rules on CIs, SFs, Local Authorities and PSEs – Option 1 do not seem to make sense when the aim is to promote the strength of domestic and international financial systems. These rules, based on the Central Government rating where the CI, SF, Local Authority or PSE is incorporated or established, deserved in the past from CPR the following criticisms:
  - it assumes that each Central Government supports the CIs and SFs incorporated in that sovereign, when the international trend is for an increasingly strengthening of the resilience of banks and the banking sector, to avoid the need of such intervention from Central Governments in CIs and SFs so as not to bias international-level competition among CIs and SFs;
  - even though some level of support by Central Governments to the bigger CIs

registered in those states is admissible, the same does not seem plausible in regard to smaller CIs and to SFs in general, as was patent even in the recent crisis;

- in either case, implicit support by the Central Government to the CIs, SFs, Local Authorities and PSEs incorporated or established in that sovereign cannot but affect the rating of the Central Government itself, penalising its entire financial system and motivating possible incorporation arbitrages of CIs and SFs (which will seek to move their headquarters to lower credit risk sovereigns) and/or unfair competition based on the place of incorporation; to give you an example, Portuguese CIs and SFs may decide to relocate their headquarters to Spain if a difference between ratings in the two countries, even a marginal one, leads to a completely different risk weighting of claims issued by CIs and SFs in each of these countries; note that this is not a merely theoretic hypothesis considering the current ratings of these two countries: it would suffice for a marginal downgrading of the rating of the Portuguese Republic and the risk weights for banks incorporated in Portugal would be 50%, which would compare with 20% for banks incorporated in Spain; on the other hand, banks registered in Spain would originate lower capital requirements in their counter parties, and therefore gain better financing conditions than Portuguese banks with a similar risk profile – thus raising the question of unfair competition based on place of incorporation;
- by benefiting CIs and SFs with poorer credit risk (their liabilities being favoured by a lower risk weight) and harming CIs and SFs with lower credit risk (their liabilities being penalised by a higher risk weight), it once again encourages the incorporation arbitrage of CIs and SFs - ultimately, countries with poorer ratings would lose their attraction as an incorporation location for CIs and SFs, and their financial systems would be made up of CIs and SFs incorporated in other countries;
- in the specific case of the EMU, the relevant sovereign risk (recognised by the various rating agencies at national and international level) is the risk of the monetary authority in that space (ECB / ESCB, whose medium and long-term rating is currently AAA), and not the risk of each EMU member country (in the case of the Portuguese Republic, it is rated between AA and A+); i.e., the rating ceiling for any Portuguese entity, be it a corporate, a CI, an SF or any other, is currently AAA rather than between AA and A+, and therefore setting the risk weight for CIs and SFs based on the rating of the Central Government where the CI or SF is incorporated does not

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make any kind of sense in terms of actual risk, unless the ECB / ESCB is deemed as being Central Government for all companies registered in the EMU.

As a case in point, note the following:

- Lehman Brothers, even after the problems it was struggling with had become public knowledge, received, under Basel II rules, the same risk weight (20%) as the current risk weight of the Portuguese Republic (assuming the A+ rating) and a better one than that currently assigned to Caixa Geral de Depósitos (50%), the largest Portuguese CI, fully owned by the Portuguese State;
- the liabilities of a Greek bank with a rating below B-, instead of receiving option 2's 150% risk weight, receives, under option 1, a 50% or 100% risk-weight (in accordance with Greece's rating between A and BBB-) or a 20% risk-weight (in accordance with the ECB / ESCB rating) while the liabilities of a company rated BBB+ are weighted at 100%.

Additionally, the existence of two treatment options for CIs, SFs, Local Authorities and PSEs creates a distortion in the treatment given to similar institutions in different countries, once again leading to incorporation arbitrage of CIs and SFs. Hence, CPR maintains that only one of the two options should be allowed, and that this should be option 2 and never option 1 (keeping the two options would actually be better than choosing option 1, such are its inconsistencies).

- Behind the setting of only 5 risk-weighting levels (0%, 20%, 50%, 100% and 150%), we perceive the intent of not making the system unduly complex. But on the other hand this establishes a very wide differentiation / discrimination between ratings that are only marginally different (e.g., from 20% to 50% in the risk of corporates, when the rating goes from AA- to A+, or from 50% to 100% in the risk of corporates when it goes from A- to BBB+), as opposed to no discrimination between substantially different ratings (e.g., between BBB+ and B- for CIs, SFs, Local Authorities and PSEs - Option 1). In fact, those abrupt points of change in risk weights can actually trigger liquidity crisis in the issuers (especially in the more vulnerable ones), and affect the strength of financial systems (as the present Greek situation illustrates): in summary, cliff effects do not apply only to eligible guarantors (which led to the new proposal of paragraph 195 of CRM rules for Standardised banks / paragraph 198 of the Document), but much more importantly, to all issuers and issues.

The exponential increase of risk weights as ratings decline makes all the more sense if considering that the risk of default has statistically followed that historical trend.

To sum up all these comments, it is CPR's opinion that it would be preferable to adopt a single schedule of risk weights for all categories of issuers, in which risk weights would suffer higher increases as risk increased. Exponentiality would be maintained and unrated assets penalised, or at least placed on an equal footing in terms of risk weighting as higher-risk claims. As an example, we suggest a risk-weight schedule on the following model:

AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-	< B-	Unrated
20%	25%	30%	35%	40%	45%	50%	55%	60%	65%	75%	85%	95%	110%	125%	140%	150%	150 or 180%

or

AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-	< B-	Unrated
20%	22%	24%	26%	28%	30%	32%	34%	37%	40%	45%	50%	57%	65%	75%	87%	100%	100 or 150%

The rule of considering the immediately lower level risk weight in the case of claims on CIs and SFs of a short-term original maturity (in the cases indicated above) could still be applied within our suggestion, providing, once again, that there is no discrimination between the various categories of issuers. Also, this lower risk-weighting should probably be limited to lower risk claims (for instance, those with credit quality not lower than A-1), so as not to encourage claims' maturity arbitrages, which would affect the issuers' liquidity risk and necessarily reflect on the overall credit risk level of CIs and SFs.

Another way of discouraging (or at least of diluting) this maturity arbitrage (and of doing it consistently with existing statistics, which demonstrate that risk is cumulative as the claim's duration increases) would be to weight credit risk weights by maturity weights, while maintaining the restriction of doing it only for better risks (e.g., the credit risk weights would be weighted at 75%, 80%, 85%, 90%, 95% and 100% for claims with an original maturity of respectively under 1 year, 1 to 2 years, 3 to 4 years, 4 to 5 years and more than

5 years).

The fact that unrated claims of an original maturity of 3 months or less on CIs and SFs with rated medium and long-term claims receive under option 2 a risk weight one category more favourable than that assigned to long term claims of the same CI or SF, and that these risk weights may be lower than those that would be given directly to those short-term claims if they were rated, also leads to the non-disclosure of ratings for those claims. This can be avoided if it is established that the risk weight to be applied would be the best one obtained under the two methods, this rule also serving to encourage the extension of the ratings assigned to claims of either maturity.

3. Non-solicited “ratings” and scorings

Lately CPR has became aware of some grey aspects of several pieces of legislation that may lead to the consideration of scores as true credit ratings in legislation worldwide.

Although being valuable instruments for certain credit decisions, scores are measures completely different from ratings:

	Ratings	Scores
Information	Both public and confidential / private	Just public
Analysis	Very deep	None or very limited
	Solicited	Typically unsolicited
	Including access to the board	No access to the issuer
Focus of the analysis / model	Future	Past performance
Type of analysis	Quantitative and qualitative (with a great emphasis in this last one)	Quantitative or mainly quantitative
Time to make analysis	Typically from 200 to 800 hours or more	Up to a few hours (but normally less than an hour)
Number of annual opinions per analyst	Up to 20	Several hundreds to thousands
Access to the credit opinions	General public (sale of the report)	Private or by subscription
Price	Several dozens of thousand of euros	A few euros up to some hundred euros
	Paid by the issuer	Typically paid by the user / investor
Target entities	Soberan states, medium and large corporates and financial firms, public finance, structured products	Micro and small companies
Amount of each issue rated	Typically more than 10 million euros	Typically thousands of euros or a few millions of euros

THE USE OF SCORES AS TRUE "RATINGS" SHALL LEAD TO A CONFUSION OF THE MARKETS THAT WILL HAVE MUCH BIGGER CONSEQUENCES THAN THE ONES THAT ORIGINATED THE PRESENT WORLD CRISIS. CAN YOU IMAGINE MARKET PARTICIPANTS USING SCORES OF BARCLAYS, EDF, TELECOM ITALIA, THE UNITED KINGDOM OR DEUTSCH BANK AS TRUE "RATINGS" OF THESES ENTITIES?

The same underlying logic should be applied to unsolicited "ratings", due to the enormous difference there is between solicited and unsolicited ratings. In fact, the difference between solicited and unsolicited ratings is far more important than being paid or not being paid by the issuer.

Unsolicited "ratings" have two very important setbacks that should be considered:

- they are not performing one of the priority objectives / functions of a rating: to reduce information asymmetries between issuers and investors; in fact, as unsolicited "ratings" are based on public information only, they are only capitalizing on economies of scale (which is another very important function of ratings), but they are not considering all the private information considered in a solicited rating (direct access to information from meetings with the board of directors, shareholders' agreements, clients and suppliers identification and concentration analysis, long term agreements with clients and suppliers, financial contracts details, insurance details, long term strategy, budget and long term plans, forecasted investments, just to mention a few); how can, then, unsolicited "ratings'" quality as a timely capacity of full payment indicators be "not inferior in quality to the general quality of solicited ratings", as envisaged by the proposal for paragraph 108 of CRM rules for Standardised banks / paragraph 201 of the Document?
- because unsolicited "ratings" are typically not paid for by the issuer, they contain a strong potential for conflict of interest: CRAs can very easily be tempted to apply a discount to an unsolicited "rating" to force the issuer to contract with them the issuance of a (paid) solicited rating, and CRAs may, without authorization from the issuer, affect their image without having all the information needed to form a fair judgement of the timely capacity of full payment of the financial obligation being rated, which is very difficult to identify and even more difficult to prove, again as envisaged by the proposal for paragraph 108 of CRM rules for Standardised banks / paragraph 201 of the Document.

For these reasons, CPR believes that Basel II rules should not allow the use of any form of scores and unsolicited credit risk analysis (except may be for small and micro enterprises), since such types of credit risk analysis are simplified and automated (even though sometimes try to say they have some kind of qualitative analysis or opinion to overcame this) and/or lack access to all the information required to duly substantiate a definite opinion about credit risk, and in fact use methodologies that are substantially different from

(solicited) rating methodologies and only serve to provide an approximation to a rating opinion when, for one reason or another, a (solicited) rating is not available.

Unsolicited "ratings" and scorings have their place and utility to investors or other counter parties in analysis of small and micro enterprises of homogeneous sectors or as a rough approximation of (true) ratings, but should not be allowed to be used as true ratings, unless we want to welcome problems similar or greater than the recent ones in the credit rating of structured products (another case of completely different ratings used as if they were traditional ones).

Anyway, if, for any reason, the Committee wants to include scorings and / or unsolicited "ratings" in Basel II rules, then they must be considered apart from true (solicited) ratings, with specific mappings based on their specific characteristics and applied only when that may make sense (small and micro enterprises).

Kind regards,

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