



March 11, 2016

Via upload at www.bis.org/bcbs/commentupload.htm

Basel Committee on Banking Supervision
c/o Bank for International Settlements
CH-4002
Basel
Switzerland

Re: Comment on second consultative document “Revisions to the Standardised Approach for credit risk”

On behalf of Rating and Investment Information, Inc. (“R&I”), I appreciate this opportunity to comment on the second consultative document “Revisions to the Standardised Approach for credit risk” (the “Proposal”).

R&I, headquartered in Tokyo, Japan, is one of the largest rating agencies in Asia and is a respected independent source of financial information for investors, underwriters and other market participants in Japan as well as in overseas markets. R&I is registered as a Credit Rating Agency with the Financial Services Agency of Japan, and is recognized as an External Credit Assessment Institution for Basel III purposes in Japan as well as in Hong Kong. I hope that our comments will be of assistance to the Basel Committee on Banking Supervision.

R&I basically supports the general principles indicated in the Proposal. That said, R&I would like to comment on the following points.

* * *



“(a) External Credit Risk Assessment Approach” Paragraph 17 on Page 28

1-1 When credit rating agencies (“CRAs”) assign credit ratings on banks, the methodology to reflect government support on the bank credit ratings varies among CRAs. For example, the major US CRAs adopt a methodology where they determine the final bank credit ratings by first assigning stand-alone credit ratings without government support to the banks, and then lifting them up according to the degree of the government support. Therefore, US CRAs have two types of bank credit ratings i.e. stand-alone credit ratings and credit ratings with government support. On the other hand, R&I does not adopt such methodology.

1-2 R&I’s rating methodology on banks has been consistent since the end of 1990s. Under R&I’s methodology, there are very limited cases where government support is reflected on bank credit ratings. In countries where deposits and senior debts are strongly protected, government support may be reflected on bank credit ratings when stand-alone credit ratings are, for example, at certain levels at or below BB. In other words, R&I considers government support as the floor of bank credit ratings. On the other hand, in countries where bank senior debts are subject to bail-in, R&I does not reflect government support on bank credit ratings. This methodology of R&I reflects its views on bank credit analysis as follows:

- (1) The objective of government support is not the protection of individual banks, but the avoidance of the systemic risk. To achieve this objective, government support is extended to the banks whose credit worthiness deteriorated substantially. Government support should not be used to enhance the creditworthiness of sound banks any further.
- (2) Government support is actually enforced when the credit worthiness of a bank deteriorated substantially to the point of non-viability.
- (3) Government support is extended only temporarily and will be withdrawn when the stand-alone creditworthiness of the bank recovers.

R&I’s methodology as described above is consistent with the views of the financial authorities of major countries who have strong will to stop Too-Big-To-Fail and are implementing several measures to make it happen. R&I’s bank credit ratings are well understood and used by the users of credit ratings. For these reasons, R&I does not make available stand-alone credit ratings nor credit ratings with government support.

1-3 R&I believes that the Proposal was prepared in reference to the methodologies adopted by the US major CRAs. However, as discussed above, the approach to the bank creditworthiness varies globally, therefore a proposal solely relying on one



particular type of methodology is not appropriate. Should the Proposal be adopted as it is, CRAs including R&I that do not have a concept of stand-alone bank credit ratings (bank credit ratings that do not consider government support) and therefore do not provide such ratings would be forced to accept a methodology and a rating system that are entirely different from those such CRAs have adopted, in order to provide bank credit ratings that would qualify under the new Basel rule. This would mean that the new rule would force CRAs to adopt a particular type of methodology and amend their existing methodologies or rating systems as, otherwise, credit ratings of those CRAs would not be accepted by the market. This would cause unfair competition in the credit rating industry as the CRAs with credit ratings that would suit the new Basel rule would become more useful and more competitive.

- 1-4 What is essentially important for the sound development of the capital market and the avoidance of the systemic risk is that there are a variety of views on the credit risk. Especially for the avoidance of the systemic risk, an important factor is that there are several views in the market not only on credit risk but also on several other matters. Under the current CRA regulations in the US, Europe and Japan, one of the very important principles is that the regulatory authorities should not interfere with the content of the credit ratings. They should allow different views to exist and, thus enhance sound competition among the CRAs. However, the Proposal would impair the diversity of the views that CRAs provide to the market as it would effectively force CRAs to adopt one particular view on the credit risk as we discussed in 1-3 above, and create unfair competition among the CRAs. R&I believes that the Proposal on the risk weight of bank exposures would hinder the sound development of the capital market and the avoidance of the systemic risk.
- 2-1 R&I believes that it is not appropriate for the Basel Committee to adopt the Proposal as it is based on R&I's basic understanding of the Proposal described above. However, should the Basel Committee decide to use bank credit ratings without government support, a technical but very important problem would arise: The financial authority of each country would find it very difficult to conduct the mapping of evaluation of each external credit assessment institution ("ECAI") and the risk weight on the same terms as traditional credit ratings.
- 2-2 The traditional method of mapping credit ratings is to compare the default rate of each rating category of an ECAI with the benchmark level designated by the authority in order to secure objectivity. The high level of objectivity is secured as the benchmark designated by the authority is produced based on the default rate of each rating category for the past 20 years.



On the other hand, unlike traditional credit ratings, credit ratings without government support cannot be mapped based on the historical data of the default rate of each rating category, as ECAIs including R&I that do not have credit ratings without government support do not possess historical data of default rate of such credit ratings which are to be compared with the benchmark. In reality, when a bank falls into bankruptcy, government support is enforced in one way or another, therefore credit ratings without government support are simply hypothetical things. Even the default rate data of those ECAIs which assign credit ratings without government support are hypothetical too, or they should not have enough track record. Therefore, the authorities should not be able to compare the level of default rate with objectivity.

2-3 The benchmark designated by the authorities itself is produced from the default rate of traditional credit ratings, and not from the default rate of credit ratings without government support. If there were banks in the past which were in lower categories of stand-alone credit ratings, and escaped from bankruptcy due to government support, the default rates of those categories might have been lower than traditional credit ratings. Therefore, the benchmark with respect to the traditional credit ratings cannot be applied here.

3-1 As a final comment, we would like to point out the impact it would have on the management of each ECAI if the Basel Committee should decide to use credit ratings without government support. Those ECAIs including R&I that do not provide credit ratings without government support would be forced to choose either to maintain their existing evaluation systems as they are, or to accept a methodology that would not conform with their own methodologies in order to provide credit ratings that would qualify under the new rule. Should they decide to alter their existing evaluation systems, the cost associated with it would be enormous as they would first need to consider how they would position the new evaluation system in their existing credit rating methodologies for financial institutions including banks, and then to reorganize the entire evaluation systems including, among others, definitions of category and default, rating methodologies, method of providing credit ratings, and method of calculation of default rates. This would be a big burden for smaller and less cost competitive CRAs. On the other hand, the large US CRAs would incur only little additional cost as their existing methodologies are already in conformity with the new Basel rule. In this way, the introduction of credit ratings without government support would position smaller CRAs further less competitive than the large US CRAs, and result in stronger oligopolistic control by the large CRAs, which would affect the quality of credit ratings. It is understood essential that the quality of credit ratings is



improved through increased competition among CRAs and new entry by cultivating smaller CRAs. To force smaller and less cost-competitive CRAs to bear excessive burdens or to prevent new entry by smaller CRAs would be contradictory to the principles of the CRA regulation of each country or area that are developed based on the above understanding.

“1. The recognition process” paragraph 83 on page 42

It is not clear what the phrase “all criteria and conditions” in line 7 refers to. Judging from the context, it can be interpreted either as “the criteria listed in paragraph [84]” in line 4, or as “the criteria and conditions provided in the *IOSCO Code of Conduct Fundamentals for Credit Rating Agencies*” in lines 4 to 5.

If it is interpreted that the phrase refers to “the criteria and conditions provided in the *IOSCO Code of Conduct Fundamentals for Credit Rating Agencies*”, the ECAI recognition process based on such interpretation is not appropriate due to the reasons below. In order to prevent such interpretation, R&I respectfully requests that the Basel Committee explicitly clarify that the phrase “all criteria and conditions” refers to “the criteria listed in paragraph [84]”.

IOSCO recognizes that there are different market, legal and regulatory circumstances in which CRAs operate, and the varying size and business models of CRAs, and requests CRAs to disclose their own code of conduct, which are developed in line with the *IOSCO Code of Conduct Fundamentals for Credit Rating Agencies* (the “*IOSCO Code*”) to the extent possible. If a CRA’s code of conduct deviates from the *IOSCO Code*, the *IOSCO Code* requests that the CRA should explain where and why these deviations exist, and how any deviations nonetheless achieve the objectives contained in the *IOSCO Code* and the *IOSCO Principles Regarding the Activities of Credit Rating Agencies*. Under this so-called “comply or explain” self-regulatory framework, each CRA develops and implements its individual code of conduct which reflects the spirit of the *IOSCO Code* to the extent possible as well as the situation of each country.

For example, clause 2.8a of the *IOSCO Code* (May 2008 version) states, “Where a CRA receives from a rated entity compensation unrelated to its ratings service, ... , a CRA should disclose the proportion such non-rating fees constitute against the fees the CRA receives from the entity for ratings services.” R&I, in clause 2.8a of its own code of conduct, explains that R&I does not disclose the amount of revenue received from specific issuers because revealing the identity of clients of a credit rating agency may unnecessarily reveal confidential business secrets of the agency and implicate the



privacy concerns of its clients. R&I understands that the purpose of article 2.8a of the IOSCO Code is to request CRAs to disclose over-dependence on the increasing proportion of non-rating fees for particular clients relative to the fees received for rating services as a potential conflict of interest, and discloses in its code of conduct, as an alternative to clause 2.8a of the IOSCO Code, that R&I has instituted policies and procedures to limit the percentage of total revenues that R&I receives from issuers who generate the highest amounts of income for R&I, and R&I discloses on its public website the overall proportion of non-rating fees relative to the fees received for rating services.

Just like the Basel Committee, which aims to make its new rule consistent with the IOSCO Code, the supervisory authority of each country or area established the framework of its own CRA regulation to comply with the IOSCO Code to the extent possible, so that the framework become consistent with those of other countries. However, in detail, the CRA regulation of each country or area is based on the market, legal and regulatory circumstances of each country or area, and pays regard to the code of conduct developed by the CRAs in each country or area which took into account the individual situation of the country or area. As a result, the CRA regulation of each country or area is generally consistent with the IOSCO Code, but some of the individual clauses do have some deviations from the IOSCO Code. Consistency with the IOSCO Code does not mean full compliance with all the clauses of the IOSCO Code.

The IOSCO Code is not meant to be fully complied with by the code of conduct of the CRAs, or by the CRA regulations of each country or area, nor should it be interpreted as such in practice. Therefore, if the banking authorities of each country should interpret the phrase “all criteria and conditions” in paragraph 83 of the Proposal as referring to “the criteria and conditions provided in the *IOSCO Code of Conduct Fundamentals for Credit Rating Agencies*”, and implement the ECAI recognition process as such, it would not be appropriate as such ECAI recognition process would deviate from the spirit of the IOSCO Code and the CRA regulations of each country or area.

“2. Eligibility criteria - Independence” paragraph 84 on page 41

The Proposal states, “Furthermore, a CRA should separate operationally, legally and, if practicable, physically its rating business from other businesses and analysts.” under *Independence* in paragraph 84 on page 42. *R&I understands that this sentence refers to clause 2.5 of the IOSCO Code, which states, “A CRA should separate, ...its credit rating business and CRA analysts ... from any other businesses of the CRA ... that*



may present a conflict of interest.” However, the Proposal only says, “a CRA should separate ...its rating business from other businesses and analysts.” Therefore, the scope of the business that should be separated under the Proposal is larger than the scope of the business that should be separated under the IOSCO Code. As a result, there could be cases where the Proposal is not consistent with the CRA regulations of certain countries that are based on the clause 2.5 of the IOSCO Code.

For example, taking into consideration the aim of the clause 2.5 of the IOSCO Code, the Japanese CRA regulations, allow CRAs to run other lines of business so long as the CRAs implement measures to prevent other lines of business from unreasonably affecting the credit rating activities. R&I actually has lines of business other than its credit rating business, as it has implemented such measures.

In order to have the Basel rules, the IOSCO Code, and the CRA regulations of each country, which takes into account the aim of the IOSCO Code, consistent, R&I respectfully requests that the Basel Committee explicitly clarify that other businesses that should be separated from the rating business are “businesses that may present a conflict of interest”.

“2. Eligibility criteria – Cooperation with the supervisor” paragraph 84 on page 42

The Proposal has a new clause which specifically requires ECAIs to notify the supervisors of significant changes to methodologies under the eligibility criteria – cooperation with the supervisor in paragraph 84 on page 42. However, the treatment of significant changes to methodologies varies among the CRA regulations of each country or area.

Rating methodologies are the most important foundation of credit ratings. The CRA regulations of several countries or area stipulate that the content of credit ratings and rating methodologies should not be interfered. Therefore, the CRA regulations of each country or area take cautious approaches to the significant changes to rating methodologies, and the treatment varies.

For example, the Japanese CRA regulations require that, where a CRA intends to effect any material change to its rating methodology, it announce the fact that the change will be effected and an outline of such change in advance, but do not require the CRA to notify the supervisor of the change as set forth in the Proposal.

Therefore, R&I respectfully requests that the Basel Committee revise the language under “Cooperation with the supervisor” so that it would enable the supervisory authority of each country or area to treat significant changes to methodologies in



accordance with its own CRA regulations.

Should the language remain as it is, R&I respectfully requests that the Basel Committee explicitly clarify that the notice of significant changes to methodologies by CRAs to banking supervisors should be given only after the CRAs make such changes public. The EU CRA regulations require CRAs to notify significant changes to the European Securities and Markets Authority, but it is only after the CRAs announce planned changes to the market for public consultation.

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For further information or clarification regarding our comments, please feel free to contact me at htanaka@r-i.co.jp or Mr. Masahiro Kambe at mkambe@r-i.co.jp.

Sincerely,

A handwritten signature in blue ink, appearing to read "Hidetaka Tanaka", is written over a light yellow rectangular background.

Hidetaka Tanaka
Senior Executive Vice President
Rating and Investment Information, Inc.