

Basel Committee on Banking Supervision

CRE

Calculation of RWA for credit
risk

CRE21

Standardised approach: use
of external ratings

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Changes due to the December 2017 Basel III
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Recognition of external ratings by national supervisors

The recognition process

21.1 In jurisdictions that allow the use of external ratings for regulatory purposes, only credit assessments from credit rating agencies recognised as external credit assessment institutions (ECAIs) will be allowed. National supervisors are responsible for determining on a continuous basis whether an ECAI meets the criteria listed in [CRE21.2](#) and recognition should only be provided in respect of ECAI ratings for types of exposure where all criteria and conditions are met. National supervisors should also take into account the criteria and conditions provided in the International Organization of Securities Commissions' Code of Conduct Fundamentals for Credit Rating Agencies¹ when determining ECAI eligibility. The supervisory process for recognising ECAIs should be made public to avoid unnecessary barriers to entry.

Footnotes

¹ Available at www.iosco.org/library/pubdocs/pdf/IOSCOPD482.pdf.

Eligibility criteria

21.2 An ECAI must satisfy each of the following eight criteria.

- (1) Objectivity: The methodology for assigning external ratings must be rigorous, systematic, and subject to some form of validation based on historical experience. Moreover, external ratings must be subject to ongoing review and responsive to changes in financial condition. Before being recognised by supervisors, a rating methodology for each market segment, including rigorous backtesting, must have been established for at least one year and preferably three years.
- (2) Independence: An ECAI should be independent and should not be subject to political or economic pressures that may influence the rating. In particular, an ECAI should not delay or refrain from taking a rating action based on its potential effect (economic, political or otherwise). The rating process should be as free as possible from any constraints that could arise in situations where the composition of the board of directors or the shareholder structure of the credit rating agency may be seen as creating a conflict of interest. Furthermore, an ECAI should separate operationally, legally and, if practicable, physically its rating business from other businesses and analysts.

- (3) International access/transparency: The individual ratings, the key elements underlining the ratings assessments and whether the issuer participated in the rating process should be publicly available on a non-selective basis, unless they are private ratings, which should be at least available to both domestic and foreign institutions with legitimate interest and on equivalent terms. In addition, the ECAI's general procedures, methodologies and assumptions for arriving at ratings should be publicly available.
- (4) Disclosure: An ECAI should disclose the following information: its code of conduct; the general nature of its compensation arrangements with assessed entities; any conflict of interest, the ECAI's compensation arrangements, its rating assessment methodologies, including the definition of default, the time horizon, and the meaning of each rating; the actual default rates experienced in each assessment category; and the transitions of the ratings, eg the likelihood of AA ratings becoming A over time. A rating should be disclosed as soon as practicably possible after issuance. When disclosing a rating, the information should be provided in plain language, indicating the nature and limitation of credit ratings and the risk of unduly relying on them to make investments.
- (5) Resources: An ECAI should have sufficient resources to carry out high-quality credit assessments. These resources should allow for substantial ongoing contact with senior and operational levels within the entities assessed in order to add value to the credit assessments. In particular, ECAIs should assign analysts with appropriate knowledge and experience to assess the creditworthiness of the type of entity or obligation being rated. Such assessments should be based on methodologies combining qualitative and quantitative approaches.
- (6) Credibility: To some extent, credibility is derived from the criteria above. In addition, the reliance on an ECAI's external ratings by independent parties (investors, insurers, trading partners) is evidence of the credibility of the ratings of an ECAI. The credibility of an ECAI is also underpinned by the existence of internal procedures to prevent the misuse of confidential information. In order to be eligible for recognition, an ECAI does not have to assess firms in more than one country.
- (7) No abuse of unsolicited ratings: ECAIs must not use unsolicited ratings to put pressure on entities to obtain solicited ratings. Supervisors should consider whether to continue recognising such ECAIs as eligible for capital adequacy purposes, if such behaviour is identified.

- (8) Cooperation with the supervisor: ECAIs should notify the supervisor of significant changes to methodologies and provide access to external ratings and other relevant data in order to support initial and continued determination of eligibility.

21.3 Regarding the disclosure of conflicts of interest referenced in [CRE21.2\(4\)](#) above, at a minimum, the following situations and their influence on the ECAI's credit rating methodologies or credit rating actions shall be disclosed:

- (1) The ECAI is being paid to issue a credit rating by the rated entity or by the obligor, originator, underwriter, or arranger of the rated obligation;
- (2) The ECAI is being paid by subscribers with a financial interest that could be affected by a credit rating action of the ECAI;
- (3) The ECAI is being paid by rated entities, obligors, originators, underwriters, arrangers, or subscribers for services other than issuing credit ratings or providing access to the ECAI's credit ratings;
- (4) The ECAI is providing a preliminary indication or similar indication of credit quality to an entity, obligor, originator, underwriter, or arranger prior to being hired to determine the final credit rating for the entity, obligor, originator, underwriter, or arranger; and
- (5) The ECAI has a direct or indirect ownership interest in a rated entity or obligor, or a rated entity or obligor has a direct or indirect ownership interest in the ECAI.

21.4 Regarding the disclosure of an ECAI's compensation arrangements referenced in [CRE21.2\(4\)](#) above:

- (1) An ECAI should disclose the general nature of its compensation arrangements with rated entities, obligors, lead underwriters, or arrangers.
- (2) When the ECAI receives from a rated entity, obligor, originator, lead underwriter, or arranger compensation unrelated to its credit rating services, the ECAI should disclose such unrelated compensation as a percentage of total annual compensation received from such rated entity, obligor, lead underwriter, or arranger in the relevant credit rating report or elsewhere, as appropriate.

- (3) An ECAI should disclose in the relevant credit rating report or elsewhere, as appropriate, if it receives 10% or more of its annual revenue from a single client (eg a rated entity, obligor, originator, lead underwriter, arranger, or subscriber, or any of their affiliates).

Implementation considerations in jurisdictions that allow use of external ratings for regulatory purposes

The mapping process

- 21.5** Supervisors will be responsible for assigning eligible ECAIs' ratings to the risk weights available under the standardised risk weighting framework, ie deciding which rating categories correspond to which risk weights. The mapping process should be objective and should result in a risk weight assignment consistent with that of the level of credit risk reflected in the tables above. It should cover the full spectrum of risk weights.
- 21.6** When conducting such a mapping process, factors that supervisors should assess include, among others, the size and scope of the pool of issuers that each ECAI covers, the range and meaning of the ratings that it assigns, and the definition of default used by the ECAI.
- 21.7** In order to promote a more consistent mapping of ratings into the available risk weights and help supervisors in conducting such a process, [Standardised approach - implementing the mapping process \(April 2019\)](#) provides guidance as to how such a mapping process may be conducted.
- 21.8** Banks must use the chosen ECAIs and their ratings consistently for all types of exposure where they have been recognised by their supervisor as an eligible ECAI, for both risk-weighting and risk management purposes. Banks are not allowed to "cherry-pick" the ratings provided by different ECAIs and to arbitrarily change the use of ECAIs.

Multiple external ratings

- 21.9** If there is only one rating by an ECAI chosen by a bank for a particular exposure, that rating should be used to determine the risk weight of the exposure.
- 21.10** If there are two ratings by ECAIs chosen by a bank that map into different risk weights, the higher risk weight will be applied.

21.11 If there are three or more ratings with different risk weights, the two ratings that correspond to the lowest risk weights should be referred to. If these give rise to the same risk weight, that risk weight should be applied. If different, the higher risk weight should be applied.

Determination of whether an exposure is rated: Issue-specific and issuer ratings

21.12 Where a bank invests in a particular issue that has an issue-specific rating, the risk weight of the exposure will be based on this rating. Where the bank's exposure is not an investment in a specific rated issue, the following general principles apply.

- (1) In circumstances where the borrower has a specific rating for an issued debt – but the bank's exposure is not an investment in this particular debt – a high-quality credit rating (one which maps into a risk weight lower than that which applies to an unrated exposure) on that specific debt may only be applied to the bank's unrated exposure if this exposure ranks in all respects pari passu or senior to the exposure with a rating. If not, the external rating cannot be used and the unassessed exposure will receive the risk weight for unrated exposures.
- (2) In circumstances where the borrower has an issuer rating, this rating typically applies to senior unsecured exposures to that issuer. Consequently, only senior exposures to that issuer will benefit from a high-quality issuer rating. Other unassessed exposures of a highly rated issuer will be treated as unrated. If either the issuer or a single issue has a low-quality rating (mapping into a risk weight equal to or higher than that which applies to unrated exposures), an unassessed exposure to the same counterparty that ranks pari passu or is subordinated to either the senior unsecured issuer rating or the exposure with a low-quality rating will be assigned the same risk weight as is applicable to the low-quality rating.
- (3) In circumstances where the issuer has a specific high-quality rating (one which maps into a lower risk weight) that only applies to a limited class of liabilities (such as a deposit rating or a counterparty risk rating), this may only be used in respect of exposures that fall within that class.

21.13 Whether the bank intends to rely on an issuer- or an issue-specific rating, the rating must take into account and reflect the entire amount of credit risk exposure the bank has with regard to all payments owed to it. For example, if a bank is owed both principal and interest, the rating must fully take into account and reflect the credit risk associated with repayment of both principal and interest.

21.14

In order to avoid any double-counting of credit enhancement factors, no supervisory recognition of credit risk mitigation techniques will be taken into account if the credit enhancement is already reflected in the issue specific rating (see [CRE22.5](#)).

Domestic currency and foreign currency ratings

21.15 Where exposures are risk-weighted based on the rating of an equivalent exposure to that borrower, the general rule is that foreign currency ratings would be used for exposures in foreign currency. Domestic currency ratings, if separate, would only be used to risk-weight exposures denominated in the domestic currency.²

Footnotes

² *However, when an exposure arises through a bank's participation in a loan that has been extended, or has been guaranteed against convertibility and transfer risk, by certain multilateral development banks (MDBs), its convertibility and transfer risk can be considered by national supervisors to be effectively mitigated. To qualify, MDBs must have preferred creditor status recognised in the market and be included in the first footnote to [CRE20.14](#). In such cases, for risk-weighting purposes, the borrower's domestic currency rating may be used instead of its foreign currency rating. In the case of a guarantee against convertibility and transfer risk, the local currency rating can be used only for the portion that has been guaranteed. The portion of the loan not benefiting from such a guarantee will be risk-weighted based on the foreign currency rating.*

Short-term/long-term ratings

21.16 For risk-weighting purposes, short-term ratings are deemed to be issue-specific. They can only be used to derive risk weights for exposures arising from the rated facility. They cannot be generalised to other short-term exposures, except under the conditions of [CRE21.18](#). In no event can a short-term rating be used to support a risk weight for an unrated long-term exposure. Short-term ratings may only be used for short-term exposures against banks and corporates. The table^{3 4} below provides a framework for banks' exposures to specific short-term facilities, such as a particular issuance of commercial paper:

Risk weight table for specific short-term ratings

Table 15

External rating	A-1/P-1	A-2/P-2	A-3/P-3	Others
Risk weight	20%	50%	100%	150%

Footnotes

³ The notations follow the methodology used by S&P and by Moody's Investors Service. The A-1 rating of S&P includes both A-1+ and A-1-.

⁴ The "others" category includes all non-prime and B or C ratings.

21.17 If a short-term rated facility attracts a 50% risk-weight, unrated short-term exposures cannot attract a risk weight lower than 100%. If an issuer has a short-term facility with an external rating that warrants a risk weight of 150%, all unrated exposures, whether long-term or short-term, should also receive a 150% risk weight, unless the bank uses recognised credit risk mitigation techniques for such exposures.

21.18 In cases where short-term ratings are available, the following interaction with the general preferential treatment for short-term exposures to banks as described in [CRE20.19](#) will apply:

- (1) The general preferential treatment for short-term exposures applies to all exposures to banks of up to three months original maturity when there is no specific short-term exposure rating.
- (2) When there is a short-term rating and such a rating maps into a risk weight that is more favourable (ie lower) or identical to that derived from the general preferential treatment, the short-term rating should be used for the specific exposure only. Other short-term exposures would benefit from the general preferential treatment.
- (3) When a specific short-term rating for a short term exposure to a bank maps into a less favourable (higher) risk weight, the general short-term preferential treatment for interbank exposures cannot be used. All unrated short-term exposures should receive the same risk weighting as that implied by the specific short-term rating.

21.19

When a short-term rating is to be used, the institution making the assessment needs to meet all of the eligibility criteria for recognising ECAIs, as described in [CRE21.2](#), in terms of its short-term ratings.

Level of application of the rating

21.20 External ratings for one entity within a corporate group cannot be used to risk-weight other entities within the same group.

Use of unsolicited ratings

21.21 As a general rule, banks should use solicited ratings from eligible ECAIs. National supervisors may allow banks to use unsolicited ratings in the same way as solicited ratings if they are satisfied that the credit assessments of unsolicited ratings are not inferior in quality to the general quality of solicited ratings.