Comment of Companhia Portuguesa de Rating, S.A. on “The New Basel Capital Accord”

1. Introduction

Following the replies given by Companhia Portuguesa de Rating, S.A. (CPR) to the first and second 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, CPR maintains on the whole its agreement with the main objectives of this revision. However, we would like to put forward a few suggestions regarding changes that could be introduced in these papers in the area of rating, which would improve them and pre-empt the need for their 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 insist that these aspects are, from our point of view, very relevant.

2. Differentiated Treatment of Sovereign Risk, CIs, SFs, Non-Central Government Public Sector Entities (PSEs) and Corporates,

Preferential Treatment of Unrated Assets,

Treatment Based on Sovereign Risk,

Non Differentiated or Excessively Differentiated Treatment Between Different Rating Levels and

Differentiated Treatment According to Original Maturity of the Claim

Point

“II. Credit Risk – The Standardised Approach

A. The Standardised approach – general rules

1. Individual claims”

of “Part 2: The First Pillar – Minimum Capital Requirements” (paragraphs 27. to 59.) proposes a different treatment for claims of CIs and SFs on sovereign risk, CIs, SFs, 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. sovereigns requesting loans to support CIs, SFs, PSEs and corporates, or else CIs, SFs, PSEs requesting loans to support corporates), and in turn leading to an increase in the credit risk of sovereigns and CIs, SFs and PSEs entering this type of arbitrage.

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, 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, 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 “sovereign”, no such definition being given either in the paper under analysis or in the text of paragraph 34. of the same paper.

Under the standardised approach, paragraphs 27. to 42. of the paper under analysis propose the following risk weights for the various claims, according to the ratings assigned:

	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to BB-	B+ to B-	< B-	Unrated
Sovereign risk (1)	0%	20%	50%	100%	100%	150%	100% (2)
CIs, SFs and PSEs – Option 1 (3) (4)	20%	50%	100%	100%	100%	150%	< or = to 100% (2)
CIs, SFs and PSEs – Option 2 (4)(5)	20%	50% (6)	50% (6)	100% (6)	100% (6)	150%	50% (2) (6)
Corporates (7)	20%	50%	100%	100%	150%	150%	100% (2)(8)

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

(2) Or 150%, if the issuer's short-term rating is lower than A-3.

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

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

(5) Risk weighting based on the rating of the CI, SF 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) By option and subject to authorisation of the supervisory authorities, all claims on Corporates" may be risk-weighed at 100%, i.e., without regard to external ratings. No unrated company may be assigned a lower risk weight than that assigned to the sovereign of its incorporation.

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

This proposal deserves from CPR the following comments and suggestions:

- 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 and SFs of countries (including European Union countries) where the rating activity is not much divulged and widespread. However, this alternative:
    - will only help perpetuate the backwardness of such countries, insofar as it encourages the non-disclosure of ratings below BBB- (in the case of sovereign risk), AA- (in the

case of CIs, SFs and PSEs – option 2) and A- (in the case of risk of CIs, SFs 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 and PSEs – option 2, where it is preferable not to be rated than to be rated BB+, 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 and PSEs – option 1; hence, in this specific case, CPR suggests that the risk weight for unrated issuers and issues in CIs, SFs and PSEs – options 1 and 2, be set at 100%, as is the case for sovereign risk and the risk of unrated corporates.

- will encourage 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 affect the solvency of these countries' CIs and SFs and the strength of their financial systems.

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.

This is actually the spirit behind the rules set in paragraphs 73. and 74. of the paper under analysis for short-term claims, and therefore it is not clear why the same rationale is not followed for medium and long-term claims.

If the approach that will be adopted is not that suggested by CPR, 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 paragraph 528. of the paper under analysis, concerning the treatment of capital requirements to cover securitisation exposures, which establishes a risk weight of 350% for exposures rated below BBB- and deduction from

capital (i.e., a risk weight of 1250%) for 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.

- The proposal on CIs, SFs and PSEs – Option 1 (paragraph 37.) does not seem to make sense when the aim is to promote the strength of domestic and international financial systems. This proposal, based on the rating of the sovereign where the CI, SF or PSE is incorporated or established, deserves from us the following criticisms:

  - it assumes that each sovereign supports the CIs and SFs incorporated in that sovereign, when the international trend is for an increasingly lower intervention of sovereigns in CIs and SFs so as not to bias international-level competition among CIs and SFs.

  - even though some level of support by sovereigns to the CIs registered in those states is admissible, the same does not seem plausible in regard to SFs in general;

  - in either case, implicit support by the sovereign to the CIs, SFs and PSEs incorporated or established in that sovereign cannot but affect the rating of the sovereign 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 the rating of the Portuguese Republic to be downgraded from AA to A+ 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 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 AA); 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 AA, and therefore setting the risk weight for CIs and SFs based on the rating of the sovereign where the CI or SF is incorporated does not make any kind of sense in terms of actual risk, unless the ECB / ESCB is deemed as being sovereign for all companies registered in the EMU.

As a case in point, note the following:

- BCCI, even after the problems it was struggling with had become public knowledge, would, under this methodology, receive the same risk weight (20%) as the current risk weight of Greece and South Korea, and a better one than that currently assigned to Caixa Geral de Depósitos (50%), the largest Portuguese CI;
- the liabilities of a Greek bank with a rating below B-, instead of receiving Option 2's 150% risk weight, would, under Option 1, be risk-weighted at 50% (in accordance with Greece's A+ rating) or at 20% (in accordance with the ECB / ESCB rating) while the liabilities of a company rated BBB+ would be weighted at 100%.

Additionally, the existence of two treatment options for CIs, SFs and PSEs will create a distortion in the treatment given to similar institutions in different countries, once again leading to incorporation arbitrage of CIs and SFs. Hence, and given the openness shown in the paper under analysis, CPR maintains that only one of the two options should be chosen, 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).

- the proposal to give a risk weight of 100% to the "corporates", though subject to the authorisation of the supervising authorities, raises the following questions:
  - it may happen that a sovereign's claims are given a risk weight of 150% (rating below B-) and the liabilities of a company incorporated in that sovereign and subject to its monetary supervision are given a risk weight of 100%!
  - it may happen that a sovereign's claims have a risk weight of 150% (rating below B-), but the claims on a corporate absolutely dependent from that sovereign (a public-sector entity) are given a risk weight of 100%!
  - it may also happen that that the liabilities of a PSE have a risk weight of 150% (rating below B-), but the liabilities of a public-sector entity absolutely dependent from that PSE (a municipal company) have a risk weight of 100%!
- 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 and PSEs - Option 1). In fact, those abrupt points of change in risk weights can actually trigger liquidity crises in the issuers (especially in the more vulnerable ones), and affect the strength of financial systems.

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 proposal 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 of change, 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 rated above A+), 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).

4. The Existence of Two Separate Rules to Treat Very Short-Term Liabilities and their Combination

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 in accordance with paragraph 75., and that these risk weights may be lower than those that would be given under paragraph 73. if those short-term claims were rated, will lead to the non-disclosure of ratings for those claims when they harm the application of paragraph 75.. This could be avoided if it had been 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.

5. Recognition of Rating Agencies for Purposes of Using their Ratings in the Calculation of Capital Requirements Applicable to CIs and SFs

CPR's opinion in this regard is that the criteria employed for this recognition should be such as will guarantee the trustworthiness of the agencies that are being recognised, without preventing the appearance of new agencies that will foster competition in the rating market. Hence, at national level, all rating agencies authorised to operate by the regulatory authorities of the country where they are registered and actively in business for more than (for instance) five years, and at international level, all rating agencies authorised to operate by the regulatory authorities of the country where they are registered and actively in business for more than (for instance) eight years should be recognised, in both cases subject to the publication of a minimum number of ratings (ex.: 10 per year) and eventually to other criteria of objectivity, independence, international access/transparency, disclosure, resources and credibility common to all jurisdictions and supervised by the same regulatory authorities.

Consequently:

- we believe that the paper should set out specific rules for assessing the above mentioned criteria (of objectivity, independence, international access/transparency, disclosure, resources and credibility) – these rules are broadly, though vaguely described in paragraph 61. of the paper under discussion – in order to prevent possible location arbitrages of rating agencies arising out of the various specific rules established by each of the supervisory authorities for the said criteria, leading to the emergence of true off-shores of these entities;
- we believe that extreme care should be taken in the mapping process referred in paragraphs 62. to 65. of the paper under analysis and in its Annex 2, to prevent its biasing through the effect known, for instance, in the United States, where, due to the existing rules for choosing the second best rating assigned, the smaller-size agencies apparently assign better ratings than the two largest international rating agencies, for the simple reason that smaller-size agencies are only contracted when there is a feeling that one of the two largest ones was "mistaken" when assigning the rating, thus biasing the statistical analysis *a posteriori*.

Moreover, it is CPR's opinion that the criteria referred above to recognise rating agencies are already quite sufficient. Therefore, nothing justifies that a rating agency accredited by the supervisory authority of the European Union Member State where that agency is registered

(this authority being by itself recognised as credible at European Union level for making such recognition and for supervising the respective country's financial system) should not be immediately recognised by (at least) the supervisory authorities of the other European Union Member States, and that it has to be recognised by each supervisory authority, as may be inferred from paragraph 60. of the paper under analysis, on penalty of questioning the trustworthiness of the supervisory authorities of the various Member States. Hence it is CPR's opinion that the only option that makes sense is the full recognition of rating agencies and of the mappings established by the supervisory authorities, as at one time had been foreseen, putting aside the possibility of there existing any option at this level (bounded recognition).

6. Treatment of Securitisation Exposures

The requirement of expertise, which may be evidenced by strong market acceptance, for a rating agency to be recognised as eligible for purposes of calculating capital requirements to cover securitisation claims (sub-paragraph (c), paragraph 525. of the paper under analysis) or any other specific category of claim, will lead to a situation of the "egg and chicken" type: a rating agency will not be able to operate in this market segment without being recognised for the purpose, and it will not obtain such recognition without having the expertise in this specific market segment.

Hence CPR holds that the expertise of a rating agency should be analysed as a whole (i.e., the capacity to independently assess, in observance of the criteria referred in the previous point, the credit risk, whatever the claims in question) and not on a market segment by market segment basis, as this will only benefit the large (American) international rating agencies.

7. Applicable Treatment in the Case of Multiple Ratings

In CPR's opinion, multiple ratings should be treated by making an "average" out of the various ratings assigned, eventually "rounding" it down to the nearest worse rating. Any other system will be penalising and liable of stifling competition and transparency in the assignment of ratings. In fact:

- if the highest of the ratings assigned is used, there is an incentive to assign inflated ratings, when rating agencies are less trustworthy;
- if the lowest rating is used, this will give excessive importance to ratings based on public information only, which is less reliable and for which the rating must make due

allowance, creating the conflicts of interest referred in paragraph 78. of the paper under analysis.

Use of the second best rating, as proposed in paragraphs 66. to 68. of the paper under analysis:

- minimises the problems referred in the first two dashed paragraphs above, but fosters, as well as any of the previous options (though to a lesser extent) sharp changes in risk weights;
- makes the third and following ratings useless, unless it may be expected that any of them may be better than one of the first two assigned, reducing competition in the market of rating agencies, which is already highly concentrated in Standard & Poor's, Moody's and the Fitch Group;
- the preceding dashed paragraph will also give rise to the already referred known effect, for instance, in the United States, where there are similar rules: the smaller-size agencies apparently assign better ratings than the two largest international rating agencies, for the simple reason that smaller-size agencies are only contracted when there is a feeling that one of the two largest ones were "mistaken" when assigning the rating, thus biasing the statistical analysis *a posteriori*; as referred, such bias may harm those smaller-size agencies in the mapping foreseen in paragraphs 62. to 65. of the paper under analysis and in Annex 2 to this paper, and hence also harm competition in the market of rating agencies.

The use of an "average", besides providing a better way of minimising sharp variations in risk weights than the second best rating rule, does not have the drawbacks referred in the two last mentioned dash paragraphs.