

Eligibility Criteria for recognition of External Credit Assessment Institutions (ECAIs)

According to the Roadmap for the implementation of Basel II in Pakistan issued by the State Bank in March 2005, banks/DFIs are required to initially adopt Standardized Approach of the New Accord. Under this approach the capital requirement against credit risk is determined on the basis of risk profile assessed by the External Credit Assessment Institutions (rating agencies) duly recognized by the supervisory authority. In order to ensure transparency in this recognition process, the State Bank has developed eligibility Criteria, after due consultation with the stakeholders, for the recognition of ECAIs in Pakistan. This policy document would serve as a benchmark on the basis of which the status of recognized ECAI for the purpose of Basel II would be granted by SBP.

All rating companies that meet the eligibility criteria and are interested in getting themselves recognized as ECAI for the purpose of Basel II, may apply to the Director, Banking Supervision Department, State Bank of Pakistan by providing the required information / documents as specified on Appendix A of the criteria.

**Banking Supervision Department
State Bank of Pakistan
01.07.2005**

Criteria for the recognition of External Credit Assessment Institutions

Introduction :

The new capital adequacy framework commonly known as Basel II¹ broadly prescribes two methodologies to banks for the allocation of capital against their credit risk. The Standardized Approach, which is relatively simple and easy to implement, allows banks to use risk assessment of External Credit Assessment Institutions (ECAI)² for the calculation of their capital requirement against credit risk. According to the Road Map rolled out by SBP for the implementation of Basel II in Pakistan, initially banks shall be offered Standardized Approach except for the banks that enjoy sophisticated risk management capabilities and have sufficient data to support more advanced approaches of Basel II. Consequently, it is envisaged that most of the banks will be adopting the Standardized Approach for the calculation of their capital against credit risk.

In view of the foregoing, it has become very important that this external risk assessment must be robust and accurate so that the capital calculated represent true risk profile of the banks. This can be ensured if only credible ECAs are awarded status of recognized ECAI for Basel II purposes. SBP has therefore outlined eligibility criteria for ECAs, based on broad principles prescribed in Basel II to recognize an ECAI for Basel II purposes. Only those ECAs that fulfill the criteria would be granted status of recognized rating agencies.

The criteria provide a basis for the evaluation and recognition of the rating agencies that apply to SBP for eligibility for the purpose of Basel II. Securities and Exchange commission of Pakistan will continue to remain the supervisory / licensing authority for credit rating companies in Pakistan and only those credit rating companies that are duly licensed by SECP under the Credit Rating Companies Rules, 1995, will be eligible to apply to the State Bank for Basel II recognition. The credit rating companies incorporated in Pakistan will also be required to follow the Code of Conduct for Credit Rating Companies issued by SECP.

Each ECAI will be required to apply to the SBP for granting it the status of recognized ECAI for the purpose of Basel II. The recognition shall mean that the banks can use ECAI's risk assessment rating of their portfolio for the calculation of capital requirement under Basel II. The ECAI applying for the said status shall submit along with its application the information outlined in Appendix A. SBP on receipt of the application will decide to grant the status of recognized ECAI. The decision will be conveyed to the ECAI in writing and in case the ECAI is recognized, SBP shall convey the mapping of its various ratings with that of

¹ International Convergence of Capital measurement and Capital Standards, A revised Framework, June 2004.

² External Credit Assessment Institution can be a Credit Rating Company or an Export Credit Agency.

Standard & Poor's. The eligibility of applicant ECAI shall be made on the basis of following parameters:

a) Objectivity of the methodology :

ECAI should have methodology of assigning credit rating that is rigorous, systematic, continuous and subject to validation. To establish that ECAI fulfils this primary component of eligibility criteria, it must demonstrate that it meets minimum standards given below:

1. It has established rating definition, criteria and methodology.
2. The methodology, systems and procedures for assigning risk rating shall be consistent across the board.
3. The ECAI should have robust procedure of rating assignment based on published information, market data, interviews with the management and any other mean that provide reasonable assurance for assigning the risk ratings.
4. While assigning risk rating, the ECAI should take into account all major features of credit quality and ensure that the ratings are assigned taking into account all risk factors of the rated entity.
5. ECAI should demonstrate that the rating methodologies are subject to quantitative back testing. For this purpose, ECAI should calculate and publish default studies, recovery studies and transition matrices. For the purpose, the ECAI should have a definition of default that is equivalent to international standard and is relevant to domestic market.
6. The assessment methodology for each market segment including rigorous back testing must have been established for at least one year
7. All rating decisions should be made by the rating committee, by utilizing ECAI's established criteria and methodology.
8. The ECAI should have mechanism to review its procedures and methodologies to adapt them to the changing environment.
9. The ECAI should maintain adequate system/internal records to support its assigned ratings.

b) Independence :

The ECAI should be independent, free from economic or any external pressures that may influence its credit assessment. The independence of an ECAI shall be assessed on the basis of following four parameters:

1. **Ownership:** The ownership structure should not be such that could jeopardize the objectivity of the rating process. For instance, the owners have other businesses or are members of businesses or associations that are rated by the ECAI.
2. **Organizational Structure and Corporate Governance:** The ECAI should demonstrate that their organizational structure minimizes the scope of external influence that can negatively impact the rating process. The ECAI have in place high standards of corporate governance that safeguard independence of its risk assessment and promote integrity.
3. **Financial Resources:** Since the core earning of an ECAI is the issuer fee, this commercial pressure may give rise to conflict of interest. The ECAI must demonstrate that their business is financially viable and is able to sustain any commercial pressure exerted by rated entities. The ECAI must demonstrate that their financial viability is not dependent on a few clients. Similarly, the ECAI should not be providing any other services to the rated entities.
4. **External Conflict of Interest:** The Risk assessment process of ECAI should have ability to withstand external pressure. The ECAI should demonstrate that it is free from all sorts of external conflict of interest.

c) International Access and Transparency :

The risk assessment of ECAI should be available to both domestic as well as foreign institutions on equivalent terms. The ECAI may charge fee for provision of rating/ risk assessment, however the fee structure should be same.

In order to promote transparency and enable its stakeholders to make decisions about the appropriateness of its risk assessment methodology, ECAI should disclose enough information. The information at minimum includes, the rating definition, general methodology for arriving at rating, the rating process, time horizon of rating and the surveillance and review procedure.

d) Disclosure :

ECAI should demonstrate that it provide access to information that are sufficient to enable its stakeholders to make decision about the appropriateness of risk assessments. The purpose of this disclosure requirement is to promote

transparency and bring in market discipline. ECAI is therefore expected to make public following information:

1. Code of conduct
2. Definition of default
3. Use of time horizons
4. Rating definitions
5. Assessment methodologies (any material changes in methodologies should be disclosed as and when made)
6. Actual default rates experienced in each assessment category
7. Transition matrices
8. Whether rating was solicited or unsolicited
9. The date of last review and updation

e) Resources :

ECAI should possess sufficient human and technical resources to carry out high quality credit assessment.

1. The assessment with respect to adequacy of human resources shall be made on the basis of technical expertise of the people carrying out risk assessment and to what extent the ECAI can extend ongoing contact with the management of entities that are rated.
2. With respect to technical resources, ECAI is expected to have quantitative techniques and models that can process and analyze large quantities of data.

f) Credibility:

ECAI must demonstrate that it enjoys credibility in the market where it operates. The credibility of an ECAI will be gauged on the basis of;

1. The extent to which it meets the criteria a to e mentioned above.
2. The extent to which independent parties (investors, insurers, trading partners etc) rely on ECAI's risk assessment.
3. Existence of internal procedures to prevent the misuse of confidential information.

Withdrawal of Recognized Status :

In case any recognized ECAI is subsequently found non-compliant with any of the prescribed eligibility conditions or is found non compliant with any other instructions issued by the Sate Bank from time to time, the State Bank may

withdraw its status of recognized ECAI and prohibit banks to use the credit ratings of that ECAI for the calculation of their capital requirement.

Information required to be submitted to SBP

Ownership

- Summary of major shareholders (shareholders with more than 10% of shareholding)
- Allied business of the shareholders or the entities wherein the major shareholders have 5% or more shares.

Organizational structure and corporate governance

- Organizational Chart
- Detailed profile of the key executives.
- Summary of executive committees, including composition and accountability of such committees.
- Summary of arrangements for separating rating and non-rating parts of the ECAI.
- Summary of internal audit setup, if any, and its functions
- Summary of rating committee(s)

Financial resources

- Sources and amount of earnings
- Income from clients constituting more than 10% of total income (name of clients need not mentioned)

Staffing and expertise

- Total staff and no of employees involved in analysis work, their qualification and experience.
- Summary containing minimum qualification at entry level, the recruitment process and trainings.

Ratings definition:

- Definition of default.
- The details of rating scale for all products.
- Use of time horizons

The ratings process:

- A brief on how the ratings are arrived, reviewed and withdrawn.

Assessment methodology

- How policy concerning rating methodology is determined
- A high level description of quantitative aspects that ECAI make use of while assigning risk ratings
- A description of qualitative aspect incorporated in assigning a rating
- The extent of input taken from entity being rated.

- A summary of technical research (industry, economic etc) undertaken by ECAI
- A description of compliance mechanism inside the organization to ensure uniformity of methodology across whole ECAI.
- Information on rating reviews
- A brief description of validation process (back-testing of ratings)

Transparency and disclosure

- List of information that are made public to promote transparency

International Access

- The fee structure and accessibility for various geographic locations

Other

- Any important information/document that supports the set out eligibility criteria