convergence

SPI Project:

Rating Agencies Development

Regulatory Impact Assessment

Approach Note

Background* - 1

Under Basel II, banking regulators can allow banks to use credit ratings from certain approved credit rating agencies (called “ECAIs" - “External Credit Assessment Institutions") when calculating their capital requirements, provided that the ECAIs that produce those assessments have been recognised as eligible for that purpose by the competent supervisory authorities.

The Capital Requirements Directive (CRD) that transposes the provisions of the Basel II requirements allows EU member states to recognise an ECAI as eligible in two ways: direct recognition, in which the competent authority carries out its own assessment of the ECAI’s compliance with the CRD eligibility criteria; and indirect recognition, in which the competent authority relies on the recognition of the ECAI by the competent authority of another member state. In broad terms, the CRD eligibility criteria for ECAIs refer to their objectivity, independence, international access/transparency, disclosure, resources, and credibility.

*= Drawn from the Project Working Group ToR

Background* - 2

In Romania, which will fully transpose the CRD provisions as of January 2007, most of the local companies cannot afford to be clients of international rating agencies. Since borrowers unrated by ECAIs will be assigned a 100% risk weighting according to CRD, initially most domestic credits may end up under this category. Therefore, in order to increase the risk sensitivity of the new capital framework, there is a perceived need for developing domestic ECAIs.

At present, in Romania there are only three local rating agencies, whose main activities consist of drafting business credit reports, data quality checks, debt recovery, receivables management, and risk management consulting. Local rating agencies are not allowed to carry out rating activities due to lack of legislation in this area. The National Securities Commission (NSC) has drafted a regulation in this respect, which has not been issued as yet. Following the enactment of the NSC regulation, the NBR will have to issue distinct regulations stating the eligibility criteria for ECAIs, based on which the ratings assigned by local ECAIs could be used by banks for determining their capital requirements according to Basel II.

*= Drawn from the Project Working Group ToR

Economic impact assessment - 1

i - Section on capital relief

A	Total non-government credit (September 2006) (Mln, RON) (*)	85,229
B	Total credit to private companies	59%
C	Percentage of credit granted to borrowers eligible for being rated by local CRAs (%)	20%
D	Banks using standard approach measured in terms of share of total assets (%)	95%
E	Amount of credit granted to borrowers eligible for being rated by local CRAs (Mln, RON) [A*B*C*D]	9,554
F	Percentage of credit granted that would receive a better assessment if rated by local CRAs (%)	10%

Economic impact assessment - 2

i - Section on capital relief

G	Amount of credit granted that would receive a better asses. if rated by local CRAs (%) [E*F]	209
H	Risk weight assigned as unrated credit (%)	100%
I	Risk weight assigned as rated credit (%)	50%
J	Capital adequacy ratio (%)	12%
K	**Free capital (Mln, RON) [G*(H-I)*J]**	57.3
K1	**Savings in cost of equity**	
	<u>1-year horizon:</u> (Mln, RON)	5.7
	<u>5-year horizon:</u> present value (Mln, RON)	15.7

Economic impact assessment - 3

ii - Section on market development

L	Estimate of the average standard pricing of a loan to companies (%)	12%
M	Cost of equity (%)	10%
N	Cost of equity savings in loan pricing due to freeing capital (%) [100*(H-I)*L*M]	0.60%
O	**New pricing due to capital savings (%) [K-M]**	11.4%
P	Change in the demand for credit that happens due to change in lending interest rates (%) (*)	(0.3)

*= Shows percentage change in the demand for credit when interest rate changes by one percent

Economic impact assessment - 3

ii - Section on market development

Q	**Increase in demand for loans from firms rated by CRAs (Mln, RON)**	143
R	Interest income (%)	11.7%
S	**Interest income**	
	1-year horizon: (Mln, RON)	17
	5-year horizon: present value (Mln, RON)	46

Analytics - 1

Total non-government credit(September 2006) (Mln, RON)	a)	85,229
Total credit to private companies (%)	b)	59%
Percentage of credit granted to borrowers eligible for being rated by local CRAs (%)	c)	20%
Banks using standard approach measured in terms of share of total assets (%)	d)	95%
Amount of credit granted to borrowers eligible for being rated by local CRAs (Mln, RON)	e)=a*b*c*d	**9,554**
Percentage of credit granted that would receive a better assessment if rated by local CRAs (%)	f)	10%
Amount of credit granted that would receive a better assessment if rated by local CRAs (%)	g)=e*f	955
Risk weight assigned as unrated credit (%)	h)	100%
Risk weight assigned as rated credit (%)	i)	50%
Capital adequacy ratio (%)	j)	12%
Free Capital (Mln,RON)	k)=g*(h-i)*j	**57.3**
Estimate of the average standard pricing of a loan to eligible for but unrated companies (%)	l)	12%
st of equity savings in loan pricing due to freeing capital (%)	m)	0.60%
Decrease in pricing due to capital savings (%)	n)	11.4%
% of price reduction	o)	-5%
Change in the demand for credit that happens due to change in lending interest rates	p)	-30.0%
Increase in demand for loans by companies rated by CRAs	q)=e*o*p	**143.3**
Interest income (%)	r)	11.7%
Net interest margin for legal entities (Mln, RON)	s)=q*r	**17**

Analytics - 2

		2007	2008	2009	2010	2011	5-years	Annual Average
Banks using standard approach measured in terms of share of total assets (%)	i)	95%	75%	50%	20%	20%		
Amount of credit granted to borrowers eligible for being rated by local CRAs (Mln, RON)	ii)=a*b*c*i*f	9,554	7,543	5,029	2,011	2,011		
PV - Free capital (Mln, RON)	iii)=ii*f*(h-i)*j	57.3	45.3	30.2	12.1	12.1	**156.9**	31.4
PV - Savings in cost of equity (Mln, RON)	iv)=iii*COE (10%)	5.7	4.5	3.0	1.2	1.2	**15.7**	
PV - Increase in demand for loans by companies rated by CRAs (Mln, RON)	v)=ii*o*p	143.3	113.1	75.4	30.2	30.2	**392.2**	78.4
PV - Interest income (Mln, RON)	vi)=v*r	16.8	13.2	8.8	3.5	3.5	**45.9**	9.2

Discount rate (%)	7.10%				
Discount factor	0.933707	0.871808	0.814013	0.76005	0.709664

Analytics - 3

Data and assumptions:

Basel II
Claims on corporates

Credit assessment	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk weight	20%	50%	100%	150%	100%

a) Total credit to private companies (%) 59%

Source: IMF, Romania: Selected isues and Statistical Appendix.

b) Banks using standard approach measured in terms of share of total assets (%)

Year	2007	2008	2009	2010	2011
%	95%	75%	50%	20%	20%

c) Percentage of credit granted to borrowers eligible for being rated by local CRAs (%)	20%
d) Percentage of credit granted that would receive a better assessment if rated by local CRAs (%)	10%
e) Risk weight assigned as rated credit (%)	50%
f) Cost of equity	10%
g) Estimate of the average standard pricing of a loan to eligible for but unrated companies (%)	12%

Source: NBR, Monthly Bulletin, 9/2006, p. 22, table 8, new loans in RON, legal entities

h) Interest income (%) 11.7%

Source: NBR, Monthly Bulletin, 9/2006, p. 22, table 8, new loans in RON, legal entities