

Convergence Romania Financial Sector Modernization

Special Projects Initiative Public-Private Steering Committee



TERMS OF REFERENCE

Project: Rating Agencies Development

Project Team: National Securities Commission,

**National Bank of Romania, banking community representatives,
local rating agencies**

Proposed Technical Anchor (TAN): International Finance Corporation

I- Background

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.

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. Likewise, Basel II/CRD assigning a higher risk weighting of 150% for entities rated below BB(-), thereby providing the companies a perverse incentive to remain unrated. 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 so called "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.

II - Project Objective

To prepare a set of draft regulations that will enable local rating agencies to carry out rating activities, and will establish eligibility criteria for ECAIs in conformity with the Basel II/CRD requirements, to be accompanied by a document on implementation constraints and criticalities.

III – Intended Strategy

The project management group (Project Owner, Project Manager, Deputy Project Manager, supported by the SPI Secretariat) acts based on the mandate received from the SPI Committee to achieve the project objective.

In order to have an adequate representation of all the stakeholders, the PMG should form a project working group (PWG) with meaningful representation by authorities (NBR and NSC) and by market players (local rating agencies and banks).

The project management group (PMG) will start by reaching a common level of understanding of the issues raised by the creation of a consistent legal and institutional infrastructure for the credit rating activity in Romania. The development of the legal framework should be conceived downstream from the design of the institutional characteristics that would be required from ECAIs to undertake credit rating activities at a level of reliability and consistency that would allow use of their work for capital adequacy purposes.

In this respect, the PMG should acquire an understanding of the technical skills, organizational set-up and business mix requirements for ECAIs from EU member states that currently qualify for Basel II/CRD purposes. For this purpose, the NBR should seek guidance from the Committee of European Banking Supervisors on the necessary institutional set-up of ECAIs as resulted from its previous research on the matter. Likewise, the SPI Secretariat will prepare (possibly with IFC support) an international benchmarking of the institutional characteristics of ECAIs operating in the EU. Based on these contributions, the SPI Secretariat will prepare a paper on international experience on necessary ECAIs institutional characteristics.

The PWG will then start designing the regulatory principles needed to underpin an adequate institutional set-up, in line with international regulations and practices. To help document the PWG work, the SPI Secretariat will prepare an issues paper based on the following contributions:

- a. NSC: the existing draft regulation for enabling local CRAs to carry out rating activities and any other relevant documentation (i.e. technical assistance received on the matter), together with a presentation of the perceived drawbacks in issuing the regulation;

- b. NBR: a paper on the relevant Basel II/CRD requirements regarding the eligibility criteria for ECAIs, outlining the envisaged regulatory and institutional solutions for transposing the international standards into the domestic legislation;
- c. SPI Secretariat: paper on international experience on necessary ECAIs institutional characteristics.

The PWG will analyze the NSC draft regulation and will outline possible improvements from the perspective of the institutional set-up requirements previously highlighted. Likewise, the PWG will discuss the drawbacks perceived by NSC in issuing and enforcing the regulation and will agree on possible solutions to overcome these difficulties.

The PWG will then conceive the main elements of a proposed regulation on the eligibility criteria for ECAIs, in line with the Basel II/CRD requirements and with the international experience on the matter. To help strengthen the applicability of the proposed regulatory principles, the PWG will explore the drawbacks perceived by market players in complying with these requirements. In this respect, the PM/DPM/SPI Secretariat will ask:

- a. Local CRAs: to prepare a presentation of possible difficulties in complying with Basel II/CRD eligibility requirements, outlining possible solutions;
- b. Banks: to prepare a presentation on the perceived benefits from using ratings issued by local ECAIs and on the foreseen implementation difficulties and possible ways to overcome them.

The PWG will analyze the draft regulation on ECAIs eligibility criteria to be prepared by the NBR based on the agreed regulatory principles and the input received from the market players on the implementation drawbacks and possible solutions. The “impact” of the proposed new regulatory framework should be measured on how many existing “rating companies” could become eligible to conduct Basel II-relevant rating activities and on how likely it will be that it will enable new entrants.

The PWG will finalize the regulatory proposals and will prepare a document on the implementation constraints and criticalities requiring the attention and guidance from SPI Committee, to accompany the set of draft regulations.

IV- Methodology: from kick off to the accomplishment of the project

Project Strategy Meeting – June 8

The PWG will reach a common level of understanding of the issues raised by the creation of a consistent legal and institutional infrastructure for the credit rating activity in Romania.

Also, the PWG will discuss and approve the project TORs and the next steps and individual contributions.

Preparation of PWG 1st meeting (PM/DPM and SPI Secretariat) - June 11 – July 13

The PWG will start by acquiring an understanding of the technical skills, organizational set-up and business mix requirements for ECAIs from EU member states that currently qualify for Basel II/CRD purposes. For this purpose:

- a. NBR: will seek guidance from the Committee of European Banking Supervisors on the necessary institutional set-up of ECAIs as resulted from its previous research on the matter;
- b. SPI Secretariat: will prepare (possibly with IFC support) an international benchmarking of institutional characteristics of ECAIs operating in the EU.

Based on these contributions, the SPI Secretariat will prepare a paper on international experience on necessary ECAIs institutional characteristics.

To help document the PWG work, the SPI Secretariat will prepare an issues paper based on the following contributions:

- a. NSC: the existing draft regulation for enabling local CRAs to carry out rating activities and any other relevant documentation (i.e. technical assistance received on the matter), together with a presentation of the perceived drawbacks in issuing the regulation;
- b. NBR: a paper on the relevant Basel II/CRD requirements regarding the eligibility criteria for ECAIs, outlining the envisaged regulatory and institutional solutions for transposing the international standards into the domestic legislation;
- c. SPI Secretariat: paper on international experience on necessary ECAIs institutional characteristics;
- d. Local CRAs: a presentation of the foreseen difficulties in complying with Basel II/CRD eligibility requirements, outlining possible solutions;
- e. Banks: a presentation on the perceived benefits from using ratings issued by local ECAIs and on the foreseen implementation difficulties and possible ways to overcome them.

PO/PM will send to the PWG members the SPI Committee Mandate Letter together with the following documents, before the PWG 1st meeting:

- a. the issues paper prepared by the SPI Secretariat;
- b. draft TORs prepared by SPI Secretariat and endorsed by PO and PM/DPM.

PWG 1st meeting - July 16 – 20

1. PWG members discuss the characteristics of the needed institutional infrastructure for the credit rating activity in Romania, in line with international regulations and practices;
2. PWG members analyze the NSC draft regulation and outline possible improvements from the perspective of the institutional set-up requirements previously highlighted;
3. PWG members discuss the drawbacks perceived on issuing and enforcing the proposed NSC regulation and agree on possible solutions to overcome these difficulties;
4. PWG members take note of Basel II/CRD requirements on ECAIs eligibility criteria and of the international experience/practices on the matter;
5. PWG members discuss the market players' concerns (local rating agencies and banks) regarding the foreseen difficulties in applying the Basel II/CRD framework and outline possible ways to overcome them;
6. PWG members outline the main elements of a proposed regulation on the eligibility criteria for ECAIs, in line with relevant international regulation and practices and taking into account suggestions of market players;
7. PWG members agree on TORs prepared by SPI Secretariat and endorsed by PO and PM/DPM;

8. PM/DPM establish **homework** for PWG members:

NSC: finalize the draft regulation enabling local rating agencies to carry out rating activities based on possible necessary improvements as resulted from the PWG discussions;

NBR: prepare a proposal of a draft regulation on ECAIs eligibility criteria in line with international regulations and practices on the matter and with the input received from the market players on implementation drawbacks and possible solutions;

Rating Agencies, Banks: prepare a proposal for a set of practical measures that the rating agencies and banks could jointly take to facilitate the implementation of the proposed legislation.

The individual contributions will be sent to PM/DPM/SPI Secretariat. SPI Secretariat will circulate a package of documents before the PWG 2nd meeting.

PWG 2nd meeting - July 30 – August 3

1. PWG members analyze the and agree on the draft regulation establishing eligibility criteria for ECAIs in conformity with the Basel II/CRD requirements;
2. PWG member from MOPF provides an opinion on the proposed draft regulations;
3. PWG members discuss and agree on the set of practical measures that the rating agencies and banks could jointly take to facilitate the implementation of the proposed legislation;
4. PWG members start preparing the document on the implementation constrains and criticalities requiring the attention and guidance from SPI Committee, to accompany the proposed set of draft regulations.

Homework:

Rating Agencies: assess the “impact” of the proposed new regulatory framework in terms of how many existing “rating companies” could become eligible to conduct Basel II-relevant rating activities and on how likely it will be that the regulation will enable new entrants;

PM/DPM: prepare the document on implementation constrains and criticalities requiring the attention and guidance from SPI Committee, to accompany the proposed set of draft regulations and the “impact” assessment prepared by the local rating agencies.

PWG 3rd meeting - August 20 - 24

PWG members approve the actionable proposal for SPI Committee.

V- Output

PWG 1st meeting

- PWG members outline the issues raised by the creation of a consistent legal and institutional infrastructure for the credit rating activity in Romania;
- PWG members analyze the NSC draft regulation;
- PWG members outline the main elements of a proposed regulation on the eligibility criteria for ECAIs.

PWG 2nd meeting

- PWG members analyze the NBR draft regulation;
- PWG members agree on the set of practical measures that the rating agencies and banks could jointly take to facilitate the implementation of the proposed legislation;
- PWG members draft the document on the implementation constraints and criticalities;
- PWG members perform an impact assessment.

PWG 3rd meeting

- PWG members approve actionable SPI Committee proposal;
- SPI Secretariat sends SPI Committee Actionable Paper to Convergence.

VI - Project Team

The team will be composed of:

- NBR:
 - 2 experts from the Regulation and Licensing Department and from the Financial Stability Department.
- NSC:
 - 3 experts from the Regulation Department.
- Banks:
 - 3 experts from the RBA Basel II Technical Commission.
- Credit Rating Agencies:
 - 1 expert with background on credit rating and Basel II.
- Ministry of Public Finance
 - 1 expert from the General Department for Legislative Harmonization and European Integration.

The team will be chaired by the Project Manager and co-chaired by the Deputy Project Manager.

PM/DPM have to report to PO at least after each meeting of the PWG.

Technical anchor: expert with financial policy/institutional development background.