



**Guernsey Financial Services Commission  
Isle of Man Financial Supervision Commission  
Jersey Financial Services Commission**

**Basel II – External Credit Assessment Institutions’ Ratings  
and Mapping of Ratings to Risk-Weights**

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## **Introduction**

In 1988 the Basel Committee on Banking Supervision (“Basel Committee”) issued a report entitled “International Convergence of Capital Measurement and Capital Standards”. The report was updated in 1997. Its purpose was to secure international convergence of supervisory regulations governing the capital adequacy of international banks. The report has become known in recent years as “Basel I”.

Latterly, the Basel Committee has worked to revise Basel I. The new revised framework was last updated in November 2005 and was re-issued as a “Comprehensive Version” in June 2006. The revised framework is referred to hereafter as “Basel II”.

Basel II allows banks to use external credit assessments to determine the risk weight of certain credit and credit securitisation exposures, provided the External Credit Assessment Institutions (“ECAI”s) (rating agencies) that produce those assessments have been recognised as eligible for that purpose by the relevant national supervisor. ECAIs may be considered eligible for recognition if they meet the six criteria of:

- Objectivity;
- Independence;
- International access / Transparency;
- Disclosure;
- Resources; and,
- Credibility.

National supervisory authorities are responsible for establishing a mapping process i.e. assigning eligible ECAIs’ assessments to the risk weights available under the standardised risk weighting framework and the securitisation framework for the standardised approach.

## **The Pan-Island Approach**

The Guernsey Financial Services Commission, the Isle of Man Financial Supervision Commission and the Jersey Financial Services Commission have been working together to establish a unified approach, wherever possible, to implementing Basel II. This is not only because a number of banks operate in all three (or two of the three) jurisdictions, but also because their geographical proximity and similar constitutions leave them vulnerable to regulatory arbitrage if a common approach is not reached.

The publication of the paper: “National Discretions for the Standardised Approaches to Credit and Operational Risk under the Basel II Capital

Framework”, issued in August 2006 (hereafter referred to as the “**Tri-party National Discretion paper**”), reflected this unified approach and brought together work carried out by each island’s Basel II implementation teams. This paper expands further on the cooperation between the islands. Throughout this publication, the three Commissions are referred to as the “**Tri-party Group**”, and the three islands as the Crown Dependencies. Any further use of the word “Commission” refers to the relevant individual Commission.

It is the Tri-Party Group’s understanding that the vast majority of banks in the Crown Dependencies will be adopting the standardised approaches to credit and operational risk under Basel II, including the simplified standardised approach for credit risk, or the basic indicator approach for operational risk.

The Tri-Party Group has concluded that, due to the large number of banks which are part of European banking groups and the similar nature of the banking activity undertaken in the Crown Dependencies to that in Europe, it should have regard to the work performed by the Committee of European Banking Supervisors (CEBS) in relation to ECAIs.

### **Recognition of External Credit Assessment Institutions (ECAIs)**

CEBS published guidelines on the recognition of ECAIs in January 2006 (refer to the website [www.c-eps.org](http://www.c-eps.org)) which supervisory authorities across Europe used in a single joint assessment of three ECAIs conducted, being:

- Fitch Ratings;
- Standard & Poor’s Ratings Services; and,
- Moody’s Investors Service.

On the basis of information provided by the above ECAIs, all supervisory authorities reached the view that regulated firms applying Basel II could use the ratings of the above ECAIs, and also reached agreement on the mapping process.

The Tri-Party Group considers that it can rely on the work performed by the supervisory authorities, based on the CEBS guidelines, with respect to the recognition of the above ECAIs, and will therefore permit banks in the Crown Dependencies to use the above ECAIs. The Tri-Party Group also considers that it can apply the same mapping process as prescribed by CEBS.

The Tri-Party Group will not itself assess ECAIs independently but will have ongoing regard to publications by CEBS and any other such body that may be appropriate.

### **Mapping of ECAIs' ratings to risk weights for capital adequacy purposes**

The mapping of the recognised ECAIs' ratings to risk weights is shown in *Appendix 1* for the standardised approach, and in *Appendix 2* for securitisation under the standardised approach. *Appendix 3* shows the mapping of ECAIs' ratings to risk weights in respect of collective investment undertakings.

The general rule within Basel II is that banks should use solicited ratings from ECAIs. However, national supervisory authorities may, at their discretion, allow banks to use unsolicited ratings in the same way as solicited ratings. The Tri-Party Group will permit banks to utilise unsolicited ratings by any of the three recognised ECAIs listed above. However, the Tri-Party Group may indicate that individual unsolicited ratings are not to be used if those assessments are considered to be inferior in quality to the general quality of solicited assessments or if it considers that an ECAI's strategy in relation to the issuing of unsolicited assessments is founded in the placing of pressure on the rated entity to pay for a rating.

Banks must use the chosen ECAIs and their ratings consistently for each type of claim, for both risk weighting and risk management purpose. Banks will not be allowed to "cherry-pick" the assessments provided by different ECAIs, and must disclose the ECAIs that they intend to use for the risk weighting of their assets by type of claim as per the mapping process in *Appendices 1, 2 and 3*. Further guidance is provided below.

### **Guidelines applicable to banks with respect to the nomination of ECAIs**

For the purpose of applying ECAI ratings to derive risk-weights for exposures under the portfolio of claims on sovereigns, claims on banks, claims on securities firms and claims on corporate entities under the standardised approach or the securitization framework for credit risk, a bank should satisfy the following four steps:

- (a) Nominate one or more ECAI(s) (the "nominated ECAI(s)") whose assigned ratings will be used by the bank for deriving risk weights for exposures in each of the external ratings-based portfolios, provided that the nominated ECAI(s) can provide a reasonable coverage on the bank's exposures within the portfolios in terms of the types of counterparties and different geographical regions covered by the ECAI(s);
- (b) Notify the Commission of its nominated ECAI(s) and the application of the ratings of such ECAI(s) on each of the bank's external ratings-based portfolios;

- (c) Use the ratings of the nominated ECAI(s) within each of the external ratings-based portfolios consistently, and seek the consent of the Commission on any subsequent changes to such ECAI(s) and the application of its/their ratings; and
- (d) Treat a relevant exposure or the person to whom the bank has a relevant exposure as “unrated” for risk weighting purposes if that exposure or that person does not have a rating assigned to it by any ECAI chosen by the bank.

The above requirements are to ensure that a bank applies the ratings of its nominated ECAI(s) consistently and avoid any possible cherry picking of ratings provided by different ECAIs.

In determining its nominated ECAI(s), a bank should pay special attention to the criterion of “reasonable coverage”. Where a bank has significant exposures within the external ratings-based portfolios to a particular type/set of counterparties or a particular country that is not rated by the bank’s nominated ECAI(s) but by other ECAI(s) recognised by the Tri-Party Group, the bank should include such ECAI as a nominated ECAI to comply with the “reasonable coverage” requirement.

### **Multiple assessments**

If there is only one assessment by a nominated ECAI chosen by a bank for a particular claim, that assessment should be used to determine the risk weight of the claim.

If there are two assessments by nominated ECAIs chosen by a bank that map into different risk weights, the higher risk weight will be applied.

If there are three assessments with different risk weights, the assessments corresponding to the two lowest risk weights should be referred to and the higher of those two risk weights will be applied.

### **Level of application of assessments**

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

### **Issue versus issues assessment**

Where a bank invests in a particular issue that has an issue-specific assessment, the risk weight of the claim will be based on this assessment. Where a bank's claim is not an investment in a specific assessed issue the following principles apply:

- In circumstances where the borrower has a specific assessment for an issued debt, but the bank's claim is not an investment in this particular debt, a high quality credit assessment (that being one which maps into a risk weight lower than that which applies to an unrated claim) on that specific debt may only be applied to the bank's un-assessed claim if this claim ranks *pari passu* or senior to the claim with an assessment in all respects. If not, the credit assessment cannot be used and the un-assessed claim will receive the risk weight for unrated claims; and
- In circumstances where the borrower has an issuer assessment, this assessment typically applies to senior unsecured claims on that issuer. Consequently, only senior claims on that issuer will benefit from a high quality issuer assessment. Other un-assessed claims of a highly assessed issuer will be treated as unrated. If either the issuer or a single issue has a low quality assessment (mapping into a risk weight equal to or higher than that which applies to unrated claims), an un-assessed claim on the same counterparty will be assigned the same risk weight as is applicable to the low quality assessment.

Where a bank intends to rely on an issuer or an issue specific assessment, the assessment must take into account and reflect the entire amount of credit risk exposure a bank has with regard to all amounts owed to it.

### **Short-term / long-term assessments**

For risk weighting purposes, short-term assessments are deemed to be issue-specific. They can only be used to derive risk weights for claims arising from the rated facility. They cannot be generalised to other short-term claims, except under the conditions as prescribed in *Appendix 4* in relation to short-term inter-bank claims under Option 2 of the standardised approach to credit risk, which the Tri-Party Group has applied.

Short-term ratings cannot be used to support a risk weight for an unrated long-term claim, and may only be used for short-term claims against banks and corporate entities. The mapping process for short-term claims is shown in *Appendices 1 and 2*.

### **Collective investment undertakings ("CIU"s)**

The mapping for CIUs is the same as the mapping for long-term fundamental credit ratings. Fitch and Moody's use the same rating scale for their Managed Funds Credit Quality Ratings as for their fundamental credit ratings, while Standard & Poors uses a slightly different rating scales for Principal Stability Fund ratings and for Fund Credit Quality Ratings, the rating scales are identical in terms of number of rating categories.

Credit assessments in relation to exposures in the form of CIUs are to be applied purely for fixed income CIUs within the standardised approach. The mapping of ECAIs' ratings to risk weights is shown in *Appendix 3*.

### **Export Credit Agencies ("ECA"s)**

#### **Standardised approach to credit risk**

Basel II (para 55) allows supervisors to recognise the country risk scores assigned by ECAs in respect of the risk weighting of sovereign and central bank exposures. This is in addition to banks being able to use ECAIs for such exposures. The Tri-Party Group exercised this National Discretion (refer Tri-party National Discretion paper), stating that banks can only use the consensus risk scores of ECAs participating in the "OECD Arrangement on Officially Supported Export Credits". The consensus country risk classification is available on the OECD's website ([www.oecd.org](http://www.oecd.org)). The mapping of the score to risk weights is shown in *Appendix 5*. Banks wishing to use the consensus risk scores of ECAs must use these consistently.

#### **Simplified standardised approach to credit risk**

Under the simplified standardised approach, banks do not use ECAIs' ratings for determining risk weights associated with sovereign, central bank and other bank exposures. Instead, banks must use the consensus risk scores of ECAs participating in the "OECD Arrangement on Officially Supported Export Credits". The consensus country risk classification is available on the OECD's website ([www.oecd.org](http://www.oecd.org)). The mapping of the score to risk weights is shown in *Appendix 5*.

Any queries relating to the eligible ECAs and mapping process should be addressed in the first instance to the persons below, as appropriate to the place of incorporation of the bank concerned.

**Mr C M Le Marchant  
Deputy Director of Banking  
Banking Division**

Guernsey Financial Services Commission  
PO Box 128  
La Plaiderie Chambers  
La Plaiderie  
St Peter Port  
Guernsey  
GY1 3HQ

[clemarchant@gfsc.gg](mailto:clemarchant@gfsc.gg)

**Mr A J Kermode  
Deputy Senior Manager  
Supervision Division**

Isle of Man Financial Supervision Commission  
PO Box 58  
Finch Hill House  
Bucks Road  
Douglas  
IM99 1DT

[andrew.kermode@fsc.gov.im](mailto:andrew.kermode@fsc.gov.im)

**Mr D Fisher  
Analyst  
Banking**

Jersey Financial Services Commission  
PO Box 267  
Nelson House  
David Place  
St Helier  
Jersey  
JE4 8TP

[d.fisher@jerseyfsc.org](mailto:d.fisher@jerseyfsc.org)



## Appendix 1 – Standardised approach - Mapping of ECAIs' credit assessments risk weighting

### Long-term mapping

S&P assessments	Fitch's assessments	Moody's assessments	Corporate	Banks and securities firms		Sovereign
				Credit assessment method (Option 2)		
				Maturity > 3 months	Maturity 3 months or less	
AAA to AA-	AAA to AA-	Aaa to Aa3	20%	20%	20%	0%
A+ to A-	A+ to A-	A1 to A3	50%	50%	20%	20%
BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	100%	50%	20%	50%
BB+ to BB-	BB+ to BB-	Ba1 to Ba3	100%	100%	50%	100%
B+ to B-	B+ to B-	B1 to B3	150%	100%	50%	100%
CCC+ and below	CCC+ and below	Caa1 and below	150%	150%	150%	150%

Sterling denominated and funded sovereign exposures to, and guaranteed by, the Crown Dependency and UK governments attract a risk weighting of 0%, as stated in the Tri-party National Discretion paper.

For the mapping of ratings to risk weights for exposures to banks and securities firms, only the risk weights associated with Option 2 are shown. The Tri-Party Group exercised this Option for the standardised approach, as stated in the Tri-party National Discretion paper, rather than Option 1 which is based on the sovereign rating.

**Short-term mapping (applied to exposures to banks, securities firms and corporate entities)**

<b>S&amp;P assessments</b>	<b>Fitch's assessments</b>	<b>Moody's assessments</b>	<b>Risk weight</b>
A-1+, A-1	F1+, F1	P-1	20%
A-2	F2	P-2	50%
A-3	F3	P-3	100%
All short-term ratings below A-3	Below F3	Not prime (NP)	150%

For the use of short term ratings refer to the main body of this paper and Appendix 4.

## Appendix 2 – Standardised approach - Securitisation - Mapping of ECAIs' credit assessments to risk weighting

### Long-term mapping

S&P assessments	Fitch's assessments	Moody's assessments	Risk weight
AAA to AA-	AAA to AA-	Aaa to Aa3	20%
A+ to A-	A+ to A-	A1 to A3	50%
BBB+ to BBB-	BBB+ to BBB-	Baa1 to Baa3	100%
BB+ to BB-	BB+ to BB-	Ba1 to Ba3	350%
B+ and below	B+ and below	B1 and below	1250%

### Short-term mapping

S&P assessments	Fitch's assessments	Moody's assessments	Risk weight
A-1+, A-1	F1+, F1	P-1	20%
A-2	F2	P-2	50%
A-3	F3	P-3	100%
All short-term ratings below A-3	Below F3	Not prime (NP)	1250%

**Appendix 3 – Standardised approach - collective investment undertakings - mapping of ECAIs' credit assessments to risk weighting**

<b>S&amp;P assessments (principal stability fund ratings)</b>	<b>S&amp;P assessments (fund credit quality ratings)</b>	<b>Fitch's assessments</b>	<b>Moody's assessments</b>	<b>Risk weight</b>
AAm to AA-m	AAAf to AA-f	AAA to AA-	Aaa to Aa3	20%
A+m to A-m	A+f to A-f	A+ to A-	A1 to A3	50%
BBB+m to BBB-m	BBB+f to BBB-f	BBB+ to BBB-	Baa1 to Baa3	100%
BB+m to BB-m	BB+f to BB-f	BB+ to BB-	Ba1 to Ba3	100%
B+m to B-m	B+f to B-f	B+ to B-	B1 to B3	150%
CCC+m and below	CCC+f and below	CCC+ and below	Caa1 and below	150%

#### **Appendix 4 – Conditions for the use of short-term ratings for short-term bank exposures under Option 2 under the standardised approach to credit risk**

The interaction between short-term bank exposures under Option 2 of the standardised approach to credit risk and short-term assessments of ECAIs is as follows:

- The general preferential treatment for short-term claims, as defined under paragraphs 62 and 64 of Basel II, applies to all claims on banks of up to three months original maturity when there is no specific short-term assessment (i.e. apply the long-term ratings and associated risk weights as defined in Appendix 1 for short-term claims);
- Where there is a short-term assessment, and such an assessment maps into a risk weight that is more favourable (i.e. lower) or identical to that derived from the general preferential treatment, the short-term assessment should be used for the specific claim only; and
- Where a specific short-term assessment for a short-term claim on a bank maps into a less favourable (i.e. higher) risk weight, the general preferential treatment for inter-bank claims cannot be used. All unrated short-term claims should receive the same risk weighting as that implied by the specific short-term assessment.

### Appendix 5 – Mapping consensus risk scores from participating ECAs to risk weighting

Country Score	Standardised approach	Simplified standardised approach	
	Sovereign	Sovereign	Banks and securities firms
0-1	0%	0%	20%
2	20%	20%	50%
3	50%	50%	100%
4-6	100%	100%	100%
7	150%	150%	150%

Sterling denominated and funded sovereign exposures to, and guaranteed by, the Crown Dependency and UK governments attract a risk weighting of 0%, as stated in the Tri-party National Discretion paper.

Note that the use of the country score in determining the risk weighting for exposures to a bank or securities firm is only allowed, and is then an ongoing requirement, under the simplified standardised approach.