



**RESERVE
BANK**

O F N E W Z E A L A N D

Approving credit rating agencies for the non-bank deposit taker sector

Consultation paper

September 2008

Introduction

1. Submissions are invited on the proposals in this public consultation paper. This consultation paper proposes the Reserve Bank's criteria and process for approving rating agencies under the non-bank deposit taker regime established by the Reserve Bank of New Zealand Amendment Act (No 3) 2008.
2. The Amendment Act establishes a regime for non-bank deposit takers ("deposit takers") under Part 5D of the Reserve Bank of New Zealand Act 1989 ("the Act"). Under Part 5D, deposit takers are required to have credit ratings from approved rating agencies by 1 March 2010, unless exempted. As a pre-condition to this, the Reserve Bank must approve rating agencies for deposit takers to use to meet this requirement.
3. For approving rating agencies in relation to non-bank deposit takers, we propose to use effectively the same approval criteria as have been established for banks. In making an application, an applicant would need to benchmark itself against the approval criteria and provide information that would enable the Reserve Bank to decide whether to approve the applicant as a rating agency. Draft credit rating agency approval criteria are appended as part of this consultation paper.

How to make submissions

4. Submissions are invited on the Reserve Bank's proposed credit rating agency approval criteria and process set out in this consultation paper.
5. Submissions should be made by 30 September 2008 and addressed to:

Approving credit rating agencies for the non-bank deposit taker sector
 c/- Alistair Henry
 Prudential Supervision Department
 Reserve Bank of New Zealand
 PO Box 2498
 Wellington
 New Zealand

Or email: nbd.enquiry@rbnz.govt.nz with "Approving credit rating agencies for the non-bank deposit taker sector" in the subject line.

6. Please note that submissions may be the subject of a request under the Official Information Act 1982 and could be published as a result. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you think any part of your submission should properly be withheld under the Act, you should indicate this clearly.

Credit rating requirement for deposit takers

7. Under Part 5D of the Act, a current credit rating must be held by a deposit taker, as required by regulations, for either or both the deposit taker or the borrowing group of which it is part. This credit rating must be from a rating agency approved by the Reserve Bank.
8. This paper addresses matters associated with the approval of rating agencies to enable deposit takers to meet the credit rating requirements under Part 5D of the Act.
9. Part 5D also provides for regulations to specify the type and scope of the credit ratings deposit takers must hold. A separate consultation process will address the details for these regulations.

Key matters and principles for approving rating agencies

10. In charging the Reserve Bank with deciding whether to approve a person as a rating agency for the purposes of the non-bank deposit taker regime, Part 5D of the Amendment Act provides two sets of considerations that apply to the Reserve Bank's decision process. One is a set of 6 key matters "the Reserve Bank must have regard to." The other is a set of 8 principles "the Reserve Bank must take into account." These requirements are set out in sections 157J and 157F respectively, the essential details of which are set out in the next two paragraphs.
11. Under section 157J, in deciding whether to approve a person as a rating agency, the Reserve Bank must have regard to:
 - (a) the independence of the rating agency:
 - (b) the adequacy of resources available to the rating agency:
 - (c) the credibility and objectivity of the rating agency's methodology:
 - (d) the consistency and comparability of the rating agency's ratings when assessed against ratings industry practice:
 - (e) the adequacy of the rating agency's disclosure of information, including information about its processes, experience, and ownership:
 - (f) relevant international standards, codes, and recommended practices relating to the ratings industry.
12. Under section 157F, the Reserve Bank must also take into account the following principles:
 - (a) the desirability of consistency in the treatment of similar institutions, regardless of matters such as their corporate form:
 - (b) the importance of recognising that it is not the purpose of Part 5D to eliminate all risk in relation to the performance of deposit takers or to limit diversity among deposit takers:
 - (c) the importance of recognising that depositors are responsible for assessing risk in relation to potential investments and for their own investment choices:
 - (d) the desirability of providing to depositors adequate information to enable them to assess risk in relation to potential investments and to distinguish between high-risk and low-risk deposit takers:
 - (e) the desirability of sound governance of deposit takers:
 - (f) the desirability of effective risk management by deposit takers:
 - (g) the need to avoid unnecessary compliance costs:
 - (h) the need to maintain competition within the deposit taking sector.

Reserve Bank criteria for approving rating agencies

13. The appendix in this paper sets out the Reserve Bank's proposed criteria for rating agencies for the non-bank deposit taker regime. These are effectively the same as the criteria

established in relation to banks – the difference being the minor changes discussed in paragraph 17.

14. When it comes to thinking about approving rating agencies, the Reserve Bank considers that much the same considerations apply in relation to both the banking and non-bank deposit taking sectors and that the key matters provided in the Act for approving rating agencies reinforce this.
15. The approval criteria are intended to provide guidance on key areas of interest in a rating agency's practices that will be factored into deciding whether to approve a rating agency. In essence, to be approved, a rating agency would need to demonstrate that its operations conform to accepted best practices. To this end, the approval criteria provide a basis for applicants, in making an application, to document and provide relevant information that will enable the Reserve Bank to properly carry out its approval function.
16. In making a decision the Reserve Bank may also use information from other sources. For example, this can be seen in relation to the requirement to have regard to international standards or codes where the recently revised Code of Conduct Fundamentals for Credit Rating Agencies¹ produced by IOSCO (the International Organization of Securities Commissions) provides an important benchmark.
17. Minor changes are proposed to the wording of the approval criteria used in relation to banks. The changes are to clarify the purposes of some of the criteria on independence. The changes are marked in the appendix and in due course will also be made to the approval criteria established for bank supervisory purposes.

Applications and process for consideration

18. We do not propose any specific form for the information that should be provided on application. Rather, an applicant should look to draw from, or point to, aspects of its operations that address the Reserve Bank's approval criteria and document this in its application.
19. The information provided when making an application may be supplemented by discussions or requests for more information to form the basis on which a decision can properly be made. In this regard, each application will be treated on a case-by-case basis but in relation to the approval criteria and the Part 5D requirements. Under this approach, in many cases, there will be a number of ways an applicant could satisfy the criteria.

¹ A report of the Technical Committee of IOSCO, revised May 2008 and available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf>

Appendix – draft Reserve Bank policy

Credit rating agency approval criteria

1. This appendix sets out the Reserve Bank’s criteria for approving rating agencies for the purposes of Part 5D of the Reserve Bank of New Zealand Act 1989.

2. Approval criteria

For a rating agency to be approved, the Reserve Bank must first be satisfied the rating agency meets the criteria set out in this appendix for:

- (a) independence;
- (b) resources;
- (c) objectivity;
- (d) third party access to ratings;
- (e) disclosure;
- (f) consistency and comparability; and
- (g) credibility.

3. Independence

(1) A rating agency should be independent and should conduct itself in a manner that supports its independence. It should have established processes designed to prevent it from being subject to political or economic pressures that could influence a credit rating or its credit assessment processes.

(2) A rating agency should have clear operational policies and procedures to identify and manage potential conflicts of interest, including between the credit rating activities of the rating agency and other interests of its shareholders or directors.

(3) A rating agency should—

- (a) have high standards of corporate governance that are effective in safeguarding the independence and integrity of its credit risk assessment processes;
- (b) ~~have regularly subject~~ its credit rating methodologies, procedures, processes and practices to an audit audited regularly or a similar external or internal independent review of their integrity and suitability for the purposes for which they are used;
- (c) establish and maintain firewalls separating its credit ratings activities from any affiliated businesses to help prevent conflicts of interest; and
- (d) adopt and adhere to a code of conduct that reflects market standards and internationally recognised principles.

4. Resources

(1) A rating agency should have sufficient financial and human resources to carry out high quality credit assessments and maintain its credibility and independence.

(2) A rating agency should—

- (a) be able to develop and maintain systems on an ongoing basis to produce timely, reliable, accurate, consistent and credible credit assessments and ratings;
- (b) allocate a sufficient number of appropriately qualified and competent people to the analysis, review and approval processes for the production of ratings; and
- (c) have sufficient resources to allow for regular substantive interaction with the subjects of its credit assessments.

- (3) A rating agency's financial viability should not depend upon a small number of clients.

5. Objectivity

- (1) A rating agency's assessment methodology should be—
- (a) documented;
 - (b) rigorous and systematic;
 - (c) applied accurately and consistently;
 - (d) validated by substantial historical experience;
 - (e) based on both qualitative and quantitative approaches; and
 - (f) subject to ongoing review.
- (2) A rating agency's assessment methodology should be established for a sufficient period of time to provide for it to be rigorously back-tested and refined to a high level of confidence.
- (3) The ratings produced by its assessment methodology should—
- (a) provide credible, reliable and consistent measures of credit risk;
 - (b) be responsive to changes in financial condition;
 - (c) be continuous (that is, not be point in time ratings); and
 - (d) be subject to ongoing review, including—
 - (i) after all significant events; and
 - (ii) at least annually.
- (4) Rating decisions should be made by a rating committee composed of adequately qualified and experienced individuals in accordance with the rating agency's methodology.

6. Third party access to ratings

- (1) A rating agency's individual credit assessments should be accessible on equivalent terms to all credit institutions and investment firms that have a legitimate interest in them, regardless of the jurisdiction in which they operate.
- (2) A rating agency should not use unsolicited ratings to pressure the subjects of those ratings to obtain solicited ratings.
- (3) A rating agency should not prevent the subjects of its credit assessments from disseminating their ratings.

7. Disclosure

A rating agency should publicly disclose and maintain in a readily accessible form the following information:

- (a) its ownership and corporate structure;
- (b) its code of conduct;
- (c) its process for assigning, monitoring and changing its credit ratings;
- (d) definitions for each of its rating categories and rating modifiers, including:
 - (i) the definition of default;
 - (ii) the time horizons, where applicable; and
 - (iii) the full rating scale;
 (these definitions should be in a form that enables comparisons with ratings in other sectors and those produced by other rating agencies);
- (e) the actual default rates experienced in each rating category over time;
- (f) the probabilities associated with transitions between rating categories, (for example,

- the likelihood of AA ratings becoming A over time);
- (g) its policy on the release of ratings, including changes in ratings or rating modifiers; and
- (h) its policy on unsolicited ratings.

8. Consistency and comparability

- (1) Ratings should represent credit risk in a consistent and comparable manner with regard to established market practices for ratings.
- (2) The nomenclature associated with ratings, including the use of terms such as “investment grade,” should be established with regard to existing market practices and with particular regard to the default rates associated with other ratings in the market.

9. Credibility

In addition to the extent to which credibility is derived from the other criteria for approval, the Reserve Bank may have regard to other factors in assessing a rating agency’s credibility including, for example, the extent to which its credit assessments and ratings are used in the market by participants such as issuers, investors, bankers, insurers, securities traders and other financial services regulators.