

**Recommendation No. 1/2008 of the Board of the Hungarian Financial Supervisory
Authority on the recognition of external credit assessment institutions and their
assessments**

I.

Aim and scope of the recommendation

The new rules on capital adequacy assign a significant role to the application of external credit assessments.

The directives (No.'s 48/2006/EC and 49/2006/EC) defining the new rules of calculating the capital requirement for credit institutions and investment firms allow that the institutions apply the credit assessments of recognized external credit rating agencies or export credit agencies in the calculation of the capital requirement. However, the fulfillment of a high number of requirements is prescribed by the CRD as a condition for it.

By the implementation of the requirements set out in the directives, it became possible for the Hungarian credit institutions and investment firms as well to apply external credit assessments in the course of applying the standardised approach to determine the risk weighting of exposures and of securitization positions, as long as the external credit rating agency was classified by the Supervisory Authority resolution as a recognized credit rating agency, and its credit assessment categories were assigned to the credit quality steps.

The recognition of the external credit rating agencies and their assessments by the Supervisory Authority on the basis of the recommendation is exclusively related to the determination of the risk weights according to the standardised approach of the capital requirement for credit risk, as well as the risk weights of the securitization positions, the recognition can be used for other purposes only on the basis of the express guideline of the Supervisory Authority.

Aim of the recommendation:

- to determine the individual steps as well as the rules of the recognition process observed by the Supervisory Authority in relation to the recognition of external credit assessments,
- to inform the market players of those criteria on the basis of which the Supervisory Authority makes decisions on the recognition of external credit rating agencies, and the assignment of credit assessment categories to credit quality steps,
- to inform the affected parties on the conditions of applying the credit assessments of export credit agencies.

The recommendation is directly addressed to the external credit rating agencies and export credit agencies, while it is indirectly addressed to the credit institutions, financial enterprises that comply with the prudential regulations equivalent to the credit institutions and to investment firms, which apply the credit assessments of the external credit rating agencies or export credit agencies in the calculation of their capital requirement (hereinafter jointly referred to as: "institutions").

The statutory background of the recognition of external credit assessments is defined by Sections 76/G.-76/I of Act CXII of 1996 on Credit Institutions and Financial Enterprises, chapters VI-VII of government decree No. 196/2007 on the Management and Capital Requirement of Credit Risk (hereinafter referred to as: "Hkr"), as well as Sections 11-13 of government decree No. 380/2007 on the Credit Institutions' Capital Requirement of Securitization positions.

The Supervisory Authority proposed that until the statutory background for the investment firms is developed, the provisions set forth in the recommendation should be observed by all the institutions that apply the credit assessments of an external credit rating agency or an export credit agency in the calculation of their capital requirement.

II. Preambles

1. Two important steps of the recognition of external credit assessments are the recognition of the agency itself that performs the external credit assessment on the one hand, and the assignment of the applied credit assessment categories to the credit quality steps by the Supervisory Authority on the other hand (mapping).
2. The recognition of an external credit rating agency is not of general effect: the risk weights of the exposures of which exposure classes the recognition refers to is determined separately in each case, and a separate procedure is carried out with regard to the recognition of determining the risk weights of securitization positions.

III. Recognition of external credit rating agencies by way of application

3. The Supervisory Authority will launch the procedure for the recognition of a credit rating agency not yet recognized in another member state of the European Union, as well as one for the assignment of the credit assessment categories, to the credit quality steps at the request of the credit rating agency.
4. The Supervisory Authority will conduct proper procedures for the recognition and the assignment of the applied credit assessment categories to the credit quality steps only after receiving such a declaration by which the applicant certifies that the credit rating is planned to be used for the calculation of the capital requirement of a financial organization supervised by the Hungarian Financial Supervisory Authority.
5. In the framework of a procedure for the recognition of an external credit rating agency not yet recognized in another member state of the European Union, the Supervisory Authority will conduct a comprehensive audit independently, or if necessary, by initiating a joint recognition process.

6. A comprehensive audit is aimed at concluding how high standard, consistent and reliable the assessments prepared by the external credit rating agency are, and whether they are thus suitable for serving as the basis for the calculation of the capital requirement.
7. The following assessment criteria are defined in the regulation:
 - The Supervisory Authority can only declare an external credit rating agency as recognized, for determining the risk weights of the standardized approach, if the rating methodology applied by the agency complies with the requirements of objectivity, independence, on-going reviews and transparency, as well as if the credit assessment of the agency meets the requirements of credibility and transparency.
 - For determining the value of the risk-weighted exposure of the securitization position, the credit assessments of the recognized external credit rating agency should meet the following conditions, besides the ones defined in the previous section:
 - a) there should be no difference between the expiry of the payment method taken into account in the course of the credit assessment, and that of the payment method that the credit institution calculating the capital requirement is entitled to apply on the basis of the contract establishing the securitization position in question,
 - b) the credit assessment is publicly accessible to the market, and this is contained by the migration matrix of the external credit rating agency, which shows the migration rates between the assessment categories.
 - For the determination of the risk-weighted exposure value of a securitization position, it is a further condition to the recognition of the credit assessment of a recognized external credit rating agency that the external credit rating agency should comply with the requirements of credibility and market acceptance as defined in the Hkr, with respect to securitization.
8. In order for the Supervisory Authority to be able to make its decision on the recognition of an external credit rating agency in possession of information of the appropriate level and adequate quantity, as well as in convergence with the supervisory practices of the other member states, in the process of collecting and assessing the information on the external credit rating agencies it will act in accordance with the basic principles and criteria determined in the legal requirements and the relevant CEBS recommendation ¹.
9. In the context of this, the Supervisory Authority expects the applicant to make available the information required by the “Common Basis Application Pack” attached to the CEBS recommendation as appendix 1, to which supplementary information and documents may be required to be added if necessary.
10. Based on the available information and by taking the requirements defined in Section 2 of the CEBS recommendation into account, the Supervisory Authority will assess:
 - whether the method of classification into the credit assessment categories applied by the external credit rating agency is rigorous and systematic, and is based on past experience,
 - whether the applied credit assessment method is free of political influence, constraints, or economic pressure,

¹ Guidelines on the recognition of External Credit Assessment Institutions, CEBS, 20 January, 2006

- whether the credit assessments are reviewed at least once a year and after all significant events,
 - how sensitive the credit assessments are to the changes in financial conditions,
 - whether there exist any procedures, and if so, what kind, by which it is possible to ensure that the relevant authorities are immediately notified of any significant changes,
 - through what channels, in what language and to whom the fundamental principles of the methods applied by the applicant are disclosed,
 - whether the credibility and market acceptance of the applicant is appropriately proven,
 - whether it is ensured that the credit assessments of the applicant are available to each user who has legitimate interest in getting familiar with the credit assessments under the same conditions, with special regard to access to domestic and non-domestic users under equivalent conditions.
11. In the course of assigning the credit assessment categories to the credit quality steps, the Supervisory Authority assesses the quantitative and qualitative factors in accordance with the provisions defined in Section 3 of the CEBS recommendation, in order to enforce the criteria of objectivity and consistence.

IV.

Official recognition of external credit rating agencies

12. The Supervisory Authority will regard those external credit rating agencies which are recognized as external credit rating agencies as a result of the joint recognition process conducted by the European banking supervisors as external credit rating agencies recognized in Hungary as well, based on the official press release issued on this subject².
13. With regard to the above credit rating agencies, recognition refers to the determination of both the risk weights according to the standardized approach and of the risk weighting of the securitization positions.
14. In the course of calculating the capital requirement of the Hungarian institutions, in the case of these credit rating agencies the Supervisory Authority will furthermore accept those mapping of the credit assessment categories to the credit quality steps which were determined in the framework of the joint recognition process.
15. In other cases, the Supervisory Authority will officially launch the procedure for the Hungarian recognition of credit rating agencies recognized in another member state of the European Union, as well as the application in Hungary of the mapping of the credit assessment categories to the credit quality steps applied in another member state of the European Union as long as the Authority officially becomes aware of the fact of recognition through a Hungarian institution, or based on its own information.

² Europe Agrees on the Eligibility of Three External Credit Assessment Institutions for Capital Purposes, CEBS Press Release, 4 August, 2006

V.
Disclosure by the Supervisory Authority

16. The Supervisory Authority keeps records of the external credit rating agencies recognized in Hungary, as well as the mapping of the credit assessment categories accepted by the individual credit rating agencies to the credit quality steps.
17. The Supervisory Authority discloses the records both on its own homepage, as well as on the CEBS supervisory disclosure webpage.
18. The Supervisory Authority meets its disclosure obligation with regard to the description of the recognition process of the external credit rating agencies by issuing this recommendation, as well as by disclosing it on its own homepage, as well as on the website of CEBS.
19. The Supervisory Authority regularly maintains the records on the recognition of external credit rating agencies, the mapping of the applied credit assessment categories to the credit quality steps, the modifications of the mapping, as well as on any such decision as a result of which a credit rating agency does not qualify as recognized any longer.

VI.
Export credit agencies

20. In line with the content of the CEBS recommendation, no separate recognition procedure with regard to the export credit agencies is conducted by the Supervisory Authority. The Supervisory Authority recognizes the credit assessment of the export credit agency in accordance with the provisions set forth in Section 23 of government decree No. 196/2007 on the Management and Capital Requirement of Credit Risk (hereinafter referred to as: the “Decree”). The Supervisory Authority recognizes the credit assessment of the export credit agency if the export credit agency certifies that
 - a) its credit assessment is in line with the consensus risk scoring of the export credit agencies participating in the Arrangement on Officially Supported Export Credits of the Organization for Economic Cooperation and Development (hereinafter referred as to: the “OECD”), or
 - b) the export credit agency discloses its credit assessments, applies the methods accepted in Section *a*), and assigns one of the eight credit assessment classifications as defined by the methods accepted by the OECD to the credit assessment, for which one of the risk weights indicated in the following table should be applied.

Credit assessment classification	0	1	2	3	4	5	6	7
Risk weighting	0%	0%	20%	50%	100%	100%	100%	150%

VII.
Closing provisions

21. When the recommendation takes effect, recommendation No. 4/2002 on the registration of credit rating agencies of the President of the Hungarian Financial Supervisory Authority will lose effect.
22. The recommendation qualifies as a legal instrument issued in accordance with Note d), Paragraph (1), Section 12 of Act CXXXV of 2007 on the Hungarian Financial Supervisory Authority. The content of the recommendation issued by the Supervisory Commission expresses the requirements of the law, the principles and methods proposed to be applied on the basis of the jurisdiction practices of the Supervisory Authority, as well as the market standards and practices.