FSB FINANCIAL STABILITY BOARD

14 October 2010

Reducing Reliance on CRA Ratings

Report to G20 Finance Ministers and Governors

This report sets out principles to reduce reliance on credit rating agency (CRA) ratings. The principles have been developed by the FSB, in consultation with international standard setters.

G20 Leaders at the Toronto Summit committed to reduce reliance on external ratings in rules and regulations, and asked the FSB to report on its development of principles to the Finance Ministers and Governors meeting in October.

The goal of these principles is to reduce the cliff effects from CRA ratings that can amplify procyclicality and cause systemic disruption. The principles would do so by removing the "hard wiring" of CRA rating thresholds into regulatory regimes, causing mechanistic market responses to CRA rating changes. The principles aim to catalyse a significant change in existing practices, setting out in broad terms the direction of change needed and asking standard setters and regulators to follow up by defining the more specific actions that will be needed to implement the changes.

The removal or replacement of CRA ratings in rules and regulations, and the associated reduction in market reliance, cannot happen overnight. In many cases it will require the development of alternative measures of creditworthiness and of alternative risk management capacity, which will take time. For instance, increasing the use of the internal-ratings-based approach under the Basel capital rules, so as to reduce the banking system's reliance on CRA ratings through use of the standardised approach, would require banks to develop greater expertise at credit assessment and internal ratings. Increased disclosure by issuers of securities would also be important to strengthen investors' ability to make their own credit assessments. The follow-up work will therefore need to incentivise and encourage a transition over a reasonable timeframe extending into the medium term but with clear milestones.

The FSB will work with standard setters and regulators going authorities going forward, asking them to consider next steps that could be taken to translate the principles into more specific policy actions to reduce reliance on CRA ratings in laws and regulations, taking into account the particular circumstances of products, market participants and jurisdictions, while at the same time maintaining adequate international consistency and avoiding regulatory arbitrage. The FSB will report back to G20 Finance Ministers and Governors on progress during 2011.

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Principles for Reducing Reliance on CRA Ratings

The FSB has drawn up the following principles to reduce reliance on CRA ratings in standards, laws and regulations. Reducing reliance in this way will reduce the financial stability-threatening cliff effects that currently arise from CRA rating thresholds being hard-wired into laws, regulations and market practices. The principles aim to catalyse a significant change in existing practices, to end mechanistic reliance by market participants and establish stronger internal credit risk assessment practices instead. They set out broad objectives, for standard setters and regulators to follow up by defining the more specific actions that will be needed to implement the changes over time.

Principle I. Reducing reliance on CRA ratings in standards, laws and regulations

Standard setters and authorities should assess references to credit rating agency (CRA) ratings in standards, laws and regulations and, wherever possible, remove them or replace them by suitable alternative standards of creditworthiness.

- ***References to CRA ratings should be removed or replaced only once alternative provisions in laws and regulations have been identified and can safely be implemented.***
- ***It is particularly pressing to remove or replace such references where they lead to mechanistic responses by market participants.***
- ***Standard setters and authorities should develop alternative definitions of creditworthiness and market participants should enhance their risk management capabilities as appropriate to enable these alternative provisions to be introduced.***
- ***Standard setters and authorities should develop transition plans and timetables to enable the removal or replacement of references to CRA ratings wherever possible and the associated enhancement in risk management capabilities to be safely introduced.***

The "hard wiring" of CRA ratings in standards and regulations contributes significantly to market reliance on ratings. This in turn is a cause of the "cliff effects" of the sort experienced during the recent crisis, through which CRA rating downgrades can amplify procyclicality and cause systemic disruptions. But, more widely, official sector uses of ratings that encourage reliance on CRA ratings have reduced banks', institutional investors' and other market participants' own capacity for credit risk assessment in an undesirable way.

Some jurisdictions have already implemented or are considering actions to remove or replace references to CRA ratings in their laws and regulations. In other cases, it may take a number of years for market participants to develop enhanced risk management capability so as to enable reduced reliance on credit rating agencies. Authorities should take actions to incentivise the necessary enhancements to be made.

Principle II. Reducing market reliance on CRA ratings

Banks, market participants and institutional investors should be expected to make their own credit assessments, and not rely solely or mechanistically on CRA ratings.

- ***The design of regulations and other official sector actions should support this principle.***
- ***Firms should ensure that they have appropriate expertise and sufficient resources to manage the credit risk that they are exposed to. They may use CRA ratings as an input to their risk managements, but should not mechanistically rely on CRA ratings.***
- ***Firms should publicly disclose information about their credit assessment approach and processes, including the extent to which they place any reliance on, or otherwise use, CRA ratings.***
- ***Supervisors and regulators should closely check the adequacy of firms' own credit assessment processes, including guarding against any upward biases in firms' internal ratings.***

At the same time, CRAs play an important role and their ratings can appropriately be used as an input to firms' own judgement as part of internal credit assessment processes. They can provide economies of scale in analysing credit on behalf of smaller and less sophisticated investors, and can be used as an external comparator by all investors in their own internal assessments. In general, therefore, principles in this area should recognise these useful functions and should differentiate according to size and sophistication of firm, and according to the asset class of instruments concerned (e.g. sovereign, corporate, or structured) and the materiality of the relevant exposures. At the same time, the principles should make clear that any use of CRA ratings by a firm does not lessen its own responsibility to ensure that its credit exposures are based on sound assessments.

While hard limits on the amounts of investments that are not internally credit-assessed might be challenging to implement in the near term, they could be an option in some cases if appropriately phased in. In the shorter term, changes in supervisory approaches and increased disclosure by firms about investment practices could be implemented relatively quickly.

Application of the basic principles to particular financial market activities

The following provides more specific principles for particular areas of financial market activity.

Principle III.1. Central bank operations

Central banks should reach their own credit judgements on the financial instruments that they will accept in market operations, both as collateral and as outright purchases. Central bank policies should avoid mechanistic approaches that could lead to unnecessarily abrupt and large changes in the eligibility of financial instruments and the level of haircuts that may exacerbate cliff effects.

Central banks should avoid mechanistic use of CRA ratings by:

- ***except when infeasible, making independent determinations of whether a financial instrument should be eligible in its operations (both by being prepared to reject assets offered as collateral or for outright purchase despite its external ratings and by assessing whether any external rating change should lead to a change in a financial instrument's eligibility or haircut);***
- ***reserving the right to apply risk control measures such as additional haircuts to any individual financial instruments or classes of collateral based on an internal risk assessment; and***
- ***reserving the right to apply additional risk control measures such as additional haircuts to any individual financial instrument that has not been subject to an internal risk assessment by the central bank.***

This would have a knock-on benefit in reducing the effect of CRA ratings on private sector investment policies, to the extent the policies key off acceptability as central bank collateral (e.g. in regulatory liquidity policies). At the same time, central banks should conduct their communications and market operations in a way that avoids unnecessary market uncertainty from the use of internal assessments in determining eligibility.

Principle III.2. Prudential supervision of banks

Banks must not mechanistically rely on CRA ratings for assessing the creditworthiness of assets. This implies that banks should have the capability to conduct their own assessment of the creditworthiness of, as well as other risks relating to, the financial instruments they are exposed to and should satisfy supervisors of that capability.

- ***In order to provide market discipline, banks should publicly disclose information about their credit assessment approach, and the proportion of their portfolio (or of particular asset classes) for which they have not conducted an internal credit assessment. This could be required for instance through Pillar 3 of the Basel II framework.***
- ***Banks using the standardised Basel II approach currently have minimum capital requirements based on CRA credit ratings. As long as some banks continue to have capital requirements based on CRA ratings, supervisory processes should be put in place to check the understanding of the appropriate uses and limitations of CRA ratings by these banks' risk managers.***

III.2.a. Larger, more sophisticated banks within each jurisdiction should be expected to assess the credit risk of everything they hold (either outright or as collateral), whether it is for investment or for trading purposes.

- ***In order to ensure that credit risks are adequately managed, banks should, where needed, enhance their capacity for internal credit assessment. Some aspects of this enhancement may take a number of years before the relevant references to CRA ratings in regulations can be completely removed or replaced.***

- ***Supervisors should incentivise banks to develop internal credit risk assessment capacity, and to increase use of the internal-ratings-based approach under the Basel capital rules. In order to do this, supervisors should enhance their ability to oversee and enforce sound internal credit policies.***
- ***This may require an increase in resources devoted to bank risk management and supervisory oversight of risk management.***

Banks' enhancement of internal credit risk assessment processes could be incentivised through restricting the proportion of the portfolio that is CRA rating-reliant, e.g. by:

- requiring all large exposures (as defined under supervisory rules) to be internally assessed;
- setting a limit on the share of the overall portfolio or of particular asset types that solely relies on CRA ratings;
- raising the capital requirements for investments not internally assessed.

Particular restrictions could be applied to certain types of asset, e.g.:

- large banks could be required to internally assess the creditworthiness of all sovereign and corporate exposures;
- use of CRA credit ratings that incorporate an assumption of government support could be particularly tightly restricted;
- the amended Basel II framework, to be implemented from end-2011, already states that securitisations will be deducted from capital if banks do not collect data on the underlying assets to be able to make their own assessment of credit and other risks. Further steps could be taken to reduce the reliance on CRA ratings, and the cliff effects resulting from reference to CRA ratings, in the capital requirements for securitisations;
- particular restrictions could be placed on investments in structured products too complex for banks to be able adequately to internally assess the credit risk;
- restrictions could be eased for modest amounts of assets that are held for a short period only, which were acquired e.g. for market-making purposes, with limits on such holdings agreed with supervisors.

These approaches would require further study of the ways in which they could change banks' incentives. For example, supervisors would need to oversee internal credit modelling carefully to guard against incentives for banks to make internal ratings higher than external ratings.

III.2.b. Smaller, less sophisticated banks may not have the resources to conduct internal credit assessments for all their investments, but still should not mechanistically rely on CRA ratings and should publicly disclose their credit assessment approach.

- ***Such banks should understand the credit risks underlying their balance sheet as a whole and, for all exposures that would materially affect the bank's performance, should make a risk assessment commensurate with the complexity and other characteristics to the investment product and the materiality of their holding.***

Principle III.3. Internal limits and investment policies of investment managers and institutional investors

Investment managers and institutional investors must not mechanistically rely on CRA ratings for assessing the creditworthiness of assets. This principle applies across the full range of investment managers and of institutional investors, including money market funds, pension funds, collective investment schemes (such as mutual funds and investment companies), insurance companies and securities firms. It applies to all sizes and levels of sophistication of investment managers and institutional investors.

CRA ratings are no substitute for investment managers' and institutional investors' due diligence, including the assessment of credit and other risks. While references to CRA ratings in internal limits, credit policies and mandates can sometimes play a useful role as broad benchmarks for transparency of credit policies, they should not substitute for investment managers' own independent credit judgements and that should be clear to the market and customers.

III.3.a. Investment managers should conduct risk analysis commensurate with the complexity and other characteristics of the investment and the materiality of their exposure, or refrain from such investments. They should publicly disclose information about their risk management approach, including their credit assessment processes.

Investment managers generally are subject to a fiduciary duty to act in the best interests of the investors whose funds they manage. To fulfil this obligation, appropriate internal controls and procedures need to be in place to assess and manage on an ongoing basis the credit and other risks associated with the investments. Where CRA ratings are used as input, investment managers should understand the basis on which the CRA opinion has been formed.

For structured finance instruments, IOSCO has issued good practices for investment managers' due diligence, which include that an investment manager should understand how the opinion of the CRA was formed and should not rely excessively or solely on it to form his own opinion of the instrument.

III.3.b. Senior management and boards of institutional investors have a responsibility to ensure that internal assessments of credit and other risks associated with their investments are being made, and that the investment managers they use have the skills to understand the instruments that they are investing in and exposures they face, and do not mechanistically rely on CRA ratings. Senior management, boards and trustees should ensure adequate public disclosure of how CRA ratings are used in risk assessment processes.

In the case of smaller, less sophisticated institutional investors (who do not have the resources to conduct internal credit assessments for all their investments or who may outsource all or part of their investment management rather than invest directly themselves), this could be through the trustees or others responsible for directing the investment strategy ensuring that they understand the risks in the strategy which they are following and that they understand the appropriate uses and limitations of CRA ratings.

III.3.c. Regulatory regimes should incentivise investment managers and institutional investors to avoid mechanistic use of CRA ratings.

- ***Regulators of investment managers should enhance their ability to oversee and enforce sound internal credit policies.***

Incentives to avoid mechanistic use of CRA ratings could include:

- restricting the proportion of a portfolio that is solely CRA ratings-reliant;
- supervisory monitoring of credit and other risk assessment processes (in the case of supervised investment managers and institutional investors);
- requiring the boards, trustees or other governing bodies of investment managers and institutional investors to regularly review any use of CRA ratings in their investment guidelines and mandates and for risk management and valuation;
- requiring public disclosures of internal due diligence and credit risk assessment processes, including how CRA ratings are or are not used, with the aim of encouraging investment managers to develop more rigorous and individual processes, including in investment mandates, rather than relying on common triggers;
- requiring public disclosures of risk assessment policies not only relating to rating thresholds but also according to types of instruments (thus reflecting the different nature of the risks applying to, e.g., structured finance compared with corporate bonds). Such disclosures should be made in a manner consistent with the goal of streamlining disclosures for customers.

Principle III.4. Private sector margin agreements

Market participants and central counterparties should not use changes in CRA ratings of counterparties or of collateral assets as automatic triggers for large, discrete collateral calls in margin agreements on derivatives and securities financing transactions.

While using an external measure such as CRA ratings can be helpful as a third-party reference for setting margin requirements:

- Market participants should use through-the-cycle initial margins and frequent, ideally daily, variation margin payments based on mark-to-market price changes for collateralising bilateral derivatives exposures.
- Standardised derivatives transactions should be cleared through central counterparties, with consideration given to using through-the-cycle margins and haircuts, eliminating the need for bilateral margining for these products.

III.4.a. Supervisors should review the margining policies of market participants and central counterparties to guard against undue reliance on CRA ratings.

Supervisors should not allow CRA rating triggers to be used as a factor that reduces regulatory capital requirements.

Principle III.5. Disclosures by issuers of securities

Issuers of securities should disclose comprehensive, timely information that will enable investors to make their own independent investment judgements and credit risk assessments of those securities. In the case of publicly-traded securities, this should be a public disclosure.

In some cases, investors have weaker access to issuer information than CRAs, thus adding to their reliance on CRA ratings. Improved disclosure by issuers to investors will facilitate the build-up of capabilities at banks, investment managers and institutional investors to conduct their own assessment of the creditworthiness of the financial products they invest in and thus enhance their ability to avoid mechanistic reliance on CRA ratings.

III.5.a. Standard setters and authorities should review whether any references to CRA ratings in standards, laws and regulations relating to disclosure requirements are providing unintended incentives for investors to rely excessively on CRA ratings and, if appropriate, remove or amend these requirements.

Next steps

The FSB will request standard setters and regulators to consider next steps that should be taken to translate the principles into more specific policy actions to reduce reliance on CRA ratings in laws and regulations, taking into account the particular circumstances of products, market participants and jurisdictions, while at the same time maintaining adequate international consistency and avoiding regulatory arbitrage. Authorities should share experiences as they take steps to reduce reliance, so as to learn from each other.

Standard setters and regulators should incentivise a transition to a reduced reliance on CRA ratings over a reasonable timeframe extending into the medium term, taking into account the need for market participants to build up their own risk management capabilities to replace reliance on CRA ratings, but with clear milestones.

The FSB will report to G20 Finance Ministers and Governors on progress during 2011.