FSB FINANCIAL STABILITY BOARD

29 August 2013

Credit Rating Agencies
Reducing reliance and strengthening oversight

Progress report to the St Petersburg G20 Summit

- **Authorities need to accelerate work to end the mechanistic reliance of regulatory regimes and of market participants on external ratings, which can lead to herd behaviour and cliff effects in market prices when downgrades occur.**

- **The FSB is taking forward its roadmap to reduce reliance on credit rating agency (CRA) ratings through a thematic peer review of national authorities' actions to reduce reliance. The review aims to accelerate progress and assist national authorities in fulfilling their commitments under the roadmap.**

- **The interim peer review report has been published. It notes that jurisdictions have faced different starting positions from which to make reforms. The US has moved the furthest in removing hard-wiring of ratings, and the EU has also made significant progress. Progress in most other jurisdictions has been slower.**

- **Among existing international standards, the greatest use of CRA ratings is in the Basel framework. The Basel Committee for Banking Supervision (BCBS) has made proposals to reduce reliance in its securitisation framework and by mid-2014 will make proposals on reducing reliance within its standardised approach for capital requirements. The challenge is to identify credible alternative standards of creditworthiness.**

- **Market participants need to improve their own capacity to make their own credit assessments in order that they can safely reduce their reliance on CRA ratings. This too presents challenges and will take time.**

- **FSB members should disclose action plans, as agreed under the roadmap, that identify and prioritise further areas for changes in laws and regulations. These action plans will be used in the second stage of the peer review to share lessons on the steps that can be taken by authorities to reduce references to CRA ratings in legislation and regulation and to promote strengthened credit assessment capabilities. IOSCO sees enhanced transparency as playing an important role in market competition and may enhance its transparency standards for CRAs as part of its ongoing revision of its CRA Code of Conduct. The FSB will continue to monitor whether further work is needed in this area beyond the revision of the Code.**

G20 Leaders in Los Cabos called for accelerated progress by national authorities and standard setting bodies in ending the mechanistic reliance on credit ratings, and encouraged steps that would enhance transparency of and competition among CRAs.

G20 Finance Ministers and Central Bank Governors in April supported the launch of the FSB's peer review on national authorities' steps to reduce reliance on CRA ratings, and asked for a status report including the work by standard setting bodies to be presented to the St Petersburg Summit. They also took note of the International Organization of Securities Commissions (IOSCO) Report on Transparency and Competition among CRAs delivered to them in April, and asked the FSB to examine the need for further work in this area in the light of current domestic and regional regulatory initiatives.

The FSB issued in 2010 Principles for Reducing Reliance on CRA Ratings and is closely monitoring the implementation of the principles, as described below. IOSCO had issued guidance on transparency and competition amongst CRAs. This note provides a summary of this ongoing work and next steps.

Reducing reliance on CRA ratings

The goal of the FSB's Principles is to end mechanistic reliance on CRA ratings by banks, institutional investors and other market participants by reducing the "hard wiring" of CRA ratings in standards, laws and regulations and by providing incentives for firms to develop their own capacity for credit risk assessment and due diligence. As demonstrated during the financial crisis, such reliance can be a cause of herding behaviour and of abrupt sell-offs of securities when they are downgraded ("cliff effects") which can in turn amplify procyclicality and cause systemic disruption.

The Principles recognise that 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. But any use of CRA ratings by a firm should not be mechanistic and does not lessen its own responsibility to ensure that its credit exposures are based on sound assessments.

In response to the call of G20 Leaders in Los Cabos for accelerated progress, the FSB published a roadmap[1] in October 2012 with timelines to accelerate implementation of the FSB Principles. The list of milestones in the roadmap is attached.

Peer review on authorities' actions to reduce reliance

The FSB is currently conducting a thematic peer review of progress made in member jurisdictions in implementing the Principles. The peer review's main objective is to assist national authorities in fulfilling their commitments under the roadmap. The review focuses on those aspects of the Principles that are directly addressed to the official sector. It is structured in two stages, the first of which has recently been completed. An interim report[2] was published on 29 August 2013 which includes a structured stocktaking of references to CRA

[1] See http://www.financialstabilityboard.org/publications/r_121105b.pdf.

[2] http://www.financialstabilityboard.org/publications/r_130829e.pdf.

ratings in national authorities' laws and regulations and of actions taken and underway to reduce these references.

The main findings of the interim report are as follows:

- Almost all FSB jurisdictions have conducted the requested stock-taking of references to CRA ratings in national authorities' laws and regulations and of actions taken and underway to reduce these references. Such a stock-taking exercise is an essential precondition for the removal of hard-wired references to CRA ratings in laws and regulations. Only a few member jurisdictions have not yet completed a stock-taking and the peer review team recommends that they do so by end-September 2013.
- Both the US and the EU have taken significant steps to remove the hard-wiring of CRA ratings from their rules and regulations: the US has moved furthest through the implementation of the Dodd-Frank Act (which sets a more absolute standard than the Principles since it requires the complete removal of references to CRA ratings) and the EU through the adoption of the CRA III Regulation. CRA III represents the most comprehensive other attempt so far to give effect to the Principles, although most other FSB member jurisdictions also report having made some progress in this regard.
- The extent of remaining reliance on CRA ratings in laws and regulations varies across financial sectors. At present, CRA ratings continue to play a significant role in setting bank capital adequacy requirements, although they play a less prominent role in the prudential supervision of insurance companies and other non-bank financial intermediaries.
- Many FSB member central banks report that they have either already taken or intend to take measures to reduce mechanistic reliance on CRA ratings. The majority state that they have policies and practices in place in one or more areas of their activities that are in line with the FSB Principles. Several central banks report that they have enhanced their capacity to undertake internal credit risk assessments or are looking into ways to do so.

While recognising this progress in implementing the Principles, the peer review has identified several areas where accelerated progress is required:

- FSB jurisdictions should provide incentives for market participants to develop their own independent credit assessment processes. Examples might include disclosure requirements relating to credit risk assessment practices or articulation of clear supervisory expectations concerning due diligence.
- All FSB jurisdictions, drawing on guidance from standard-setting bodies where available, should encourage or continue to enhance disclosures on financial institutions' internal credit risk assessment practices.
- National authorities agreed under the roadmap to identify and prioritise areas for change and to publicly disclose action plans for making changes, but at present only a few FSB jurisdictions have developed such plans. The peer review recommends that all FSB jurisdictions should develop such plans for publication by mid-2013 in accordance with their roadmap commitments. These plans are an essential input to the second stage of the peer review.

- The action plans could take the form of a high-level listing of steps that FSB members intend to take to implement the Principles, including the factors that would enable them to complete their implementation. Jurisdictions should, wherever possible, set explicit deadlines for implementation of the elements of their action plan to ensure that the momentum towards the elimination of hard-wiring of ratings is maintained. In some cases, though, detailed actions and timelines may need to await further policy guidance from standard-setters.

The peer review has also identified a number of challenges to be addressed in order to make further progress in implementing the Principles:

- Many FSB jurisdictions report that the continuing references to CRA ratings in their national laws and regulations result from the role that ratings play in international standards, and that removing such references will require amendments to these standards. The work of the Basel Committee on Banking Supervision to reduce reliance in their standards is described below. The peer review recommends that standard-setting bodies provide additional guidance to their members on steps to further discourage reliance on CRA ratings in accordance with the timetable set forth in the roadmap.
- Further work is required to identify and develop alternative standards of creditworthiness to CRA ratings while also taking into account the need to maintain international consistency.
- The development of firms' internal risk assessment systems is constrained by the resource requirements and by the relative scarcity of expertise in credit risk analysis. This issue is seen as particularly problematic for smaller financial intermediaries.
- Finally, references to ratings frequently feature in private contracts (for example, in the investment mandates given to asset managers) or private sector investment decisions. Obligations arising from the fiduciary duties of investors (e.g. the "prudent man" rule in pension fund investments) give rise to similar issues.

The second stage of the peer review, which will commence in September 2013, will analyse information provided through the structured stocktaking and action plans as well as other steps being taken by national authorities to reduce references to CRA ratings in legislation and regulation and to promote strengthened credit assessment capabilities. The analysis in the second stage will result in lessons of experience and guidance that national authorities will be able to use as they work towards meeting their remaining roadmap commitments. The FSB intends to issue the final peer review report in early 2014.

Work by standard-setting bodies to reduce reliance on CRAs

Standard-setting bodies continue to work to reduce references to CRA ratings in international standards and to encourage reduced reliance on CRA ratings by authorities and market participants.

Among the various financial regulatory standards, the greatest existing use of CRA ratings is in the Basel capital and liquidity standards, and accordingly the BCBS is the standard-setting body with the most substantial work programme to find ways to reduce such references. In considering potential alternatives to use of CRA ratings, the BCBS is taking account of the challenges that also exist with respect to reliance on banks' internal models, the large variations in risk weights that cannot be explained by underlying risks, the potential procyclicality of market-based indicators and the need for sufficient reliable in-house capacity to assess credit risks.

One of the areas in the existing Basel rules where most extensive use of CRA ratings is made relates to securitisations. The BCBS published in December 2012 a consultative paper on revisions to the Basel securitisation framework, which seeks to address a number of shortcomings in the existing framework including: mechanistic reliance on external ratings; too low risk weights for highly-rated securitisation exposures; and cliff effects in capital requirements following deterioration in credit quality of the underlying pool.

The BCBS has set up a Task Force on Standardised Approaches, one of whose objectives is to reduce or remove, where possible, the reliance on external ratings, including developing supplementary measures for risk classification and encouraging stronger supervisory practices to promote alternative measures for risk assessment The Task Force is investigating whether appropriate alternatives to ratings exist and is developing policy recommendations to reduce mechanistic reliance on ratings. The BCBS expects to publish a consultative proposal on the review of standardised approaches around mid-2014, in line with the FSB roadmap timetable.

Earlier stocktakes by other standard setters (IOSCO on disclosure and accounting, market intermediaries, and investment management, International Association of Insurance Supervisors on insurers, and Organisation for Economic Co-operation and Development on pension funds) have found relatively few references within their own standards that encourage reliance on CRA standards. In line with the roadmap, by end-2013 they will provide guidance to their members on steps to further discourage reliance on CRA ratings, and will facilitate sharing of ideas and best practices amongst their membership.

Improving transparency and competition among CRAs

IOSCO has provided to the FSB an update of its work in this area, drawing from its April report to the G20.[3] The update covers IOSCO's work to date to promote CRA transparency, the CRA transparency measures taken by IOSCO member jurisdictions, and IOSCO's ongoing work to further revise its Code of Conduct Fundamentals for CRAs[4] (the initial revision of its original 2004 Code took place in 2008).

The IOSCO report highlights that CRA transparency and competition are linked, in that transparency assists users of credit ratings in comparing the processes and performance of CRAs. IOSCO's stock-take shows that robust transparency requirements are a fundamental component of the CRA registration and oversight programs administered by IOSCO members, and that, especially post-crisis, IOSCO members have implemented laws and regulations that require CRAs to disclose information about rating methodologies, rating performance, conflicts of interest, and other operational matters. The update includes a

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3 IOSCO's April report to the G20 is available at http://www.iosco.org/library/briefing_notes/pdf/IOSCOBN01-13.pdf.

4 IOSCO's 2008 revised Code of Conduct is available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD271.pdf.

detailed appendix on member jurisdictions' laws and regulations that require CRAs to make disclosures.

With regard to competition, the historic dominance by three globally active CRAs that use the issuer-pays model continues. Smaller independent CRAs operate in some jurisdictions, and may focus on niche areas or on issuers not rated by the three largest CRAs, while others operate under the subscriber-pays model. Whether the smaller and new-entrant CRAs succeed in competing with the three largest CRAs in large part depends on convincing investors that their credit ratings are of high quality, which, in turn, will incentivise issuers to hire them. This is where transparency can play an important role in market competition. Transparency allows investors to compare the practices of CRAs and allows smaller CRAs and new entrants to establish points of observable competitive difference from the three largest CRAs. In turn, this incentivises larger CRAs to update their internal policies and procedures to improve the quality of their credit ratings and retain credibility among investors and other users of credit ratings. This is the competitive dynamic that the CRA transparency measures implemented by IOSCO and its members seek to foster.

IOSCO notes that the goal of the ongoing revision to the CRA Code, which will include reviewing and enhancing the Code's transparency provisions as appropriate, is to update the Code so that it can operate in tandem with national CRA laws and regulations while it continues to operate as an international standard for self-governance. IOSCO plans to discuss the working group's second draft of the revised Code at its next meeting in November 2013, with the aim of publishing a draft of the revised Code for consultation in the first quarter of 2014 and the finalised IOSCO CRA Code in the summer of 2014.

Annex: Roadmap for reducing reliance on CRA ratings

1: Reduce references to CRA ratings in standards, laws and regulation		
BCBS	**Complete work to identify remaining elements of the Basel framework that will be reviewed for potential to reduce the reliance on CRA ratings** across the Basel framework	end-2012
	Develop policy proposals for alternative approaches to reliance on CRA ratings.	mid-2014
	Adoption by jurisdictions	from 2016
IOSCO, IAIS, OECD	**Provide guidance** to members on steps to further discourage reliance on CRA ratings	end-2013
National authorities	**Complete the stock-taking** of legislation/regulation for potential reform (supervisors, central banks, market regulators, finance ministries), possibly followed by peer review	mid-2013
	Identify/prioritise areas for changes and publicly disclose action plan	mid-2013
	Propose alternative approaches to CRA references/requirements for public comment	mid-2014
	Confirm final changes	end-2014
	Implementation by market participants is completed	end-2015
2: Strengthen credit assessment capabilities		
SSBs:	**Lead discussion(s)** across members to share ideas and experiences, and to better define best practice	Ongoing
National authorities	**Promote best practice**: organise roundtable discussions across public sector, industry, and academia	Ongoing
(Policy):	**Develop guidance** regarding formulation and disclosure of appropriate risk assessment practices	mid-2014
	Encourage disclosure by financial institutions of information about their credit risk assessment processes as part of their public reporting	end-2013
Public sector investors	Public sector bodies that are investors or market participants **disclose information** about credit risk assessment processes and strategy to achieve FSB Principles	end-2013
	Participate in national authorities' roundtable discussions at international/national levels	Ongoing