FSB: Principles to reduce reliance on Credit Rating Agencies ratings. November 2010.

The Financial Stability Board (FSB) has published a report that contains principles whose goal is, to reduce the excessive -almost mechanistic- reliance on credit rating agencies (CRA) ratings of Banks, other financial institutions and markets in general. It also pretends to incentivise improvements in independent risk assessment and due diligence capacity, aiming to avoid the mechanistic use of CRA ratings. The principles are the following:

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

Standard setters and regulators should assess references to CRA ratings in standards, laws and regulations, and, wherever possible, remove them or replace them by suitable alternative standards of creditworthiness. To that effect, it is necessary to identify alternative provisions to CRA ratings references that can safely be implemented, to develop alternative definitions of creditworthiness and that the market participants enhance their risk management capabilities as appropriate to enable these alternative provisions to be introduced. This process requires transitions plans and timetables to be safely implemented.

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. To that effect, it is necessary that firms ensure that they have appropriate expertise and sufficient resources to manage the credit risk that they are exposed to; in this context, firms could use CRA ratings as an input to their risk management. The firms also should publicly disclose information about their credit assessment approach and process 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.

III.- Application of the Basic principles to particular financial market activities.

III.1.- Central Banks 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, and should avoid, if possible, mechanistic approaches that could lead to unnecessarily abrupt and large changes in the eligibility of financial instruments and the level of haircut that may exacerbate cliff effects. To that effect, it is necessary that risk control measures are taken (such as additional haircut) to individual financial instruments or classes of collateral based on an internal assessment or to any individual financial instrument that has not been subject to an internal risk assessment by the central bank.

III.2.- Prudential supervision of banks.

Banks must not mechanistically rely on CRA ratings for assessing the creditworthiness of assets, so that they 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; besides, banks should publicly disclose information about their credit assessment approach and about the proportion of their portfolio for which they have not conducted and internal credit assessment. While some Banks continue to comply with the minimum capital requirements based con CRA ratings, supervisory processes should be put in place to check the understanding of the appropriate uses and limitations for CRA ratings by these banks´ risk managers.

Larger, more sophisticated banks should be expected to assess the credit risk of everything they hold (either outright or as collateral), whether if is for investment or for trading purposes and, in order to that, they should enhance their capacity for internal credit assessment.. Smaller, less sophisticated Banks may not have de resources to conduct internal credit assessments but still should not mechanistically rely on CRA ratings understanding at least the credit risk underlying their balance sheet as a whole and, nonetheless, they should publicly disclose their credit assessment approach.

III.3.- Investment policies of investment managers and institutional investors.

Investment managers and institutional investors must –including all sizes and levels of sophistication and, surely, money market funds, pension funds, collective investment schemes, insurance companies and securities firms- must no either mechanistically rely on CRA ratings for assessing the creditworthiness of assets. Regulatory regimes should incentivise avoiding mechanistic use of CRA ratings with provisions such as: restrict the proportion of a portfolio that is solely ratings-reliant, monitor credit and other risk assessment process, require the board and governing bodies to regularly review any use of CRA ratings or require publicly disclosures of internal due diligence and credit risk assessment processes including how CRA ratings are or are not used.

III.4.- Private sector margin requirements.

Market participants and central counterparties should not use changes in CRA ratings of counterparties or of collateral assets as automatic triggers for large collateral calls in margin agreements; while using a CRA rating could be helpful as a reference for setting margin requirements, the initial and diary margins would be base on mark-to-market prices changes for bilateral derivatives, and standardised derivatives transaction should be cleared through central counterparties eliminating the need for bilateral margining for these products. Supervisor should avoid that margin policies rely excessively on CRA ratings and that the use of CRA ratings would never be used as a factor that reduces market participants regulatory capital requirements.

III.5.- Disclosure requirements for issuer of securities.

Issuers should disclose comprehensive and timely information that will enable investors to make their own independent investment judgements and credit risk assessment of those securities. In the case of publicly-traded securities, this should a public disclosure. Access to a improved disclosure will facilitate the build-up of capabilities at Banks, investment managers and institutional investors to conduct their own assessments.

IV.- Next steps.

The FSB will request standard setters and regulators to consider next stops that should be taken to translate this principles into more specific policy actions to reduce Reliance on CRA ratings in regulations maintaining, at the same time, adequate international consistency and avoiding regulatory arbitrage. Some of these actions are already taking place and FSB is supervising progress in this transition although, in general, a reasonable time frame in the medium term will be required taking into account the need for market participants to build up their own risk management capabilities. The FSB will report to G 20 on progress during 2011.

If you want to read the FSB press release, you could click on http://www.financialstabilityboard.org/press/pr_101027.pdf

If you want to open the FSB document, please click onhttp://www.financialstabilityboard.org/publications/r_101027.pdf