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International Organization of Securities Commissions
Organisation internationale des commissions de valeurs
Organização Internacional das Comissões de Valores
Organización Internacional de Comisiones de Valores

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IOSCO consults on Good Practices on Reducing Reliance on CRAs in asset management

The International Organization of Securities Commissions today published a consultation report on *Good Practices on Reducing Reliance on CRAs in asset management*. The report is aimed at gathering the views and practices of investment managers, institutional investors and other interested parties, with a view to developing a set of good practices on reducing over reliance on external credit rating in the asset management space.

Credit rating agencies (CRAs) play a prominent role in today's global financial markets. Although approaches may differ across jurisdictions, investment managers often use the services of CRAs to form an opinion on the creditworthiness of a particular issuer before purchasing securities, selecting counterparties, or choosing the best collateral to secure transactions. On their part, investors often refer to CRA ratings before buying shares of a fund, or when guiding investment managers on the basis of a tailored investment mandate.

The role of CRAs has come under regulatory scrutiny, mainly as a result of the over-reliance of market participants, including investment managers and institutional investors, on CRA ratings in their assessments of both financial instruments and issuers in the run-up to the 2007-2008 financial crisis.

To address this concern, the Financial Stability Board (FSB) published in October 2010 its report on *Principles for Reducing Reliance on CRA Ratings* ("FSB 2010 *Principles*"). The goal of these

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Principles is to end mechanistic reliance on ratings by banks, institutional investors, and other market participants. They concluded with a call for regulators and standard setters such as IOSCO to consider steps for translating the *Principles* into more specific policy action.

The good practices that result from today´s consultation paper will be addressed to national regulators, investment managers, and investors, where applicable. IOSCO also has launched a separate project to identify the good practices of intermediaries with regard to the use of alternatives to credit ratings to assess creditworthiness.

The report stresses the importance for asset managers to have the appropriate expertise and processes in place to assess and manage the credit risk associated with their investment decisions. Recognizing the utility of external ratings, the report mentions that they can be used as an input among others to complement a manager's internal credit analysis and provide an independent opinion as to the quality of the portfolio constituents. However, in order to avoid the over-reliance on external ratings, the report lists some possible good practices that managers may consider when resorting to external ratings.

The report consults on the following list of possible good practices in asset management:

1. Investment managers make their own determinations as to the credit quality of a financial instrument before investing and throughout the holding period.

   External credit ratings may form one element, among others, of the internal assessment process but do not constitute the sole factor supporting the credit analysis.

2. An internal assessment process that is commensurate with the type and proportion of debt instruments the investment manager may invest in, and a brief summary description of which is made available to investors, as appropriate.

   An internal assessment process that is regularly updated and applied consistently.

3. Regulators could encourage investment managers to review their disclosures describing alternative

sources of credit information in addition to external credit ratings

4. Regulators could encourage investment managers– as represented collectively through trade associations and/or SROs – to include in their credit assessments alternative (internal) sources of credit information in addition to external credit ratings.
5. Where external credit ratings are used, investment managers understand the methodologies, parameters and the basis on which the opinion of a CRA was produced, and have adequate means and expertise to identify the limitations of the methodology and assumptions used to form that opinion.
6. Regulators could encourage investment managers to disclose the use of external credit ratings and describe in an understandable way how these complement or are used with the manager's own internal credit assessment methods.
7. Regulators could encourage investment managers, when assessing the credit quality of their counterparties or collateral not to rely solely on external credit ratings and to consider alternative quality parameters (e.g., liquidity, maturity, etc.).
8. Where an investment manager (or CIS board, as appropriate) explicitly relies on external credit ratings among others to assess the credit worthiness of specific assets, a downgrade does not automatically trigger their immediate sale. Where the manager/board conducts its own credit assessment, a downgrade may trigger a review of the appropriateness of its internal assessment. In both cases, should the manager/board decide to divest, the transaction is conducted within a timeframe that is in the best interests of the investors.

Comments should be submitted on or before Friday 5 September 2014.

NOTES FOR EDITORS

1. IOSCO is the leading international policy forum for securities regulators and is recognized as the global standard setter for securities regulation. The organization's membership regulates more than 95% of the world's securities markets in more than 115 jurisdictions and it continues to expand.

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2. The IOSCO Board is the governing and standard-setting body of the International Organization of Securities Commissions (IOSCO), and is made up of 32 securities regulators. Mr Greg Medcraft, Chairman of the Australian Securities and Investments Commission, is the Chair of the IOSCO Board. The members of the IOSCO Board are the securities regulatory authorities of Argentina, Australia, Belgium, Brazil, China, France, Germany, Hong Kong, India, Italy, Japan, Korea, Malaysia, Mexico, Morocco, the Netherlands, Nigeria, Ontario, Pakistan, Peru, Portugal, Quebec, Romania, Saudi Arabia, Singapore, South Africa, Spain, Switzerland, Trinidad and Tobago, United Kingdom and the United States.

3. The Growth and Emerging Markets Committee (GEMC) is the largest Committee within IOSCO, representing 75 per cent of the IOSCO membership. Mr. Ranjit Ajit Singh, Chairman, Securities Commission, Malaysia, and Vice Chair of the IOSCO Board, is the Chair of the GEMC. The Committee endeavors to promote the development and greater efficiency of emerging securities and futures markets by establishing principles and minimum standards, providing training programs and technical assistance for members and facilitating the exchange of information and transfer of technology and expertise.

4. IOSCO aims through its permanent structures:

   - to cooperate in developing, implementing and promoting adherence to internationally recognized and consistent standards of regulation, oversight and enforcement in order to protect investors, maintain fair, efficient and transparent markets, and seek to address systemic risks;

   - to enhance investor protection and promote investor confidence in the integrity of securities markets, through strengthened information exchange and cooperation in enforcement against misconduct and in supervision of markets and market intermediaries; and

   - to exchange information at both global and regional levels on their respective experiences in order to assist the development of markets, strengthen market infrastructure and implement appropriate regulation. OSCO, the leading international policy forum for securities regulators, is recognized as the global standard setter for securities regulation

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