Action Plan for Reducing Reliance on CRA Ratings Switzerland

Introductory remarks

- As a member of the FSB and as a matter of principle, Switzerland is committed to implement multilateral standards endorsed by the FSB with a view to fostering global financial stability. This includes its commitment under the agreed roadmap to implement the "FSB Principles for Reducing Reliance on CRA Ratings".
- Like all member jurisdictions of the FSB, Switzerland therefore participates in the two stages of the FSB peer review on reducing the reliance on CRA ratings (see the FSB interim report). In the first stage, it completed its stock-taking exercise of the use of CRA ratings in its legislation. The second stage implies the development of an action plan composed by a high-level listing of steps that we intend to take to implement the Principles.
- The objectives of the FSB Principles are twofold: to reduce references to CRA ratings in legislation and regulation and to promote strengthened credit assessment capabilities. Mechanistic reliance on CRA ratings entails potential risks to financial stability, as this can give rise to herding behavior and to abrupt sell-offs of securities when they are downgraded ("cliff effects"). At the same time, CRA ratings constitute a valuable source of information for credit risk assessment. Therefore, efforts by the FSB members (in collaboration with standard setters) should not aim at preventing the use of CRA ratings in general, but at avoiding that these ratings are used mechanistically and as the only source of information.
- The FSB Principles do not directly concern the supervision of the CRAs. In this context, it is worth noting that the main CRAs have no offices in Switzerland. They conduct their business from their offices abroad. Switzerland hence applies an indirect approach to regulate CRAs. FINMA requires CRAs to be recognized so that supervised entities can use their ratings for regulatory purposes. Recognition criteria are based on the IOSCO Code of Conduct "Fundamentals for Credit Rating Agencies".

Current situation in Switzerland

Reducing references to CRA ratings

- The FSB requires its members to identify and to amend the laws and regulations with references to CRA ratings. As a result, Switzerland reviewed its laws and regulations to identify possible references to CRA. Overall, only few references have been found, most of which are the result of implementing international standards, in particular the Basel framework (Basel II/III). Regarding the use of ratings in general, the FINMA circular on CRAs cautions against overreliance on CRA ratings.
- Specific categories of financial market participants are affected as follows:
  - ⇒ Pension funds: no references.
  - ⇒ CCPs: no references.
  - ⇒ Banks: no references in acts. Some references in ordinances and regulations (capital adequacy and liquidity) in accordance with the Standard Approach of the Basel framework (35% of the total credit exposure of the Swiss banking system lie with banks using the Standard Approach).
  - ⇒ Insurances: no references in acts and ordinances. Some references in FINMA circulars as the credit risk approach in the Swiss Solvency Test is based on the Standard Approach to credit risk of the Basel framework. However, FINMA insurance circulars caution against overreliance on CRA ratings.
  - ⇒ CIS: no references in acts. Some references in an ordinance. The purpose of these provisions is to ensure the quality of collateral in securities lending and repo transactions as well as of guarantors in OTC transactions.

⇒ Central Bank: no references in law. Some references in internal guidelines for reserve management and collateral policy. However, there is no mechanical reliance on CRA ratings and discretion exists.

- Since the main reason for the remaining references to CRA ratings in the Swiss regulations is the implementation of international standards, Switzerland welcomes further work by the standard setters, in particular the Basel Committee for Banking Supervision (BCBS), in removing references to CRA ratings in their standards.

Promoting strengthened credit assessment capabilities

- The second objective of the Principles is that market participants should improve their own capacity to make their own credit assessments in order to safely reduce their reliance on CRA ratings.
- Generally, in Switzerland, all regulated entities such as banks or insurances are required to have adequate risk management capacities. These include approaches relying on external as well as on internal sources of information. In this respect, it is worth bearing in mind that the practical relevance of CRA ratings in Switzerland is moderate, due to a comparatively small and largely unrated domestic bond market.
- Regarding the reduction of the reliance on CRA ratings the main challenge, as recognized by the FSB, is the lack of compelling alternatives, especially for small market players with limited capacities to develop their own credit assessment tools. In that perspective, Switzerland welcomes further analysis by the FSB in collaboration with the standard setters to provide possible alternatives. This will also ensure international consistency in developing alternative standards of creditworthiness to CRA ratings, thereby addressing potential risks to financial stability that might emerge from an individual development of such alternatives and possible regulatory arbitrage.

Next steps

Against this background, Switzerland envisages to fulfill its commitment under the agreed roadmap in taking the following actions:

Participating actively in international bodies

- Going forward the key issue is – to the extent possible and where reasonable alternatives exist – <u>to remove references to CRA ratings from international standards</u>. In order to further this cause, the Swiss authorities will actively participate in corresponding work streams of the standard setters. Moreover, in light of these further works by standard setters, Switzerland will review and, if necessary, amend its regulation. The timing of the implementation will depend on the work progress of the standard setters.
- Removing references to CRA ratings from international standards critically hinges on the <u>availability of viable alternatives</u> that are both effective and efficient. Therefore, the Swiss authorities will continue to actively participate in international work streams of the FSB and the standard setters to <u>develop such alternatives</u>. For instance, FINMA is involved in the BCBS working group dedicated to the revision of the securitization framework, where the benefits of options with and without reliance on CRA ratings are being assessed in detail. FINMA also participates in the BCBS working group that is currently assessing additional criteria such as market depth of a security in order to reduce reliance on CRA ratings in the international liquidity regulation. After the FSB, in collaboration with the standard setters, will have provided possible alternatives for market players to develop their own credit assessment tools, Switzerland will conduct cost and benefit analysis before considering implementing those models.
- In addition, the SNB will continue the exchange of views in international fora like the CGFS. The SNB will also continue to avoid a mechanistic reliance on CRA ratings by continuously evaluating the adequacy of its internal risk assessment capabilities.

Removing remaining references

- To reduce mechanistic reliance on CRA ratings in the regulation of collective investment schemes, FINMA is planning to remove the references to external ratings for investment management institutions in the course of the current revision of the Collective Investment Schemes Ordinance FINMA. The revised ordinance on collective investment schemes is scheduled to enter into force in 2015, subject to results of a public hearing and decision by FINMA Board of Directors.

Fostering transparency

- In the banking regulation, FINMA's updated disclosure requirements will promote strengthened credit assessment capabilities of the market participants and foster transparency to the investors, by encouraging the publication of exposures where the capital assessment is based on external or internal credit ratings.

Guarding against procyclicality at CCPs

- In June 2014 the revised National Bank Ordinance (NBO) will enter into force, thereby implementing the CPSS-IOSCO Principles for Financial Market Infrastructures (PFMI). The revised NBO, like the former NBO, does not contain any direct references to CRA ratings. The specific provisions for the capital requirements of CCPs in the new Financial Market Infrastructure Act, which was published for consultation in December 2013, contain no references to CRA ratings either. Moreover, the revised NBO, among other things, requires Swiss CCPs to take into account their impact on the participants and the financial system. In particular, these tools and procedures shall aim to prevent procyclical effects. In order to ensure compliance with the requirements defined in the revised NBO, the Swiss CCP SIX x-clear is currently reviewing its risk management framework in general and its collateral framework in particular.

Sharing of best practices and raising awareness

- To reduce mechanistic reliance on CRA ratings and to promote the strengthening of credit assessment capabilities, the Swiss authorities will organize a workshop in 2014. Its objective will be to facilitate the exchange of views and the sharing of best practices among market participants regarding additional information used- and alternatives to CRA ratings in credit risk assessment. This workshop will also raise awareness about potential risks associated with CRAs and their ratings.
- Finally, Swiss authorities will engage in outreach activities, for instance by participating in and contributing to conferences, to raise awareness of market participants such as pension funds on possible issues with and disadvantages of CRA ratings, on additional information to be considered, and – if they exist – on potential alternatives.

Publication of the action plan

In line with the requirements of the FSB Peer Review, Switzerland will publish the action plan. Publication is tentatively scheduled for early 2014.

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