

Reducing Reliance on Credit Rating Agency (CRA) Ratings

Action Plan

Singapore

A Reducing References to CRA Ratings in Laws and Regulations

1 As part of the FSB thematic review on reducing reliance on CRA ratings, the Monetary Authority of Singapore (MAS)¹ updated its stocktake of references to credit ratings in domestic laws and regulations in 2013. The stocktake did not reveal substantial hard-wiring of credit ratings in legislation beyond what is already prescribed in international standards. The identified references were assessed to be unlikely to encourage mechanistic reliance by financial institutions.

Central Bank Operations

2 There is minimal reliance on CRA ratings in central bank operations carried out by MAS. Our liquidity facilities mainly accept Singapore government securities and MAS bills, while our risk management framework for reserves management considers a wide range of inputs for the assessment of credit risk, including market based indicators (e.g. CDS spreads) and qualitative factors (e.g. parental and government support).

Regulation and Supervision

3 Where references to credit ratings are present, MAS has taken steps to ensure that the references to credit ratings are generally accompanied by caveats that ratings are not sufficient in and of themselves and should be accompanied by appropriate credit assessments. This aims to reduce overreliance on credit ratings by financial institutions.

- Banking and capital markets intermediaries. For regulatory capital computation, Singapore-incorporated banks, merchant banks and capital markets services licensees are required to perform an appropriate level of due diligence prior to the use of any recognised external credit assessment institution (ECAI). They are also expected to assess whether regulatory risk weights applied are appropriate for the risk of the exposure, and consider any higher degree of credit risk in their evaluation of overall capital adequacy. These requirements are set out in the relevant rules, e.g. MAS Notice 637 (paragraph 7.3.3A, paragraph 3.3 of Annex 10A), MAS Notice 1111 (paragraphs 7.3.3A and 7.3.4A) and MAS Notice SFA 04-N13 (paragraph 3 of Annex 5A).

¹ The Monetary Authority of Singapore is the integrated regulator of banking, insurance and securities in Singapore. The MAS is responsible for developing and executing the action plan.

- Securities. MAS' Code on Collective Investment Schemes (CIS) includes some references to credit ratings. Accordingly, MAS amended the Code in 2011 to explicitly stress that a CIS operator should not rely solely or mechanistically on ratings issued by credit rating agencies. Where possible, the CIS operator should make its own credit assessments to verify ratings issued by CRAs. Where the credit rating differs from the CIS operator's internal assessment, the more conservative rating should be adopted. This is intended to ensure that CIS operators take a prudent approach (and consider the factors that could have caused the lower ratings) when making investment decisions or selecting counterparties².

4 In some areas, most notably bank capital adequacy and liquidity coverage rules, references to credit ratings in domestic rules are tied to their presence in international standards, i.e. the BCBS Standardised Approaches. As at the end of September 2013, 1 out of the 4 Singapore incorporated banking groups³ and all 34 Singapore-incorporated merchant banks⁴ use only the Standardised Approach for credit risk. Overall, 19.3% of the total risk-weighted assets of the locally incorporated banking groups and merchant banks are covered by the Standardised Approach for credit risk.

5 Taking into consideration the work that has already been done, MAS has identified the following key areas for further action:

Action	Timeline
a. <u>Use of ratings in bank capital adequacy requirements</u> . Ratings from external credit assessment institutions (ECAIs) are used for the purpose of regulatory capital computation, in line with the Basel Committee on Banking Supervision's (BCBS) recommendations under the Basel capital rules.	Internal review of domestic rules to be completed 6 months after BCBS' Task Force on Standardised

² This approach recognises that there could be situations where the credit rating agencies are better placed than the CIS operator to undertake credit assessments, e.g. where the operator does not have access to pertinent information to accurately assess the credit risk of an investment. Conversely, in other situations, the operator may be in a better position to undertake the credit assessment, e.g. where the operator has an in-depth understanding of the local markets and conditions. CIS operators are obliged to give due consideration to both internal and external ratings, as well as the contributing factors toward any differences between the two, and adopt the more prudent rating.

³ The 3 Singapore-incorporated banking groups adopt a partial use of the Standardised Approach for credit risk.

⁴ Merchant banks are a class of financial institutions licensed and supervised under the MAS Act. They have more specialised business models such as capital market activities (e.g. corporate finance) and wealth management activities. The 34 Singapore-incorporated merchant banks account for 4.2% of total assets of the banking system in Singapore.

<p>Banks are already required to perform an appropriate level of due diligence prior to the use of the ratings by a recognised CRA, and expected to assess whether the regulatory risk weight applied is appropriate for the risk of the exposure. Where the IRB approach has been adopted, MAS will continue to ensure that the banking group uses the approach for a meaningful proportion of credit exposures across the entire banking group.</p> <p>Further progress in removing references to credit ratings in bank capital adequacy requirements hinges upon the work of the BCBS Task Force on the Standardised Approaches, which is currently under way. As a BCBS member, MAS will take guidance from the Basel review upon its completion.</p>	<p>Approaches publishes its recommendations. Legislative changes, if any, to be issued within 1 year after the completion of the internal review.</p>
<p>b. <u>Use of ratings in the rules on exposures to single counterparty groups for banks.</u> Currently, certain exposures (e.g. exposures to AAA-rated sovereigns and public sector entities) are treated as exempt exposures for the purpose of compliance with the large exposure limits. MAS will take guidance from the BCBS review on an internationally harmonised large exposures framework. Amendments will be made to references on the use of CRA ratings accordingly.</p>	<p>A policy review of domestic rules to be completed 12 months after BCBS completes its review on the large exposures framework.</p>
<p>c. <u>Use of ratings in Code on Collective Investment Schemes.</u> Under the Code on Collective Investment Schemes, collective investment schemes constituted as property funds are subjected to a 35% leverage limit, which can be raised to 60% if the fund obtains a credit rating and discloses such ratings to the public. MAS is reviewing this requirement, and any proposed change will be put up for public consultation in late 2013/2014.</p>	<p>Public consultation in 2014.</p>

B Strengthening credit assessment capabilities

6 As noted in the FSB's September 2013 status report to G20 Leaders on progress in reducing reliance on credit ratings and strengthening oversight of CRAs, the development of market participants' internal risk assessment systems is frequently constrained by resource requirements and the relative scarcity of expertise in credit risk analysis.

7 In line with the FSB roadmap for reducing reliance on CRA ratings, MAS has also taken measures to strengthen the credit assessment capabilities of market participants. These include:

- Banking. Singapore-incorporated banks are required to comply with the public disclosure requirements prescribed under Pillar 3 of the Basel capital framework. At the broad level, a bank is required to disclose:
 - its credit risk strategies and processes;
 - the structure and organisation of the credit risk management function;
 - the scope and nature of its risk reporting and measurement systems; and
 - its policies for hedging and mitigating risk, and process for monitoring the continuing effectiveness of such policies.

Disclosure requirements with respect to internal credit risk assessment processes include:

- the role played by CRA ratings in internal credit risk assessment processes (e.g. the types of exposure for which ratings of each CRA are used);
 - the structure of internal rating systems and the relationship between internal and external ratings;
 - the process for managing and recognising credit risk mitigants; and
 - the control mechanisms for the rating system including independence, accountability, and rating system review.
- Insurance. MAS requires direct insurers to have in place a risk management strategy setting out clear methodologies and assessments to justify its selection of reinsurers and reinsurance arrangements, with credit ratings only one factor in the assessment.
 - Securities. MAS has introduced a requirement for the prospectus of asset-backed securities to disclose any form of due diligence (including any review, verification, or assessment) in respect of underlying assets that has been performed by the issuer, sponsor, originator, underwriter or any third party. The objective of this rule is to encourage parties involved in the offer to conduct more careful due diligence and risk assessment (including credit risk assessment) on underlying assets.
 - Central counterparties (CCPs). There are currently two systemically important CCPs in Singapore, namely, the Singapore Exchange Derivatives Clearing Limited and the Central Depository. MAS requires CCPs to have in place credit assessment processes in respect of their collateral policies and supervision of

members, and not rely solely on credit ratings⁵. Any changes to CCP risk management practices are subject to MAS' review and approval.

The 2013 IMF FSAP had assessed both CCPs' clearing and settlement infrastructures as sound and efficient, with effective risk management frameworks.

8 As noted in the FSB's September 2013 status report to G20 Leaders on CRA-related initiatives, the development of firms' internal risk assessment systems is frequently constrained by resource requirements and the relative scarcity of expertise in credit risk analysis. Hence, MAS will encourage market participants to enhance their credit risk assessment capabilities. In doing so, MAS will aim to ensure that market participants' credit risk management processes are robust and commensurate to the scale and complexity of their operations.

Action	Timeline
<p>a. <u>Engaging financial institutions</u>. On an ongoing basis and as appropriate, MAS will work with industry on enhancing their credit assessment capabilities through several channels:</p> <ul style="list-style-type: none"> i. On-site inspection and off-site supervisory review of credit risk assessment processes to ensure that they are robust and do not place undue reliance on credit ratings. Areas for improvement in the credit assessment processes and good credit underwriting practices observed from inspections will be shared with the respective financial institutions and the industry where appropriate. ii. Encouraging regular review of the use of CRA ratings in investment policies, guidelines and mandates of investment managers and regulated institutional investors (e.g. insurers), on a supervisory basis. iii. Regular and adequate industry wide stress testing of banks and insurers to determine that financial 	Ongoing

⁵ For instance, CCPs conduct internal assessments to ensure that only quality collateral with low credit, liquidity and market risks are accepted, and apply conservative haircuts accordingly. Assessments of credit risks include monitoring for any adverse news or developments in relation to the particular collateral. CCPs also do not currently invest collateral posted with them. With respect to supervision of members, CCPs have other membership criteria, such as financial, operational and legal requirements to ensure that admission criteria and ongoing requirements are risk-based and commensurate with risks undertaken by members.

<p>institutions take appropriate remedial or risk mitigations where warranted on their potential exposure to credit risk arising from adverse market conditions.</p> <p>iv. Promulgation and periodic update of guidelines on sound practices in credit risk management. The guidelines cover various aspects of the credit lifecycle, with a view to ensuring that financial institutions' policies, processes and practices are sound and result in a properly controlled credit risk environment.</p> <p>v. Regular dialogue with industry through firm-specific and roundtable discussions to understand challenges faced in building independent credit risk assessment systems.</p>	
<p>b. <u>Enhancing disclosures to investors.</u> Our securities offering regime is geared towards promoting effective disclosure through improving the quality of information given to investors so as to equip investors to make informed investment decisions.</p> <p>(i) Even though our current regime does not place undue reliance on credit ratings, MAS plans to amend existing regulations to improve the quality of information given to investors. Where a credit rating is disclosed in a prospectus, the prospectus must (i) explain the meaning, function and limitations of the credit rating, including the fact that it is a statement of opinion (ii) state that the rating is not a recommendation to invest in the securities, and (iii) state that the rating is current as at the date of registration of the prospectus and subject to revision or withdrawal at any time.</p> <p>We expect to effect this amendment by 1Q 2014.</p> <p>(ii) In addition, the Code on Collective Investment Schemes currently states that the manager should not rely solely and mechanistically on ratings issued by credit rating agencies and should perform its own internal credit assessment to verify these ratings.</p> <p>MAS will consult on a proposal to require the CIS manager to disclose in the prospectus the credit risk</p>	<p>Effected by 1Q 2014</p> <p>Public Consultation in 2014</p>

<p>assessment practices that it has adopted for the purposes of verifying the ratings issued by credit rating agencies. The information to be disclosed could include the scope of the assessment, the extent to which it will rely on ratings issued by credit rating agencies and other tools/metrics that will be used in the internal credit assessment. This disclosure requirement will encourage CIS operators to put in place robust credit risk assessment practices as investors are less likely to invest in CIS where the disclosure shows that the scope and extent of the credit risk assessment practices of the CIS operators are inadequate.</p> <p>We aim to conduct a public consultation on this proposal in 2014.</p>	
<p>c. <u>Taking guidance from international standard setters</u> on issues such as alternative standards of creditworthiness and ways to strengthen market participants' credit assessment capabilities. We will review international guidance as it is issued, with a view to incorporating it into our supervisory approach where appropriate.</p>	<p>Ongoing</p>