REDUCING MECHANISTIC RELIANCE ON CREDIT RATING AGENCY RATINGS

AUSTRALIA'S ACTION PLAN

March 2014

OVERVIEW

The global financial crisis illustrated how credit ratings, while continuing to play a role in financial markets, can contribute to and exacerbate the implications of a financial crisis.

Credit ratings synthesise the available information about an issuer or borrower, its market and its economic environment. This can offer investors and lenders an efficient way to understand the risks associated with particular borrowing or lending. However, developments during the crisis suggested that the hard wiring of credit rating agency (CRA) ratings within elements of prudential regulation was wrongly interpreted by some investors as providing ratings with tacit official approval. This interpretation may have reduced incentives for investors to develop their own capacity for credit risk assessment and due diligence. Over reliance on external ratings, to the exclusion of internal credit assessments, can cause herd behaviour and abrupt sell-offs of securities when ratings are downgraded. These effects can amplify the procyclicality of financial risk and cause systemic disruption to financial systems.

Australia supports the ongoing efforts of the G20, including through the Financial Stability Board (FSB) and international standard setting bodies, to reduce the mechanistic reliance on CRA ratings.

Since 2008, consistent with Australia's strong track record of ensuring effective prudential supervision, Australian regulators have assessed the mechanistic use of CRA ratings in the regulations they administer.

Australian regulators have found that CRA ratings do not play a major role in Australia's financial system and there is no strong mechanistic reliance on CRA ratings. The main use of CRA ratings in Australia is within bank prudential regulation which is based on the internationally agreed Basel framework. Even in this context, the Australian Prudential Regulation Authority (APRA) has a robust regulatory framework for ensuring that banks adequately manage their exposure to credit risk.

While Australian regulators are comfortable with Australia's current regulatory frameworks, they closely monitor international developments and will consider future recommendations arising from standard setting bodies regarding the use of CRA ratings. This action plan identifies the main areas where CRA ratings are used in Australia's regulations and outlines the next steps Australia will take regarding CRA ratings.

THE USE OF CRA RATINGS IN AUSTRALIA

CRA ratings are used in a number of ways in Australia including through: prudential regulation; central bank operations; central counterparty operations; investment fund management; and securities firms.

Reducing reliance on CRA ratings in laws and regulations and standards (Principle I)

Banks

APRA has a robust supervisory approach, which includes a focus on assessing that authorised deposit-taking institutions (ADIs) adequately manage their exposure to credit risk. APRA recently finalised a cross industry risk management prudential standard that harmonises and enhances the risk management requirements across the ADI and insurance industries.

The main use of CRA ratings in Australian regulations is in the prudential framework for ADIs, which is built around the internationally agreed Basel framework. The use of these CRA ratings within Australia is not considered to be mechanistic.

Major banks in Australia use Internal Ratings Based (IRB) approaches to assessing credit risk. This means they are required to form their own views on creditworthiness/risks as opposed to relying on CRA ratings.

- In Australia there are five banks using the IRB approach, representing around 84 per cent of total banking assets. These banks must initially seek approval from APRA to use the IRB approach (which is consistent with the Basel framework) and are subject to ongoing monitoring and review arrangements to ensure they are using this approach in a prudent manner.

While other ADIs use a more simplistic approach, APRA also actively regulates and supervises these entities to ensure they supplement CRA ratings when determining the credit risks to which they are exposed.

- At 30 September 2013, 24 banks and 95 credit unions/building societies use the standardised approach (as opposed to the IRB approach) to determine credit risk.

Insurance

Australia's regulatory regime for insurance, and APRA's approach to supervision of insurers, is consistent with that for ADIs.

While CRA ratings are used in APRA's standard method of calculating an insurer's prescribed capital amount, their use is not considered mechanistic. As part of APRA's active

supervision, insurers are monitored to ensure they supplement external credit ratings when assessing the creditworthiness of their counterparties.

An insurer must at all times have a risk management framework to manage the risks arising from its business. The risk management requirements in prudential standards require insurers to develop their own internal risk measures rather than relying only on CRAs. The insurer's risk management framework must provide reasonable assurance that the insurer's risks are being prudently and soundly managed, having regard to such factors as the size, business mix and complexity of the insurer's operations.

Since 2008 *Prudential Practice Guide GPG 200 Risk Management* and *Prudential Practice Guide LPG 200 Risk Management* have been in place. These assist insurers in complying with risk management requirements set out in the prudential standards and, more generally, to outline prudent practices in relation to risk management frameworks. In early 2014, APRA released a cross-industry guide on risk management frameworks which will replace this guidance for insurers and extend it to ADIs. This complements the cross industry risk management prudential standard that harmonises and enhances the risk management requirements across the ADI and insurance industries.

Central bank operations

CRA ratings are used by Australia's central bank—the Reserve Bank of Australia (RBA)—in managing its foreign exchange reserves, although this is largely confined to deposit and repurchase agreement counterparty limits. This use is not mechanistic, with the impact of ratings changes on the management of reserve assets considered within the broader context of the RBA's reserve management mandate and the RBA's policy objectives. Implementing an internal credit scoring methodology would consume significant resources, and it is not clear whether the credit assessments would be any better or different to those produced by the CRAs.

CRA ratings are one factor in determining eligibility for domestic repurchase agreements and margins on the collateral, with the RBA able to exercise discretion in determining eligibility and/or margins in order to avoid unnecessarily abrupt and large changes in the eligibility of financial instruments and the size of haircuts, both of which can exacerbate 'cliff' effects. Internal credit risk assessments of asset-backed securities are used to determine haircuts above CRA-related minimums. This process includes an assessment of the structural features of each transaction and the degree of support from external parties. The RBA also looks through to the underlying assets backing the transaction, with higher haircuts placed on securities backed by riskier classes of assets, regardless of the degree of subordination in the transaction. After 2015, more detailed information on asset-backed securities will be received by the RBA. This will facilitate a more detailed internal

assessment process, and allow the RBA to review the way in which CRA ratings are used to establish minimums.

Central Counterparties (CCP)

Regulatory standards for central counterparties set by the Australian Securities and Investments Commission (ASIC) and the RBA do not include references to CRA ratings.

Investment fund management

Australia's regulation of investment fund management in collective investment schemes (CIS) does not include references to CRA ratings.

Securities firms

Australia has limited references to CRA ratings in its regulation of securities firms. These appear in ASIC's capital liquidity rules for market intermediaries that are Australian Securities Exchange (ASX) equity market participants and the ASX Clearing Rules for ASX equity market clearing participants.

ASIC considers that none of these references are mechanistic in practice. First, the reference in the ASX capital liquidity rules operates in conjunction with a requirement that the rated entity be an Australian ADI. The requirement that the entity be an Australian ADI effectively overrides the requirement built on the CRA rating. Second, the reference in the ASX Clearing Rules is in a provision that is not relied upon by securities firms (i.e. the reference is not used).

Reducing market reliance on CRA ratings (Principle II)

Australian regulators monitor the credit assessment processes used within Australian entities and aim to create a culture of diligent credit assessment.

APRA uses its risk-based supervisory processes and procedures to check the adequacy of APRA-regulated institutions' credit assessment processes and to create a culture of prudent credit assessment by the entities it regulates. APRA seeks to ensure entities have their own view on the creditworthiness of obligors even though external ratings might constitute an input into that view. APRA actively encourages institutions to develop their own internal risk measures and not rely on CRAs.

ASIC monitors the conduct of market participants and operators of CIS. An operator of a registered CIS that does not have at least half of its directors meet a test for independence must have a compliance committee. A function of the compliance committee is to ensure that adequate procedures are designed, documented and implemented to ensure compliance with duties in relation to registered CIS. This includes a duty to exercise reasonable care and diligence which applies when considering the appropriateness and

implementation of an investment strategy which would not be consistent with excessive or mechanistic reliance on credit ratings. ASIC conducts surveillance as appropriate to check whether the duty is being met.

The RBA assesses annually how well each clearing and settlement facility (including each CCP) is complying with the Reserve Bank's Financial Stability Standards, which are aligned with the stability-related principles of the CPSS-IOSCO *Principles for Financial Market Infrastructures*. These assessments include reviews of CCPs' credit assessment and other risk management processes. In its most recent assessment of the CCPs in the ASX Group (2012/13) against these standards, the RBA was generally satisfied that the CCPs were applying appropriate risk management frameworks. These frameworks place some reliance on CRA ratings, but the scope of such reliance is generally limited and non-mechanistic and would not be expected to give rise to material procyclicality.[1] In particular:

- CRA ratings play no direct role in the methodologies used by the ASX CCPs to calculate initial margin requirements;
- CRA ratings are not used as a membership criterion for either CCP; and
- while CRA ratings are applied in the CCPs' credit risk assessment processes, including to determine internal credit ratings that trigger certain risk management actions and to set minimum credit-quality thresholds for collateral and treasury investments, decisions generally take into account a range of metrics and indicators and there is scope to exercise management discretion.

NEXT STEPS

As part of Australia's existing rigorous prudential regulatory frameworks, our regulators will continue to examine the use of CRA ratings and ensure sound risk assessments are undertaken in the financial system.

Australia will closely monitor international policy developments, including the findings of the FSB thematic peer review on the FSB Principles for Reducing Reliance on CRA Ratings.

Australia will continue to actively contribute to international work on reducing mechanistic reliance on CRA ratings, including further work by standard setting bodies on alternative

[1] These assessments are available at http://www.rba.gov.au/payments-system/clearing-settlement/assessments/2012-2013/index.html.

approaches to the use of CRA ratings. As a member of the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO), Australia looks forward to working on these alternative approaches.

Any further regulatory reform in Australia will be weighed alongside reforms to improve the stability, efficiency and fairness in the Australian financial system.

Specific actions planned by Australian regulators

RBA

- **Enhancing information**—The RBA is increasing the reporting requirements related to asset-backed securities (ABS) that are eligible for repurchase agreement with the RBA from the end of 2014; most of this information will also be provided publicly. Issuers of these securities will need to provide detailed information on the structure of these transactions (including information on external parties and a model of how cash flows are to be distributed) and, in many cases, data on the individual loans underlying the transaction. These developments will de-emphasise the use of CRAs' assessments of ABS at the RBA, and the increased market transparency will support investors' ability to analyse ABS independently of the CRAs. The RBA has been developing internal systems since late 2012 to use the enhanced data to determine repo-eligibility and repo-margins on ABS.
- **Review**—Australian financial regulators, including the RBA, will review the implementation of the framework for margining of non-centrally cleared derivatives developed by the BCBS and IOSCO, to ensure that initial margin requirements and collateral haircuts are calibrated in a way that limits procyclicality and does not rely mechanistically on CRA ratings.
- **Monitor**—As part of its ongoing oversight against the Financial Stability Standards, the RBA will continue to monitor and assess the Australian CCPs' risk management frameworks and will, as appropriate, work with the CCPs to identify areas where reliance on CRA ratings could be further reduced.

APRA

- **Prudential guidance**—APRA has implemented a suite of prudential guidance material relating to investment governance for superannuation (pension) entities. This clarifies that a trustee is expected to do more than just rely on the opinion of external advisors when deciding whether an investment is appropriate.
- **Monitor**—APRA is consistently monitoring and engaging in the BCBS work on progressing the reduction in reliance on CRAs.

ASIC

- **Encouraging best practice** —ASIC is exploring ways to encourage regulated CIS operators that have raised public money to consider, where relevant, the risk that there could be over reliance on credit ratings when making investment decisions on rated instruments and the need to ensure that other information is given weight in making these decisions. This work will include discussions with industry on best practice.
- **Review**—Over the next 12 months, ASIC will review and assess already identified references to CRA ratings affecting securities firms in line with Principle 1 of the FSB's Principles for Reducing Reliance on CRA Ratings.
- **Reliance by securities firms**—ASIC is participating in the work of IOSCO on reducing mechanistic reliance by market intermediaries on CRA ratings. As part of this, it will be surveying Australian securities firms to better understand the manner and degree to which they mechanistically rely on ratings. This will then allow ASIC to assess the need for further policy work.