MEDIA RELEASE

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 sound practices at large intermediaries for assessing credit risk

The International Organization of Securities Commissions today published the consultation report on *Sound Practices at Large Intermediaries: Alternatives to the Use of Credit Ratings to Assess Creditworthiness.*

The report proposes 13 *sound practices* for large market intermediary firms to consider in the implementation of their internal credit assessment policies and procedures. IOSCO believes that identifying sound practices regarding the suitable alternatives to credit ratings for assessing credit risk should reduce the potential overreliance of large intermediaries on credit rating agencies (CRAs). In turn, this reduction would help increase investor protection, while contributing to market integrity and financial stability.

While CRA ratings can offer investors and lenders an efficient way to label the risks associated with a particular borrowing or lending facility, the recent global financial crisis illustrated how a mechanistic reliance on CRA ratings can contribute to and exacerbate the fallout on the markets.

In response, numerous international and national bodies have taken measures to address the reliance of market participants such as broker-dealers on credit ratings. These efforts have mainly focused on two areas:

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- Requirements for financial firms to undertake their own due diligence and internal risk management instead of relying mechanistically on external CRA ratings, and;
- Reconsideration of references to ratings in the regulatory framework, in light of their potential to be regarded as public endorsement of CRA ratings and to negatively influence market behavior.

To identify the sound practices, IOSCO conducted a study of large market intermediary firms to gain an understanding of their current practices for assessing credit risk without mechanistically relying on CRA ratings. IOSCO also convened two roundtable discussions with intermediary representatives which are summarized in an Annex to the report.

Draft Sound Practices

1. Establish an independent credit assessment function that is clearly separated from other business units, including the development of appropriate policies and procedures to ensure that decision-making is not unduly affected by operations from other areas of the firm.

2. Involve senior management in order to ensure the successful implementation of a robust credit assessment process, including promotion of a risk-sensitive culture throughout the organization. Such involvement would entail oversight of the credit risk assessment process by a dedicated risk management team that reports to high-level management, such as a separate independent credit committee.

3. Establish a coherent oversight structure to ensure that the credit assessment process is properly implemented and adhered to, including the establishment of reporting lines and responsibilities that are clearly articulated and followed.

4. Take steps to ensure that a firm's governing committee receives an appropriate level of information on the amount of credit risk to which the firm is exposed. This may include policy exceptions, limit breaches, stress testing analysis concentrations, watch lists, and top exposures, among other things.

5. Invest in staff and other resources necessary to develop a robust internal credit assessment management system that appropriately reflects the nature, scale, and complexity of its business. This includes having in-house the necessary staff expertise and technological ability to analyze effectively the firm's portfolio and to stay abreast of market indicators.

6. Avoid exposure to particular credit risks whenever the firm does not have the internal capability to independently and adequately assess the exposure.

7. Take creditworthiness assessment capabilities into account when considering the firm's business growth plans and deciding how to structure its portfolios or whether to take on additional leverage.

8. Incorporate a wide variety of qualitative measures into robust credit assessment processes in addition to quantitative measures. This can help a market intermediary firm avoid excessive concentration risk in certain areas and provide a more holistic view of creditworthiness than simply relying on quantitative factors alone.

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9. Prescribe risk levels and investment appetites for the assessment of creditworthiness that focus on the fundamental value of the instrument to set limits and risk. These levels might distinguish between various categories, such as industry or on a geographical basis, and be reflected in the policies and procedures that set out the operating standards that must be followed by teams or individuals responsible for the assessment of credit risk.

10. Subject non-investment grade financial products to enhanced scrutiny, including bifurcation of the internal ratings of investment and non-investment grade securities, *e.g.*, a separate review process.

11. Avoid mechanistically relying on external CRA ratings. View such ratings as only one factor among several that may be used in a comprehensive credit assessment process. Carefully consider the effect of using external credit ratings as parameters to assess the creditworthiness of investments or to decide whether to invest or disinvest. Recognize and understand the possible limitations of CRA ratings and become familiar with CRA credit risk assessment methodologies. For example, CRA ratings could be a lagging indicator of more general credit risks and do not always reflect the most recent factors affecting creditworthiness.

12. Strive to update and improve continually the firm's credit risk assessment practices to help ensure that they remain abreast of developments that could have a material adverse effect on the firm's portfolios and counterparty relationships.

13. Ensure internal audit or another independent party performs regular reviews of credit policies and procedures.

Regulators could consider these sound practices as part of their oversight of market intermediaries. Large market intermediary firms may find these sound practices useful in the development and implementation of effective alternative methods for the assessment of creditworthiness.

Comments should be submitted on or before Wednesday 08 July 2015

NOTES TO THE 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.

2. The IOSCO Board is the governing and standard-setting body of the International Organization of Securities Commissions (IOSCO). The Board is made up of 34 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 Australia, Belgium, Brazil, China, Egypt, France, Germany, Greece, Hong Kong, India, Italy, Japan, Kenya, Korea, Malaysia, Mexico, the Netherlands, Nigeria, Ontario, Pakistan, Peru, Quebec, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Thailand, Trinidad and Tobago, Turkey, United Kingdom and the United States.

3. The Growth and Emerging Markets Committee 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 GEM. 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.

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