

Circular 2008/26 Rating agencies

Recognition of external credit assessment institutions (rating agencies)

Reference: FINMA Circ. 08/26 "Rating agencies"
 Date: 20 November 2008
 Entry into force: 1 January 2009
 Last amendment: **XXX**
 Concordance: Previously SFBC Circular 06/7 "Rating agencies" dated 25 October 2006
 Legal framework: FINMASA Art. 7 para. 1 let. b
 CAO Art. 52
 ISO Art. 41 ff. and Art. 79
 CISO Art. 76
 FINMA-GebV Art. 5 ff.

Addressees																					
BA			ISA			SESTA		CISA						AMLA		Other					
Banks	Financial groups and congl.	Other intermediaries	Insurers	Insurance groups and congl.	Insurance intermediaries	Stock exch. and participants	Securities dealers	Fund management	SICAVs	Limited partnerships for CISOs	SICAFs	Custodian banks	Asset managers CISOs	Distributors	Representatives of foreign CISOs	Other intermediaries	SROs	DSFIs	SRO-supervised institutions	Audit firms	Rating agencies
X	X		X	X			X	X	X	X	X	X	X							X	X

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I. Purpose

This circular governs the recognition of external credit assessment institutions (rating agencies). The assessments of creditworthiness (ratings) made by rating agencies are utilised within the context of financial market regulation by institutions which are subject to supervision by FINMA. 1

The provisions for recognising rating agencies regulated in this Circular are intended to ensure that the prerequisites for a minimum level of quality of ratings with a view to their supervisory use pursuant to Chapter IV are fulfilled. 2

II. Scope of application

This Circular is addressed to all institutions supervised by FINMA which use ratings within the context of financial market regulation pursuant to Chapter IV. 3

The use of ratings for purposes other than supervisory purposes, e.g. for information purposes or to support the risk management of supervised institutions, is not subject to restriction irrespective of whether or not the rating agency is recognised by FINMA, and is not covered in this Circular. 4

III. General principles

Institutions supervised by FINMA may only use ratings for supervisory purposes that are provided by rating agencies which are recognised by FINMA. 5

With respect to the supervisory use of ratings, the institutions supervised by FINMA are to maintain a critical attitude and limit their dependency on these ratings by appropriate means. 6

Regardless of the use of the ratings, the supervised institutions are responsible for properly identifying their risks (credit risks, investment risks, market risks, etc.) and independently assessing, limiting and monitoring them. 7

Rating agencies are not supervised by FINMA on an ongoing basis. FINMA provides no warranty for the correctness and reliability of the ratings issued by recognised rating agencies. 8

IV. Supervisory use of ratings

Institutions supervised by FINMA may use ratings from the recognised rating agencies for the following supervisory purposes:	9
Banks and securities dealers:	10
Determination of capital adequacy requirements for credit and market risks, risk diversification and liquidity risks pursuant to the Capital Adequacy Ordinance (CAO; SR 952.03).	11
Insurers:	12
(1) Determining capital in accordance with the Swiss Solvency Test;	13
(2) Determining tied assets.	14
Collective investment schemes:	15
Observance of the provisions governing investment techniques and derivatives pursuant to the FINMA Collective Investment Schemes Ordinance (CISO-FINMA; SR 951.312).	16

V. Recognition of rating agencies

A. Market segments

FINMA may recognise a rating agency for ratings of all or some of the following market segments:	17
(1) Public Finance and its credit instruments;	18
(2) Commercial Entities, including banks and insurance providers and their credit instruments;	19
(3) Structured Finance, including securitisations and derivatives.	20

FINMA may recognise a rating agency for ratings of other market segments. 21

FINMA may recognise a rating agency if the requirements of this Circular (Mn. 23 ff.) and other regulations (e.g. pursuant to Art. 52 CAO) are fulfilled. 22

B. Requirements

The recognition of rating agencies is based on the provisions of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (current version), which recognised rating agencies are required to observe at all times. 23

FINMA may make the recognition of a rating agency subject to conditions or additional requirements or effective only for a given period of time. 24

a) Objectivity

The rating method used to determine the ratings must be factually sound. 25

The method of awarding ratings must be strict and systematic and subject to a validation process that is based on historical empirical values. In addition, the ratings must be reviewed periodically and reflect changes in the business and financial situation as well as the relevant market environment. 26

Before qualifying for recognition by FINMA, the rating method for every individual market segment, including rigorous back testing, must have been in use and been proven effective for at least three years. In justified exceptional cases, FINMA may reduce the period of proven application of the rating method to not less than one year. 27

The rating method must comprise qualitative and quantitative elements. 28

The rating agency must have documented procedures for ensuring that its ratings are based on careful analysis of all information known to it and relevant to the method in question. 29

The rating agency must observe a code of conduct which essentially corresponds to the provisions of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (current version). The code of conduct of the rating agency must be publically available. If the rating agency deviates from any of the provisions of the IOSCO Code of Conduct Fundamentals, it is required to disclose any such deviations and state the reasons for them. 30

b) Independence

The rating agency and its rating procedures must be independent and completely free of any political or economic pressure that might influence the rating. The rating agency must, in particular, ensure that neither the agency itself, its employees nor any related persons have any financial interests that could potentially cause a conflict of interests. 31

The rating agency may not be associated with public-sector entities, companies or issuers of products in the structured finance market segment for which it produces ratings (ratings of issuer or issues) or with institutions subject to supervision by FINMA which use its ratings. An inadmissible association is deemed to exist not only if a participating interest exists, but also if significant influence can be exercised over the rating agency or individual ratings or there is the appearance of such influence. 32

The rating agency must identify all potential conflicts of interest and eliminate them or, if this is not possible within a reasonable period of time, disclose them. 33

The rating agency must have an independent and sufficiently well equipped internal system of controls. In addition to reviewing the ratings themselves, the rating method and the models used are to be reviewed periodically. 34

The rating agency must have a compliance function which monitors the compliance of internal guidelines and procedures with regulatory requirements. 35

The rating agency must ensure through organisational means that there is an adequate functional separation between operational rating activities and advisory activities. 36

c) Access and transparency

The rating agency must make the individual ratings publicly available, as well as the key factors on which the ratings are based and whether or not the issuer was involved in the rating process. 37

In addition, the rating agency must disclose the procedures and methodology it used and the assumptions which resulted in the credit rating. The conditions of access to this information are to be equal for all interested parties. 38

Non-public ratings, which are communicated to the issuer only, are exempted from these rules (Mn. 38 and 39). 39

d) Disclosure

The rating agency must disclose the following information:	40
• Code of conduct	41
• Principles of the remuneration agreements in place with the borrowers and issuers who are rated	42
• Rating method including the definition of default, the time horizon of the ratings and the significance of each rating class	43
• The default rates actually observed in each rating class	44
• The migration rates of each rating class (migration matrix)	45

e) Resources

The rating agency must have sufficient resources (finances, personnel, infrastructure, etc.) to enable it to carry out ratings of a high quality. Where ratings are used in agreements, the resources should have close contact with the executive bodies of the borrower being rated/issuer of the credit instruments being rated.	46
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f) Credibility

The rating agency and its ratings have to be credible.	47
Credibility is attained through consistent compliance with the criteria set down in this Circular. Furthermore, the use of the ratings produced by a rating agency by independent third parties (investors, trading partners, etc.) is also taken as an indicator of the rating agency's credibility. To ensure credibility, the rating agency must have internal procedures in place that safeguard against the misuse of confidential information.	48

C. Recognition procedure

a) Recognition of rating agencies domiciled in Switzerland

FINMA decides whether to recognise a rating agency on the basis of an application for recognition by the rating agency. The rating agency (applicant) is to document the following in its application to FINMA: 49

- The market segment(s) for which recognition is being sought; 50
- How it meets the requirements for recognition; 51
- To what extent it complies with the current version of the Code of Conduct Fundamentals of the International Organization of Securities Commissions (IOSCO). 52

In evaluating the application, FINMA takes into account whether the rating agency is recognised by foreign supervisory authorities. 53

FINMA publishes a list of the recognised rating agencies, indicating the market segments for which it has granted recognition. 54

The rating agency bears the costs of the recognition process in accordance with the FINMA Fees and Charges Ordinance (FINMA-GebV; SR 956.122). 55

b) Recognition of rating agencies domiciled abroad

In general, rating agencies domiciled abroad and rating agencies domiciled in Switzerland are subject to the same requirements. 56

If a rating agency domiciled abroad is, in principle, subject to adequate supervision in its country of domicile and if it is supervised on an ongoing basis by a foreign supervisory authority, FINMA may apply a simplified recognition process or waive proof of compliance with the recognition requirements (margin no. 25 ff.).

It is generally assumed that the regulation and government supervision of rating agencies in the following jurisdictions is sufficient:

- Australia 57
- EU countries
- Japan
- USA

D. Classification of ratings

FINMA publishes a table which shows the rating levels of the recognised rating agencies allocated to given rating classes and risk weightings (concordance table, mapping). 58

VI. Compliance with recognition requirements

The rating agencies recognised by FINMA are not subject to ongoing supervision. FINMA provides no warranty for the correctness and reliability of the ratings or the activities of the rating agencies it has recognised. 59

At any time FINMA may review the compliance of the rating agencies it has recognised with the recognition requirements. 60

For this purpose, FINMA may hold discussions with the rating agencies it has recognised or request information and documentation. 61

For rating agencies that are subject to foreign supervision, FINMA may take the findings of the foreign supervisory authorities or the measures they impose on the rating agencies into consideration when evaluating a rating agency's fulfilment of the requirements for recognition. 62

If shortcomings are found in a rating agency's fulfilment of the requirements for recognition, FINMA may impose measures appropriate to resolving the shortcoming or may temporarily or permanently revoke recognition. If FINMA revokes a rating agency's recognition, the ratings of that agency can no longer be used for supervisory purposes by institutions subject to supervision. The rating agency bears the costs of the procedures that resulted in the revocation of its recognition in accordance with the FINMA-GebV. 63

VII. Entry into force and transitional provisions

A. Entry into force

This Circular will take effect on 1 January 2012. 64

B. Transitional provisions

With respect to the use of ratings for the purpose of determining tied assets (margin no. 14), the provisions of this Circular shall enter into force as of 1 January 2015, in divergence from margin no. 68. By this date, rating agencies which are not yet recognised by FINMA and whose ratings are used by insurance companies for supervisory purposes must have applied to FINMA for recognition. Up until this date, insurance companies may continue to use ratings by rating agencies which currently qualify as "recognised" under FINMA Circ. 65

08/18 "Investment Guideline for Insurers".

Draft