

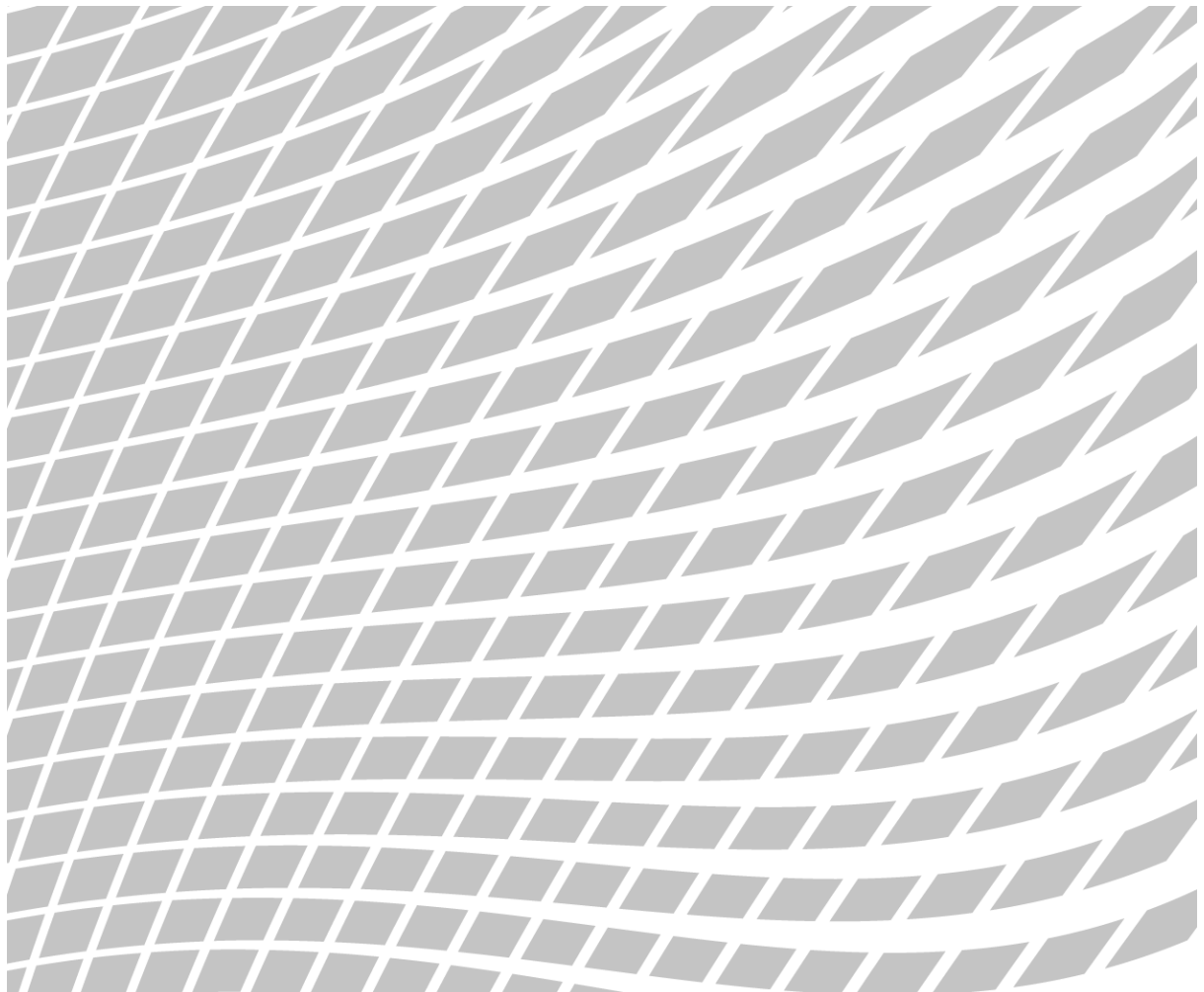
25 March 2011

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# **Amendments to FINMA Circular 2008/26 Rating agencies**

## **Explanatory report**

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# Contents

<b>Abbreviations</b> .....	<b>4</b>
<b>Key issues</b> .....	<b>5</b>
<b>1 Introduction</b> .....	<b>7</b>
<b>2 Background</b> .....	<b>7</b>
2.1 Recognition of rating agencies.....	7
2.2 Use of ratings in FINMA regulation (supervisory application).....	8
2.2.1 Banks and securities dealers.....	8
2.2.2 Insurers.....	8
2.2.2.1 SST.....	8
2.2.2.2 Tied assets.....	8
2.2.3 Collective investment schemes.....	9
<b>3 International developments</b> .....	<b>9</b>
<b>4 The FINMA position</b> .....	<b>9</b>
<b>5 Comments on amendments</b> .....	<b>10</b>
5.1 Purpose and scope of application.....	10
5.2 General principles.....	10
5.3 Supervisory use.....	11
5.3.1 Banks and securities dealers.....	11
5.3.2 Insurers.....	11
5.3.3 Collective investment schemes.....	11
5.4 Recognition.....	12
5.4.1 Objectivity.....	12

5.4.2	Independence .....	13
5.4.3	Access and transparency .....	13
5.4.4	Disclosure .....	13
5.5	Recognition procedure .....	14
5.6	Compliance with recognition requirements .....	14
5.7	Export credit agencies.....	14
5.8	Entry into force and transitional provisions .....	14

## Abbreviations

BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements, Basel
CAO	Swiss Federal Ordinance on Capital Adequacy and Risk Diversification for Banks and Securities Dealers of 29 September 2006 (Capital Adequacy Ordinance, CAO; RS 952.03)
CEBS	Committee of European Banking Supervisors (now the European Banking Authority, EBA)
CIRC.	Circular
CISO-FINMA	Ordinance of the Swiss Financial Market Supervisory Authority on Collective Investment Schemes of 21 December 2006 (FINMA Collective Investment Schemes Ordinance, SR 951.312)
ECAI	External Credit Assessment Institution
ESMA	European Securities Market Authority (formerly CESR)
FINMA	Swiss Financial Market Supervisory Authority
FINMASA	Federal Act on the Swiss Financial Market Supervisory Authority (Financial Market Supervision Act, SR 956.1)
FSB	Financial Stability Board (formerly the Financial Stability Forum, FSF)
IOSCO	International Organization of Securities Commissions (Association of Securities Supervisory Authorities)
ISO	Ordinance on the Supervision of Private Insurance Companies (Supervision Ordinance SR 0.961.514)
NRSRO	Nationally Recognized Statistical Rating Organization (US authorisation of rating agencies)
SEC	Securities and Exchange Commission
SFBC	Swiss Federal Banking Commission
SST	Swiss Solvency Test

## Key issues

FINMA is opening the hearing on amendments to Circular 2008/26 "Rating agencies", due to come into effect on 1 January 2012. By setting out the requirements for rating agencies to be recognised, the revised circular is intended to help ensure that ratings used for supervisory purposes by institutions supervised by FINMA meet minimum quality standards. In view of the market environment for rating agencies in Switzerland, the prescriptions from international standard setters such as IOSCO and the BCBS, which have been modified since the original circular came into force on 1 January 2007, will be implemented in Switzerland in anticipation of the new capital adequacy rules (Basel III). The revised circular will apply to all institutions supervised by FINMA which use ratings as part of financial market regulation. FINMA is seeking consistent rules for the recognition of rating agencies. As is the case at present, FINMA will not supervise rating agencies and provides no warranty for the ratings issued. The consultation period for the circular will run until 13 May 2011.

### **Requirements for rating agencies as a contribution towards a minimum quality of ratings**

Through their ratings, rating agencies supply information about the creditworthiness of borrowers and issuers and their debt instruments. This information is used by both market participants and, in some cases, financial market supervisors, and is subject to financial market regulation. Institutions supervised by FINMA may, in addition to voluntary use, apply ratings within previously agreed guidelines from rating agencies recognised for this purpose by FINMA to meet regulatory requirements. FINMA's recognition requirements are set out in this Circular on rating agencies and are intended to provide a minimum quality of rating for purposes of supervisory use.

### **Reflecting changes amongst international standard setters**

As a result of criticism of the practices of rating agencies made after the financial markets crisis, governments in the G-20 states called for stricter standards for rating agencies. In 2008, IOSCO revised its Code of Conduct Fundamentals for Credit Rating Agencies. In the 2010 revised capital adequacy standards for banks (Basel III), the BCBS also made changes and aligned itself with the stricter IOSCO principles. The governments of the G-20 states have agreed that, in all member states, rating agencies will come under government supervision in order to raise the quality of ratings and processes and make it possible to exercise corresponding influence on the rating agencies.

### **Taking account of the Swiss market**

With the exception of the Swiss company, fedafin AG, which is recognised in the market segment Public Finance, there is currently no rating agency recognised by FINMA which has its head office in Switzerland. The other agencies all conduct their activities from offices abroad.

**The supervisory situation abroad**

Rating agencies are not institutions supervised by FINMA (Art. 3 FINMASA) and not subject to financial market regulation, hence they are not subject to ongoing supervision by FINMA in Switzerland. In some major G-20 states such as the USA and EU, regulation programmes have been implemented with state supervision, generally linked to having a head office or using ratings for supervisory purposes in the relevant country. Switzerland is not a member of the G-20, so the general direction in which it is going is not binding; it is, however, significant, and applicable for supervisory purposes.

**Depending on foreign supervisory systems for recognition**

Rating agencies domiciled abroad are frequently subject to newly implemented supervisory systems where foreign supervisors have broad array of influence and enforcement tools. This supervision can be used indirectly by FINMA for recognition in Switzerland by making its recognition procedures easier. Such decisions are made on a case-by-case basis.

**Coverage of all areas supervised by FINMA**

The new Circular on rating agencies replaces the existing FINMA Circular 08/26 and expands its scope of application to all supervisory purposes for all categories of supervised institutions for which ratings are used under FINMA regulation. This includes extending the scope of application to insurers and collective investment schemes.

## 1 Introduction

Financial market regulation (financial market legislation under Article 1 FINMASA including implementing provisions) allows institutions supervised by FINMA to use ratings from external rating agencies for various purposes. The types of use of ratings in financial market regulation (supervisory purposes) depends on the regulation of each category of supervised institution, and in some cases date back to FINMA's predecessor institutions. Adjusting the Circular is intended to define a consistent framework for recognising rating agencies for supervisory purposes, since the objective of contributing to a minimum quality for relevant information on credit risk (ratings) is identical for all types of use in financial market regulation. The use of ratings cannot result in institutions supervised by FINMA ceasing to carry out their own assessment of credit risks.<sup>1</sup> For the purposes of their own assessment of credit risk (not for supervisory purposes), institutions supervised by FINMA may also use ratings from agencies not recognised by FINMA or from other institutions. These are not covered by this Circular.

## 2 Background

### 2.1 Recognition of rating agencies

Rating agencies are currently recognised by FINMA (formerly the SFBC) on the basis of FINMA Circular 08/26 "Rating agencies" in cases where banks or securities dealers wish to use their ratings to calculate regulatory capital under Articles 49ff CAO or in connection with risk diversification under Articles 93ff CAO, and the rating agency meets the requirements under Article 52 CAO and the terms of this Circular. Recognition is divided into the following market segments: public-sector entities and their credit instruments; corporates and their credit instruments; securitisations, derivatives and other structured credit instruments (structured finance). The precise terms of the conditions for recognition for rating agencies are based on the Code of Conduct Fundamentals for Credit Rating Agencies dated December 2004 from the technical Committee of IOSCO and the minimum standards of the BCBS (ECAI recognition), which underlie the CAO (Basel II).<sup>2</sup>

Rating agencies are recognised by FINMA for supervisory purposes in their function as conduits of information which is important for the financial market. They are not subject to ongoing supervision by FINMA. No warranty is provided by FINMA for the accuracy or reliability of the ratings.

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<sup>1</sup> Cf. FSB Report „Principles for Reducing Reliance on CRA Ratings“ of 27 October 2010  
[http://www.financialstabilityboard.org/publications/r\\_101027.pdf](http://www.financialstabilityboard.org/publications/r_101027.pdf)  
and “The G-20 Toronto Summit Declaration June 26-27, 2010”, p. 19, point 27  
[http://www.g20.org/Documents/g20\\_declaration\\_en.pdf](http://www.g20.org/Documents/g20_declaration_en.pdf)

<sup>2</sup> Cf. SFBC explanatory report 2006 on the circular on rating agencies:  
[http://www.finma.ch/archiv/ebk/d/regulier/konsultationen/060727\\_03\\_d.pdf](http://www.finma.ch/archiv/ebk/d/regulier/konsultationen/060727_03_d.pdf)

## 2.2 Use of ratings in FINMA regulation (supervisory application)

### 2.2.1 Banks and securities dealers

Under Article 49 para. 2 CAO, banks and securities dealers can use external ratings from rating agencies recognised by FINMA for the risk-weighting of individual positions, depending on the category of position, for both the Swiss Standardised Approach Switzerland (SA-CH) or the International Standardised Approach (SA-BIS).<sup>3</sup> The use of external ratings seeks a more risk-appropriate calculation of market and credit risks when calculating capital adequacy and risk diversification.

### 2.2.2 Insurers

#### 2.2.2.1 SST

When modelling credit risk to determine target capital under SST in accordance with Articles 41ff ISO, insurers can apply risk weightings based on external ratings in line with the international approach for banks (Appendix 3 to the CAO)<sup>4</sup>. The existing recognition of rating agencies therefore also applies for supervisory use of ratings by insurers as part of the SST. The objective of the use of external ratings for the SST is comparable to that for banks and securities dealers (cf. 2.2.1 above).

#### 2.2.2.2 Tied assets

Insurers have to observe certain investment principles when classifying assets as tied assets.<sup>5</sup> In particular, to meet the investment principles of safety and diversification, FINMA Circular 08/18 on investment guidelines for insurers allows decisions to be based on the rating of a "recognised rating agency." There has been no final ruling on precisely which agencies come under the term "recognised rating agency." In addition, ratings from external rating agencies are used to specify assets eligible for classification as tied assets under Article 79 ISO, e.g. for structured products and other debt.<sup>6</sup>

Non-life insurers can be seen as a special case because they include claims on reinsurers as tied assets. These have to meet qualitative requirements based on the rating of the reinsurer.<sup>7</sup>

To date, the use of external ratings for insurers' tied assets has not been subject to the rating agency being recognised by FINMA under FINMA Circular 08/26. Where claims on reinsurers are treated as tied assets by non-life insurers, FINMA Newsletter 04/2009 has a list of rating agencies used by FINMA to assess the financial strength of the reinsurer.

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<sup>3</sup> Cf. Appendices 2, 3 and 6 of the CAO.

<sup>4</sup> Cf. FINMA Circular 08/44 "SST" margin no. 90.

<sup>5</sup> Cf. Article 76 ISO.

<sup>6</sup> Cf. FINMA Circular 08/18 "Investment guideline: - insurers".

<sup>7</sup> Cf. FINMA Newsletter 4/2009: "Non-life insurance - authorisation of receivables from reinsurers to constitute tied assets".



### 2.2.3 Collective investment schemes

The rules on investment techniques (securities lending) and the use of financial derivatives by various types of collective investment scheme contain minimum requirements for the provision of collateral and sufficient creditworthiness.<sup>8</sup> One measure used is a minimum rating from a rating agency recognised by FINMA. The former SFBC Circular 98/3 "Recognised rating agencies" contained a list of rating agencies recognised for this purpose. This circular was not transposed into a corresponding FINMA circular when FINMA was established at the start of 2009. Since then it has not been clear which rating agencies are recognised by FINMA.

## 3 International developments

In view of the much-voiced criticism of rating agencies for their part in the financial market crisis, at their summit in March 2009 the governments of the G-20 states called for rating agencies to be registered and then supervised. Many G-20 states launched programmes of regulation or revised existing ones which include the ongoing supervision of rating agencies. The most important supervision systems were started in the USA with the Credit Rating Agency Reform Act and the Dodd-Frank Act, and in the EU with the EU Rating Agencies Regulation.<sup>9</sup> Most regulation programmes are still in development.

In May 2008, the IOSCO Technical Committee revised its Code of Conduct Fundamentals for Credit Rating Agencies and the new Standing Committee 6: Credit Rating Agencies took on the task of monitoring developments in supervisory programmes in IOSCO member countries. In a consultation report published in May 2010, the IOSCO Technical Committee noted that the supervisory programmes which have entered into force are based on the IOSCO principles and code, although the actual structure of national regulation differs and some member countries are following different approaches.<sup>10</sup>

In its new Basel III framework<sup>11</sup> in mid-December 2010, the BCBS followed the revised IOSCO code on recognising rating agencies for supervisory purposes and tightened its recommendations on the requirements for the recognition of rating agencies. These rules will have to be transposed when Basel III is implemented in Switzerland.

## 4 The FINMA position

With the amendment of this Circular, FINMA is implementing the provisions of the revised IOSCO Code (2008) and the Basel III framework. As a member of IOSCO, it observes the international devel-

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<sup>8</sup> Cf. CISO-FINMA Section 1: Investment techniques and derivatives.

<sup>9</sup> Cf. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:FULL:DE:PDF>

<sup>10</sup> Cf. IOSCO Consultation Report May 2010: Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies .

<sup>11</sup> Cf. Basel III: A global regulatory framework for more resilient banks and banking systems.

opments in the regulation and supervision of rating agencies and the impact these have on the sector. As a non-member of the G-20, Switzerland is not obliged to implement the supranational agreement between the G-20 governments on state registration of rating agencies with subsequent supervision, however international trends in this area must be closely monitored. As far as examining the implementation of specifically Swiss regulation with subsequent ongoing supervision of rating agencies is concerned, it is important to note that the oligopolistic market for rating agencies in Switzerland is not comparable to that in most G-20 countries. Only one of the rating agencies which has so far been recognised by FINMA is based in Switzerland. The other rating agencies are globally active and carry out their business in Switzerland from foreign locations. As part of the implementation of foreign supervisory systems, these will therefore soon be fully regulated by foreign authorities. Because the major foreign supervisory regimes are based on the same IOSCO principles as FINMA recognition, in the amended Circular FINMA provides an option for a simplified recognition procedure where a rating agency is regulated by an appropriate supervisor abroad. Given the nature of the market in Switzerland, FINMA is not currently seeking to implement ongoing supervision of rating agencies as is being implemented by the G-20 states. The current FINMA approach of linking the recognition of rating agencies to meeting certain conditions (requirements for recognition) and thereby implementing the guidelines of international standard setters while simultaneously taking sufficient account of the nature of the market in Switzerland is regarded as a pragmatic path. FINMA reserves the right to withdraw recognition from a rating agency if it finds that the conditions for recognition are not met, which will mean that as a consequence institutions supervised by FINMA will no longer be free to use those ratings for supervisory purposes. The amendment to the Circular on rating agencies is intended to update the framework for recognising rating agencies and implementing international rules.

## 5 Comments on amendments

### 5.1 Purpose and scope of application

The amended FINMA Circular 08/26 "Rating agencies" is intended to cover all types of application of ratings in financial market regulation and contribute to ensuring a minimum standard of quality. The restriction "for supervisory purposes" is significant in that the free use of ratings, e.g. for information and risk management purposes, should not be hindered and should not come under the scope of application of the Circular.

### 5.2 General principles

There is no fundamental requirement to be recognised when setting up a rating agency. Where a rating agency intends that its ratings will be used by institutions supervised by FINMA for supervisory purposes (cf. Chapter IV of the Circular), prior recognition from FINMA is required.

The use of ratings cannot result in supervised institutions carrying out no work of their own on managing risk such as credit risk. Supervised institutions will continue to be responsible for dealing with their risks themselves in terms of assessing, limiting and monitoring them. In the past, blind faith in ratings

was a contributing factor to the recent financial market crisis. The governments of the G-20 and the FSB are therefore calling for more individual responsibility in dealing with risk and less reliance on ratings.

Under the financial markets legislation, rating agencies recognised by FINMA are not subject to ongoing supervision by FINMA. No warranty is provided by FINMA for the accuracy or reliability of the ratings.

### 5.3 Supervisory use

The existing circular on the recognition of rating agencies was relevant for the use of ratings by banks and securities dealers under Article 52 CAO. Insurers and collective investment schemes now also fall within the scope of application.

#### 5.3.1 Banks and securities dealers

To date, recognition of rating agencies has been based on Article 52 CAO. This article will have to be modified as part of the implementation of Basel III, but it will remain key for the use of ratings by banks. The Basel III<sup>12</sup> liquidity regime also refers to ECAI recognition under the capital adequacy rules, so both objectives are consistent in terms of recognising rating agencies. Implementation and the associated timeline will depend on the new circular FINMA will have to draw up to implement Basel III.

#### 5.3.2 Insurers

The use of ratings under the SST has to date referred to the rating agencies recognised for capital adequacy purposes for banks and securities dealers. The objective is comparable to that for banks (capital adequacy). Listing insurance companies will take account of the objective of the Circular to be comprehensive.

Insurers are required to demonstrate that assets classified as tied assets are of a certain quality. There are rules for this, and rating is one of the criteria applied. Non-life insurers are allowed to include claims on reinsurers as tied assets. These have to meet qualitative requirements based on the rating of the reinsurer. In future, insurers will only be able to use ratings from a FINMA-recognised rating agency for this purpose. There is a transitional period running to 1 January 2015 for the recognition of rating agencies when ratings are used for tied assets. Rating agencies intending for their ratings to be used in this way by insurers have until that date to submit an application to FINMA. FINMA Newsletter 4 (2009) is not affected by this provision.

#### 5.3.3 Collective investment schemes

Under Article 4 CISO-FINMA, various forms of collective investment schemes may lend exchange-traded securities, but they have to meet the relevant rules in CISO-FINMA on securities lending. There

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<sup>12</sup> Cf. Basel III: International framework for liquidity risk measurement, standards and monitoring of 16 December 2010.

are minimum standards that apply to the provision of collateral for such lending or when entering into repos; these include a minimum rating from a rating agency recognised by FINMA (Arts. 8 and 15 CISO-FINMA). Also, when using financial derivatives, there are certain minimum requirements as to the creditworthiness of the counterparty (Art. 33 CISO-FINMA).

The old circular SFBC 98/3 "Recognised rating agencies" contains a list of rating agencies recognised for this purpose. This circular was not adopted into FINMA regulation, so the arrangements for recognition for these purposes are insufficient. By adopting the supervisory use on collective investment schemes, ratings from those rating agencies recognised under FINMA Circular 08/26 can also be used for these purposes.

## 5.4 Recognition

The market segment for which recognition is granted will continue to be based on the CEBS guidelines<sup>13</sup>. In order to make the market segments clearer, the CEBS names are now given in English: Public Finance, Commercial Entities and Structured Finance. "Public Finance" now includes ratings of companies with close links to the state and is no longer restricted to public-sector agencies. The use of consistent international terminology for market segments is intended to make the use and selection of the appropriate rating model easier, given that the rating industry is largely international. Nevertheless, new market segments can be added if required. There has been no need for this since FINMA Circular 08/26 and SFBC Circular 06/7 came into force.

The intention is that the requirements in the current version of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies should serve as the basis for recognition and be observed at all times. The previous reference to the IOSCO Code (2004) proved to be too static and will be replaced with the words "currently valid version." This will make it possible to implement changes in the IOSCO rules more quickly in Switzerland.

The amendments to the individual principles of the recognition requirements are explained below.

### 5.4.1 Objectivity

To date, the circular has required backtesting covering a period of one year to check the rating methodology. Increasing this to three years meets the BCBS recommendations to raise the quality of rating methodology. There will continue to be an option in justified cases to make exceptions down to the minimum standard of a backtesting period of at least one year.

FINMA recognition will continue to be given only to rating agencies that work with a methodology including both quantitative and qualitative elements. Pure credit scoring companies do not fall within the scope of application; in this, FINMA is following the statement by the CEBS to the EU Commission on 17 December 2010 and an associated rationale in the EU Rating Agencies Regulation<sup>14</sup>.

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<sup>13</sup> Cf. CEBS Guidelines on the recognition of External Credit Assessment Institutions (2006).

<sup>14</sup> Cf. The rationale in margin no. 7 of the EU Rating Agencies Regulation of 16 September 2009.

In order to make objective decisions on a rating easier to reconstruct, procedures have to be documented. Rating agencies must also have a code of conduct based on the rules in the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. A rating agency may deviate from these rules provided it discloses the deviations and can offer sufficient justification (comply or explain).

#### **5.4.2 Independence**

Independence is given greater importance among the conditions for recognition. This is to counteract conflicts of interest that affect the rating. The principles of "independence in mind" and "independence in appearance" apply in the same way as they do in the independence guidelines for auditors. Infringements on independence are measured by possible and apparent influence on individual ratings and decisions.

Not least due to the IOSCO code, greater emphasis will be placed in future on internal controls at rating agencies. These must have sufficient resources to be able to perform their duties to regularly check ratings and the rating methodology.

Rating agencies must also have a compliance function to monitor at all times that internal guidelines and procedures are in line with supervisory rules.

FINMA has chosen a principles-based formulation to implement the independence requirements, so as to cover this requirement as fully as possible. There are numerous ways that could be imagined to circumvent the rules on independence, but these will not be discussed here in detail.

#### **5.4.3 Access and transparency**

Under the BCBS Basel III framework, a rating agency must provide more information on the rating given, e.g. the underlying information it is based on and whether the issuer was involved in the rating process. This is mainly important in deciding whether a rating was solicited or not.

Rating agencies must also disclose their general procedures and methodologies and the assumptions their views are based on.

This should give financial market participants more of the background information on which a rating is based, so they can make a better estimate of its predictive power.

#### **5.4.4 Disclosure**

Under Basel III "A global regulatory framework for more resilient banks and banking systems," and in an extension of existing regulations, rating agencies now have to disclose their code of conduct (based on the IOSCO code) and the principles of remuneration agreements with borrowers and issuers rated.

## 5.5 Recognition procedure

As has been the case to date, rating agencies have to apply to FINMA for recognition. Once the documents and evidence submitted have been checked, FINMA may recognise the agency for the relevant market segment.

As mentioned in Section 4 above, in future where a rating agency is subject to an adequate foreign supervisory system FINMA will carry out a simplified recognition procedure or, as stated in the Circular, waive the requirement for separate proof that the conditions for recognition have been met. This is meant to allow for the fact that rating agencies domiciled abroad are frequently subject to appropriate ongoing supervision from foreign supervisory authorities. Most rating agencies recognised by FINMA to date come under this regulation. The basis for listing certain jurisdictions (Australia, the EU, Japan and the USA) is the May 2010 Consultation Report of the IOSCO Technical Committee<sup>15</sup>, which states that all regulation is based on the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies and the IOSCO principles, even though the structure is different in each country. The selection is also based on the largest and most relevant markets for rating agencies, so not all IOSCO member states are deemed to have been recognised in principle. The list is not definitive, and further jurisdictions may be added after due consideration.

## 5.6 Compliance with recognition requirements

Recognised rating agencies are not supervised by FINMA. However, FINMA reserves the right to check that recognised rating agencies fulfil the conditions for recognition at all times. To this end, it may demand information and documentation at any time.

In the case of rating agencies domiciled abroad, FINMA may make allowance for the results of foreign supervisory authorities and their work when considering whether the conditions for recognition have been met.

## 5.7 Export credit agencies

To date, export credit agencies have been recognised for the Public Finance segment provided they meet the OECD rules<sup>16</sup>. The activity of export credit agencies is not comparable to that of rating agencies for the purposes of this Circular, as they perform completely different functions on the financial market. Export credit agencies will therefore no longer be covered by the circular on rating agencies.

## 5.8 Entry into force and transitional provisions

In view of the implementation of the Basel III framework in Switzerland, the amendments to the Circular should come into force on 1 January 2012. As stated under 5.3.2 above, the use of ratings by in-

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<sup>15</sup> Cf. IOSCO Technical Committee Consultation Report: Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies.

<sup>16</sup> OECD Arrangement on Guidelines for Officially Supported Export Credits of 5 December 2005.

urers with regard to investment guidelines relating to tied assets is scheduled to come into force at the start of 2015.