# Good Practices on Reducing Reliance on CRAs in asset management

# Consultation Report

THE BOARD OF THE
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

**CR04/14** **JUNE 2014**

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# Foreword

The Board of the International Organization of Securities Commissions (IOSCO) has published this Consultation Report.

This Consultation Report is prepared by the IOSCO Committee 5 on Investment Management (C5). IOSCO seeks the views of stakeholders on the questions posed in this report to inform its final Good Practices on Reducing Reliance on CRAs in asset management. Investment managers, institutional investors and credit rating agencies are the main stakeholders targeted by this Consultation Report.

**How to Submit Comments**

Comments may be submitted by one of the three following methods **on or before Friday 5 September 2014**. To help us process and review your comments more efficiently, please use only one method.

**Important:** All comments will be made available publicly, unless anonymity is specifically requested. Comments will be converted to PDF format and posted on the IOSCO website. Personal identifying information will not be edited from submissions.

**1. Email**

- Send comments to consultation-2014-04@iosco.org
- The subject line of your message must indicate [Good Practices on Reducing Reliance on CRAs in asset management]
- If you attach a document, indicate the software used (e.g., WordPerfect, Microsoft WORD, ASCII text, etc.) to create the attachment.
- Do not submit attachments as HTML, PDF, GIFG, TIFF, PIF, ZIP or EXE files.

**2. Facsimile Transmission**

Send by facsimile transmission using the following fax number: + 34 (91) 555 93 68.

**3. Paper**

Send three (3) copies of your paper comment letter to:

**Mr Mohamed Ben Salem**
General Secretariat
International Organization of Securities Commissions (IOSCO)
Calle Oquendo 12
28006 Madrid
Spain

Your comment letter should indicate prominently that it is a "*Public Comment on Good Practices on Reducing Reliance on CRAs in asset management*".

# Contents

## Introduction

Credit rating agencies (CRAs) play a prominent role in today's global financial markets. Although approaches may differ across jurisdictions, investment managers often use the services of CRAs to form an opinion on the creditworthiness of a particular issuer before purchasing securities, selecting counterparties, or choosing the best collateral to secure transactions. On their part, investors often refer to CRA ratings to determine their investment universe before buying shares of a fund[1], or when guiding investment managers on the basis of a tailored investment mandate.

The role of CRAs has come under regulatory scrutiny, mainly as a result of the over-reliance placed by market participants, including investment managers and institutional investors, on CRA ratings in their assessments of both financial instruments and issuers in the run-up to the 2007-2008 financial crisis.

To tackle this concern, in October 2010, the Financial Stability Board (FSB) published its report on *Principles for Reducing Reliance on CRA Ratings (*"FSB 2010 *Principles*")[2]. The goal of the *Principles* is to end mechanistic reliance on ratings by banks, institutional investors, and other market participants, thereby reducing the financial stability-threatening herding and cliff effects that could arise from CRA rating thresholds being hard-wired into laws, regulations, and market practices. The FSB 2010 *Principles* contain a number of important recommendations.

**The relevant FSB Principles for investment managers in detail**

Principles I and II provide the general framework requiring that standard setters, authorities and market participants consider ways to reduce overreliance to CRA ratings.

*Principle I. Reducing reliance on CRA ratings in standards, laws and regulations*
*Standard setters and authorities should assess references to credit rating agency (CRA) ratings in standards, laws and regulations and, wherever possible, remove them or replace them by suitable alternative standards of creditworthiness.*

*Principle II. Reducing market reliance on CRA ratings*
*Banks, market participants and institutional investors should be expected to make their own credit assessments, and not rely solely or mechanistically on CRA ratings.*

Of particular relevance for investment managers is *Principle III.3* thereof:

*Investment managers and institutional investors must not mechanistically rely on CRA ratings for assessing the creditworthiness of assets. This principle applies across the full range of investment managers and of institutional investors, including money market funds, pension funds, collective investment schemes (such as mutual funds and investment companies), insurance companies and securities firms. It applies to all sizes and levels of*

[1] For the purpose of this consultation report, the term "*fund*" is understood broadly to include both registered (e.g., collective investment schemes - CIS) and non-registered (e.g. private funds) collective investment vehicles across different jurisdictions.

[2] Available at: http://www.financialstabilityboard.org/publications/r_101027.pdf.

*sophistication of investment managers and institutional investors.*

*Principle III.3.b* adds that senior management and boards of institutional investors have a responsibility to ensure that internal assessments of credit and other risks associated with their investment are being made, and that the investment managers they use have the skills to understand the instruments they are investing in and exposures they face, and do not mechanistically rely on CRA ratings[3], In addition, senior management, boards and trustees should ensure adequate public disclosure of how CRA ratings are used in risk assessment processes.

*Principle III.3.c* suggests a list of measures that regulators could adopt to avoid the mechanistic reliance on ratings. These are *inter alia*:

- Restricting the proportion of a portfolio that is solely CRA ratings-reliant;
- Supervisory monitoring of credit and other risk assessment processes (in the case of supervised investment managers and institutional investors);
- Requiring the boards, trustees or other governing bodies of investment managers and institutional investors to regularly review any use of CRA ratings in their investment guidelines and mandates and for risk management and valuation;
- Requiring public disclosures of internal due diligence and credit risk assessment processes, including how CRA ratings are or are not used, with the aim of encouraging investment managers to develop more rigorous and individual processes included in investment mandates, rather than relying on common triggers;
- Requiring public disclosures of risk assessment policies related not solely to specific rating thresholds, but also accounting for the types of instruments (thus reflecting the different nature of the risks applying to, for instance, structured finance products compared with corporate bonds). Such disclosures should be made in a manner consistent with the goal of streamlining disclosures for customers.

Finally, *Principle III.5.a* proposes that standard setters and authorities should review whether any references to CRA ratings in standards, laws and regulations relating to disclosure requirements are providing unintended incentives for investors to rely excessively on CRA ratings and, if appropriate, remove or amend these requirements.

The FSB 2010 *Principles* concluded with an exhortation for standard setters – including IOSCO - and regulators to consider steps for translating the principles into more specific policy actions[4]. In

[3] In the text accompanying the Principle III.3.b, the FSB report adds that the case of smaller, less sophisticated investors (who do not have the resources to conduct internal credit assessments for all their investments or who may outsource all or part of their investment management), this could be carried out through the trustees or others responsible for directing the investment strategy, ensuring that they understand the risks implied by the strategy they are following, as well as the appropriate uses and limitations of CRA ratings.

[4] IOSCO has already addressed these issues in a July 2009 report on *Good Practices in Relation to Investment Managers´ Due Diligence When Investing in Structured Finance Instruments*. Although the mandate focussed on due diligence when investing in structured finance products, the report recognized that many of the principles and themes discussed therein could be applied regardless of the type of product. This

line with the FSB approach, IOSCO's Policy Committee on Investment Management (C5) launched a first mapping exercise in March 2011 to better understand the extent of its Member jurisdictions' reliance on regulations explicitly referencing CRA ratings for investment managers and identify gaps between existing domestic regulations and the FSB 2010 *Principles*[5].

As a follow-up to its 2010 *Principles*, in November 2012, the FSB published its so-called "Roadmap"[6]**,** highlighting the short- to medium-term milestones for progress towards lessening the continued over-reliance on CRAs and for strengthening financial firms' own risk assessments. Both the *Principles* and the Roadmap adopt a dual-track approach, in which the removal of the "hard-wiring" of references to CRA ratings in standards, laws and regulations is to be accompanied by promoting incentives for the private sector to develop its own internal credit risk assessment processes. In this respect, the FSB has conducted a thematic peer review of progress made in member jurisdictions in implementing the 2010 *Principles*. The peer review's main objective is to assist national jurisdictions in fulfilling their commitments under the Roadmap[7].

In view of the need to provide guidance to its Member jurisdictions (and indirectly to market participants to develop alternative credit assessment procedures), IOSCO has launched a series of new mandates among its policy committees aimed at complementing the on-going FSB peer review process.

In this light, C5 carried out a second mapping exercise in October 2012. The results of this second exercise have revealed further progress in reducing the over-reliance on CRAs in national regulations applicable to investment management in line with the 2010 FSB *Principles*. In order to address the outstanding concerns, C5 Members obtained the approval of a mandate under which C5 could respond, *inter alia*, to the following objectives[8].

1. Identify *Good Practices* by analyzing the type of alternatives to CRA ratings envisaged in the various C5 jurisdictions and where appropriate build on the previous IOSCO *Good Practices in Relation to Investment Managers´ Due Diligence When Investing in Structured Finance Instruments* of 2009 ("IOSCO 2009 *Good Practices")* when investing in structured finance products;
2. Consider the issue of the ratings of investment funds, or of other collective investment schemes (CIS), with a view to determine what policy tools could be explored;
3. Monitor the FSB work to ensure the specificities of the investment management industry are appropriately taken into account.

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would concern, in particular, certain good practices related to the use of third parties, including CRAs, in the due diligence process.

5 Results demonstrated that several jurisdictions had undertaken important steps in amending their relevant regulations to discourage over-reliance, while identifying areas that had not yet been fully addressed.

6 Available at: http://www.financialstabilityboard.org/publications/r_121105b.pdf

7 The final report on its main findings was published in May 2014 and is available at: http://www.financialstabilityboard.org/publications/r_140512.pdf

8 For this purpose, a working group within C5 was established. It is co-Chaired by the French AMF and the U.S. SEC, and is comprised of the following additional regulators: the Australian ASIC, Brazilian CVM, the Japanese FSA, the Mexican CNBV and the Québec AMF.

The present consultation report is designed to gather the views of industry (investment managers and their representative trade bodies, institutional investors and their associations, including any interested party, and CRAs) and draw on their practices for the purpose of developing and finalizing a set of *Good Practices* in 2014. These will be addressed to national regulators, investment managers, and investors, where applicable, and will suggest specific practices to reduce over-reliance on external credit ratings in the asset management space. It should also be noted that IOSCO's Policy Committee for the Regulation of Market Intermediaries has launched a project to identify "*good practices*" currently in place at intermediaries with regard to the use of alternatives to credit ratings to assess creditworthiness.

# Chapter 1 – Scope

## Different notions of external rating

This consultation report distinguishes between external ratings of individual financial instruments, of issuers, and of certain types of pooled investment vehicles (e.g., money market, structured finance vehicles) that express a view on the overall creditworthiness (hereafter "*credit ratings*") from those that on the other hand emphasize other, non-credit and qualitative aspects of a selected issuer, such as managerial talent, the effectiveness of a particular strategy in meeting the desired returns, the quality of internal operations and controls, etc.[9]. It is specifically with regard to credit ratings that, when used for regulatory purposes or when included in private investment agreements, concerns arise regarding over-reliance because of the potential "*cliff effects*" resulting from a ratings downgrade[10].

Notwithstanding these concerns, it is widely accepted that credit ratings act as useful, and at times necessary, benchmarks against which investment managers and investors may wish to compare their own internal credit analysis when available. Credit ratings rely on a blend of both quantitative (e.g., the systematic assessment of financial data, the calculation of ratios, running of models, etc.) and qualitative indicators (e.g., business risks, the impact of regulatory change, the quality of management, the implied future industry outlook, etc.) to objectively assess the

9 An example of this second category is provided by Morningstar's methodology for rating funds, split between the Star Ratings, that are backward-looking, strictly quantitative, assessing a fund's past performance in terms of returns adjusted for risk/volatility, of performance vis-à-vis competitors in the same category, and of value generated for investors over specified periods; and the more recent Analyst Rating system, where more qualitative and "subjective" factors are taken into account to express a forward-looking opinion on the people (a fund's managers), the process (i.e., how a fund's proclaimed strategy is translated into a portfolio), the parent (i.e., what are the managing company's priorities), the performance (i.e., why did a fund behave in a certain way in certain markets and probability of the same repeating in the future), and the price (i.e., is a fund a good value proposition for investors compared to peers). The Analyst Rating system methodology factsheet is available at: http://corporate.morningstar.com/US/documents/MethodologyDocuments/FactSheets/AnalystRatingforFundsFactSheet.pdf.

For further information, please refer to the Morningstar *Equity Research Methodology* of January 2012, available at: http://news.morningstar.com/pdfs/Equity_Research_Methodology_010512.pdf.

See also Fitch Ratings with regard to the fund quality ratings criteria: Assessing Funds' Investment Processes and Operational Attributes, available at: https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=552845.

The Fitch Quality Ratings have three pillars: (1) an assessment of the investment process, its resources and the management company; (2) an operational "pass/fail" analysis; and (3) a 'reality check' of the qualitative assessment against the manager's historical risk-adjusted performance.

10 In the October 2010 *Principles for Reducing Reliance on CRA Ratings*, the FSB acknowledges that the hard-wiring of CRA ratings thresholds into laws, regulations and market practices causes financial stability-threatening herding and cliff effects where the downgrade of a security under a specific threshold may lead to sudden disproportionate cascading effect.

probability of default (PD) or expected loss (EL)[11].

The present report deals exclusively with this category of credit ratings, as it is with reference to them that over-reliance raises concern[12]. To the extent that ratings assigned to certain types of funds by CRAs are based on the analysis of the creditworthiness of the underlying portfolio, the present report also discusses potential issues with the use of such ratings.

For the purpose of this consultation report only external credit ratings, which express a predominant and clear outlook on the creditworthiness (i.e., in particular the implied probability of default) of a particular instrument and/or entity, will be considered.

**Uses of external credit ratings by investment managers**

Investment managers may refer to external credit ratings to different degrees in the construction and management of their portfolios. Given the diversity of asset classes and breadth of different investment vehicles, each following an investment strategy that is set to meet different investor needs, there is no single way that investment managers use external credit ratings.

According to the results of the mapping exercises conducted among C5 Member jurisdictions over 2011-2012, investment managers use external ratings predominantly:

- To guide asset selection in the construction and optimization of an investment portfolio;
- To guide the selection of eligible collateral received or posted from/to different counterparties;
- To assess a counterparty's overall financial health and ability to uphold its obligations *vis-à-vis* one or more funds, as well as to determine the credit quality of certain guarantors or of sponsors that may provide support to certain pooled investment vehicles (e.g., money market funds or structured finance vehicles)[13].

External credit ratings may also be an element that is accounted for in estimating and managing portfolio risk subject to the methods or metrics used. Depending on the standard industry models

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11 Examples of credit ratings are those assigned to individual financial instruments and issuers by the large and more established CRAs like Standard & Poor's, Moody's and Fitch. By definition their ratings are opinions on the general creditworthiness of an obligor (issuer), or of its creditworthiness in relation to a particular security or financial obligation, taking into account the foreseeable future events. See Moody's Investor Service, Ratings Symbols and Definitions (April 2014) at 4; Standard & Poor's, About Credit Ratings (2012), available at: http://www.standardandpoors.com/aboutcreditratings/RatingsManual_PrintGuide.html; FitchRatings, Definitions of Ratings and other Forms of Opinion (Jan. 2014) at 4

12 Under the IOSCO CRA Code of Conduct in 2008, a credit rating is defined as "an opinion regarding the creditworthiness of an entity, a credit commitment, a debt or debt-like security or an issuer of such obligations, expressed using an established and defined ranking system."

13 In general, a guarantor of a debt security has an unconditional obligation to pay the guarantee holder the principal amount of the underlying security plus accrued interest upon default. A sponsor of a structured finance vehicle or MMF on the other hand is not legally obligated to provide support to the entity, but some sponsors have done so, including in 2008. *See* Money Market Fund Reform; Investment Company Act Release No. 28807 (June 30, 2009) at n.54 and accompanying text (available at http://www.sec.gov/rules/proposed/2009/ic-28807.pdf)

used and on prevailing industry practices, C5 Members would like to understand more about how external ratings are used in this regard, i.e., what effects downgrades may or may not have on the average risk of the collective portfolio that is evaluated using these methods or metrics.

**Uses of external ratings by investors**

Investors may consider external credit ratings before investing and throughout the life of their investments to define the range of assets in which they choose to invest. They may often establish investment guidelines to direct investment managers as to the types of instruments that investors wish their fund or managed account to be invested in. As such, external credit ratings represent a "*common language*" used by parties to an investment management agreement. In the absence of external credit ratings provided by CRAs, many investors would need to rely almost exclusively on the investment manager in determining whether a security is of investment grade or of high credit quality. As such, references to CRA ratings, even when embedded in investment contracts, may prove beneficial to investors by offering them alternative information points from a third party, while establishing that certain expectations as to how the fund should be managed are to be taken into account by the investment manager. Investors also may rely on credit ratings, among other factors, when choosing to invest (or remain invested) in a particular investment vehicle[14].

**Questions for consultation**:

1. Do you agree with the above categorization of uses by investment managers of external credit ratings? Are there other ways in which investment managers use external credit ratings? Can you point to situations where you would consider there is no alternative to external credit ratings?
2. What benefits do you as an investment manager see in the use of external credit ratings? How does your particular size, resources, capabilities, etc., affect the benefits you perceive?
3. How do investment managers adjust their internal portfolio risk models (e.g., diversification parameters, liquidity profile, VaR, etc.) to account for external credit rating changes to their portfolio securities? Among other risk factors (e.g., currency and interest rate changes), how relevant are external ratings in determining the ultimate risk level of a specific portfolio? Where possible, please suggest some examples as to why rating changes to the underlying securities may or may not be relevant.
4. As investors, depending on the type of investment vehicle and on your own capacity to carry out your own internal credit analysis, to what extent is the credit rating of a fund's portfolio holdings or of the fund itself, a determining factor in making your investment decision? Do you require the investment manager to reference one or more CRA ratings? If yes, is this your own choice or is it required by your specific institution?

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[14] For example, some investors will only invest in money market funds that have received the highest rating

5. Before investing, do you as an investor verify that an investment manager has procedures in place to perform its own credit analysis? Please elaborate on whether the approaches differ depending on the type of investment vehicle (e.g. a money market fund ("MMF") vis-à-vis a high yield bond fund).
6. Do you as an investor have the capabilities to monitor the credit quality of portfolio securities and/or follow-up on changes to external ratings that affect the portfolio securities or the fund in which you are invested? Could you briefly describe your procedures?

## Chapter 2 – Internal credit assessment

As set out in the FSB 2010 *Principles* for reducing reliance on CRA ratings, a key measure to reduce market reliance on external credit ratings is for investment managers to conduct their own credit assessments. The FSB 2010 *Principles* state that investment managers should be able to make their own determinations of the credit quality of the assets they intend to acquire or have acquired without mechanistically relying on credit ratings, and should publicly disclose information about their credit assessment processes. Pursuant to FSB *Principles*, several jurisdictions have introduced a requirement for investment managers to conduct their own credit assessment or due diligence before investing in fixed-income products (e.g., Brazil, EU, South Africa).

IOSCO's 2009 *Good Practices* highlighted certain good practices in relation to investment managers' due diligence when investing in structured finance instruments. Among these, the following still hold true for investment managers for the present report:

- Understanding the methodology, parameters and the basis on which the opinion of a CRA was produced, and having the adequate means and expertise to question that methodology and the parameters, notably to identify their limits.
- Understanding how the opinion of the CRA was formed without relying excessively or solely on it to form an opinion of the assets invested in. External credit ratings do not substitute for a manager's due diligence: they may be the beginning of due diligence, but not the end[15].

The overarching principle is that, while CRA ratings may be used as an input by investment managers, a manager should have appropriate controls and procedures in place internally to assess and manage on an on-going basis the credit risk associated with its investment decisions. A manager has fiduciary duties to its clients, which would encompass an understanding of the material credit risks of any investments that the investment manager makes or recommends and that they are appropriate for the client's risk profile and investment objectives.

For an investment manager, developing its own in-house credit assessment expertise is an essential added value provided to clients and represents one of the key factors managers use to differentiate themselves from one another. However, although the approaches adopted by investment managers to assess credit risk may substantially differ from one another, investment managers generally should disclose in an understandable way to their investors the approach they follow.

IOSCO understands that in general two internal models exist for assessing creditworthiness. In the first model the same person performs both portfolio management and credit assessment tasks; in the second model, credit research is carried out by a separate team of professionals. As a general rule, managers should disclose to their investors the internal model used.

a) Depending on the size and resources available to them, some investment management companies may entrust the credit assessment to the same person in charge of making investment decisions. Typically, smaller investment management businesses lack the resources to constitute teams of dedicated credit analysts to cover the whole spectrum of

15 http://www.iosco.org/library/pubdocs/pdf/IOSCOPD300.pdf.

their investments. These businesses may be specialized investment firms that focus on fewer asset categories and allow the managers to develop their own views – more or less formalised – on the credit quality of the entities they choose to invest in on behalf of their clients.

The risk of this form of organization lies in the inherent conflict of interest between the desired "*objectivity*" of a manager's credit assessment and the manager's interest in pursuing higher returns through less creditworthy investments. Such conflicts are generally managed and mitigated through internal policies, procedures and controls;

b) Other investment management companies that have ample resources can maintain internal dedicated teams of analysts to assess and monitor the credit quality of their portfolio investments. Within such firms, so as to avoid conflicts of interests, the credit analysis functions are deliberately segregated from those of asset management. The risk assessment may also be conducted on an intra-group level or outsourced externally to an independent third party. Furthermore, the function of risk management plays an important role in ensuring that risk is managed in line with the funds' investment objectives.

Asset managers willing to invest in fixed-income products should have the appropriate expertise and processes in place to perform credit risk analysis in line with their investment policy. In jurisdictions where applicable, regulators may check as part of the authorization process the adequacy, means and expertise that asset managers put forward to pursue the investment policy. However, these standard setters and regulators should be wary of imposing regulations relating to standards for in-house credit assessment, in particular to the extent that it might reintroduce other types of overreliance and potential trigger effects stemming from an excessive homogeneity of practices that may result from overly prescriptive rules. In particular, standard-setters and regulators should take into account the nature, scale and complexity of the activities carried out by the management company when monitoring the adequacy of its credit assessment process.

While encouraging the development of internal credit assessment procedures, IOSCO recognizes that external credit ratings can play an important role in providing investment managers with useful inputs before investing and while managing a portfolio. Noting that the use of external credit ratings and in-house credit research are not mutually exclusive, it is suggested that the former may be used as an input for the latter. In this regard, IOSCO acknowledges that its recommendations should allow for external credit ratings to continue to be used as benchmarks, among other purposes, complementing a manager's internal credit analysis and providing an independent opinion as to the quality of the portfolio constituents.

***Possible good practice***

***Investment managers make their own determinations as to the credit quality of a financial instrument before investing and throughout the holding period.***

***External credit ratings may form one element, among others, of the internal assessment process but do not constitute the sole factor supporting the credit analysis.***

Investment managers could consider credit assessment procedures that include some or all of the following criteria, as appropriate:

- Performing the assessment on the basis of an internal assessment scale and through the application of a rigorous methodology validated by the management board;
- Basing such methodology on all the relevant information available as appropriate to the type of instruments the funds may invest in or the adviser may recommend;
- Ensuring that information used for the assessment is of sufficient quality, updated regularly and from trusted sources;
- Reviewing the assignment of internal credit assessments on an on-going basis and regularly assessing the impact of external events likely to alter the credit quality of an individual entity (e.g., events in the broader financial market, or specific to the entity such as a corporate event, a change in the relative external credit rating, etc.);
- Regularly reviewing the assessment procedure so that when there are changes in a fund's objectives and financial market conditions, or in case of material change affecting its parameters the assessment procedure can be updated accordingly;
- Documenting, where relevant, the assessment procedure and the meaning of each internal assessment so as to provide the rationale underlying specific assessments, including a description of parameters, data sources, assessment models and their underlying assumptions, ratings' assignment processes, and events likely to trigger changes in the assessments;
- Specifying if, how, and the extent to which external ratings are taken into consideration and clarifying in the procedure the type of measures the investment manager would put in place in the event of a downgrade by a CRA where external ratings are used as inputs in the internal process;
- Making available to investors, for instance, through a link on the investment manager's website or in the annual reports of the funds, a brief summary description of these internal assessment procedures focusing on salient information.

It should also be noted that external credit ratings may be used as an indicator of liquidity, in particular in periods of market stress where it may be seen as a quality seal, this being particularly true for structured finance instruments. In periods of stress, managers may be more prone to sell downgraded assets not only because of a change in the CRA's credit quality assessment, but also as managers fear the assets become illiquid. In such situations, internal credit assessment models may need to take into account other market indicators to evaluate the liquidity of a finance instrument.

***Possible good practice***

***An internal assessment process that is commensurate with the type and proportion of debt instruments the investment manager may invest in, and a brief summary description of which is made available to investors, as appropriate.***

***An internal assessment process that is regularly updated and applied consistently.***

**Questions for consultation:**

7. Is the above description of the two models of internal analysis of credit quality within investment management firms accurate?

8. What factors would be effective in mitigating the conflict described in letter a)?

9. Do investment management companies adopt different internal assessment models depending on the type of investment management vehicle (e.g., MMFs, equity or bond funds, alternative or structured investment vehicles, etc.) they manage?

10. How do smaller investment managers use external credit ratings? What methods of credit assessment do small and medium managers use in addition to review of credit ratings?

11. Do you agree with some or all of the internal credit assessment procedures described above? Are there other procedures you use or would recommend?

12. To the extent that you have internalized your credit analysis, for what sort of instruments/issuers are you better able to perform it? If external credit ratings remain as a point of reference, how are these accounted for in the internal analysis and what is their relative value in determining and monitoring the creditworthiness of an instrument or issuer?

13. In periods of market stress, are credit ratings considered as one indicator of liquidity to be taken into account in the procedures of liquidity risk management, and if so how?

## Chapter 3 – Uses of external credit ratings by investment managers

### 3.1 Asset selection

The following sub-sections address concerns regarding the way investment managers use external credit ratings for asset selection, how credit ratings may influence the relative weight of certain securities in an investment portfolio and investment managers' access to the information underlying the credit ratings.

### 3.1.1 References to external ratings in fund disclosures

Despite the long standing efforts to reduce mechanistic reliance on CRAs ratings, external credit ratings continue to be used by investment managers to communicate the level of credit risk of a given portfolio and by investors when selecting the risk profile of a fund. It remains common practice to describe in a fund's disclosures the investment universe of a specific fixed income fund by referring to a minimum external credit rating that limits the securities in which the fund can invest.

Acknowledging that there is to date no fully satisfactory alternative to external credit ratings, IOSCO could encourage investment managers to review their disclosures and consider providing a description of the targeted level of credit risk that does not refer solely to external credit ratings. External credit ratings could remain as an illustration.

> ***Possible good practice***
>
> ***Regulators could encourage investment managers to review their disclosures describing alternative sources of credit information in addition to external credit ratings.***

### 3.1.2 References to external ratings in individual investment mandates

External ratings can be viewed as a "*common language*", used by the parties to an investment management agreement to better identify the desired level of credit risk underlying the portfolio.

It is worth noting that a manager's asset selection may often be conditioned by the internal risk guidelines imposed by the manager's investor. Such may be the case for instance if the investor imposes strict investment restrictions that are derived from regulatory requirements or the investor's internal rules. For instance, an investor that is a bank or an insurance company subject to the Basel framework or in Europe the Solvency regime may determine its investment universe based on the capital cost incurred for specific instruments. Apart from these international standards, some investors may still be subject to national laws and regulations that incorporate CRA ratings in prescribing investments for those entities. For instance, in some jurisdictions retirement plans may be required by law to define their investment universe according to CRA ratings.

In such circumstances, managers may establish privately managed accounts that are tailored to the specific profile and needs of the investor (e.g., a large pension or insurance fund). The investment manager would exercise its discretion within specific bounds by purchasing only those securities rated at or above a minimum external credit rating in conformity with the guidelines established by the investor. The following box illustrates this with examples of the sort of language that has been used by (i) a large pension fund, client to a large global manager, in an excerpt taken from the relevant investment guidelines; by (ii) and (iii) with excerpts taken from the investment guidelines relative to a managed account run by another large global manager in the interest of institutional clients; and by (iv) in a national self-regulatory organization (SRO) regulation concerning certain complementary pension schemes with regard to asset eligibility rules.

**Box I - Examples of references to external credit ratings in fund investment mandates or in national SRO standards**

According to (i), *"Fixed income securities shall not be rated less than Baa3 or its equivalent."* […] *"All securities must be rated by either Moody's or Standard & Poor's."*

According to (ii), *"Securities must be rated either by S&P or Moody's. […] Securities rated equal to or lower than BBB+/Baa1 must have no more than 50% of the Fund's total NAV. In case of a downgrade, the Investment Manager can hold securities rated equal to or lower than BB+/Ba1 but must be no more than 10% of the Fund's total NAV."*

According to (iii), the following table illustrates the relative weight of government and corporate bonds as a percentage of the account's portfolio relative to their long-term rating issued by S&P[16]:

| **Long-term grade at time of purchase** | Bonds issued (or guaranteed) by a sovereign with a minimum rating of A- | Other bonds (corporates) with a rating between AAA and AA- | Other bonds (corporates) with a rating between A+ and A- | Other bonds (corporates) with a rating of BBB+ or lower |
|---|---|---|---|---|
| **Max. portfolio weight per issuer** | 35% | 5% | 3% | 1% |

According to (iv) *"Bonds and other types of debt instruments comprising the minimum 60% quota of a portfolio must obtain an (external) rating above or equal to A- or equivalent (where no rating is available, the rating of the issuer may be referred to). Nevertheless, in the case of a managed account or of a dedicated investment fund mandate, securities rated below A- or above or equal BBB- are allowed to be invested in up to a limit of 5% of a portfolio on condition that those rated at least A- represent at least 60% of the portfolio."*

In this regard, a privately managed account can offer the investor a greater degree of flexibility in negotiating a mandate, including the desired minimum credit quality of the individual assets to constitute the portfolio.

The degree of CRA rating reliance largely depends on the sort of investment vehicle, on the investment purpose this serves, and on the degree to which the investment manager must observe minimum external credit ratings under private agreement with the investor. References to external credit ratings may trigger mechanistic reliance if embedded in trigger clauses;

[16] The mandate further admits that the comparable ratings of Moody's and Fitch are also taken into account and where "split ratings" occur, the lowest of among three CRAs shall be considered.

conversely, if used for reaching a consensus between client and agent for defining the investment criteria, these references may be less problematic.

As a general principle, for the purpose of reducing over-reliance on external credit ratings, regulators could encourage investment managers, as applicable, to include in investment mandate agreements references to alternative credit information sources[17]. For example, the external credit rating could be reviewed internally by the manager using an appropriate internal credit assessment procedure and the results of that procedure approved by a board of the management company.

***Possible good practice***

***Regulators could encourage investment managers– as represented collectively through trade associations and/or SROs – to include in their credit assessments alternative (internal) sources of credit information in addition to external credit ratings.***

### 3.1.3. Investment managers' access to underlying credit rating information

When referring to external credit ratings to guide asset selection, managers should be able to form an opinion on the methodologies that the chosen CRAs have used to determine their credit ratings. In this respect, an investment manager would benefit from an adequate level of disclosure, accompanied by inquiries, when appropriate, for the chosen CRAs about rating methodologies, credit outlooks, as well as broader market events or factors likely to affect the average credit quality of the invested portfolios. Such disclosures are also in line with IOSCO's planned revision of the 2008 *Code of Conduct Fundamentals for CRAs* concerning the important role that transparency can play by allowing investment managers to understand and compare the processes of various CRAs[18], to identify, where necessary, the limitations of the CRAs' methodologies, models and key parameters, as well as to develop their own internal credit assessments, which may incorporate data disclosed by CRAs[19].

***Possible good practice***

***Where external credit ratings are used, investment managers understand the methodologies, parameters and the basis on which the opinion of a CRA was produced, and have adequate means and expertise to identify the limitations of the methodology and assumptions used to form that opinion.***

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[17] IOSCO also could encourage investors (represented collectively by their trade associations and self-regulatory organizations - SROs), but recognizes that such investors may be outside of the scope of securities regulation.

[18] Please refer to the letter from IOSCO Board Chairman, Greg Medcraft, to the Finance Ministers and Central Bank Governors of the G20 of 15 April 2013; Available at: http://www.iosco.org/library/briefing_notes/pdf/IOSCOBN01-13.pdf

[19] In this regard, especially for certain types of structured products, investment managers could decide to exercise their own due diligence in conformity with the IOSCO 2009 *Good Practices*, which notes that a good practice for the investment manager is to understand the methodology, parameters and the basis on which the opinion of the third party (e.g., the CRA) was produced, and to have the adequate means and expertise to challenge that methodology and the parameters (notably, to identify their limits).

### 3.1.4 Investment managers' disclosures on uses of external credit ratings

The C5 2011-2012 mapping exercises have shown that requirements for investment managers to disclose their use of external credit ratings vary among jurisdictions, as well as across asset classes, or types of investment contract (e.g., discretionary investment contracts or not). In some jurisdictions, disclosures remain at the discretion of the manager or depend on the significance that external credit ratings may have in determining the risk profile of a fund portfolio[20].

In light of the above and given the importance of fostering greater transparency for investors, investment managers could be encouraged to make available their policies with regard to the use of external credit ratings, for example, in prospectuses and/or in the relevant sales documents. Information could contain some or all of the following elements, as appropriate:

- The sensitivity of the invested portfolio to changes in the assigned credit ratings, downgrades on the return/risk profile[21] and redemptions from the fund. Such description could include the likely effects resulting from changes in the external credit quality of collateral or of a counterparty, or where appropriate, of a guarantor or sponsor where this could have a material impact on the portfolio;
- A description (or reference to public availability) of the methodology underlying any CRA ratings on which the manager relies, with the main assumptions;
- Where the investment manager performs its own internal assessment, a general description of its methodology, including its underlying assumptions, including, if appropriate, the use of external credit ratings.

***Possible good practice***

***Regulators could encourage investment managers to disclose the use of external credit ratings and describe in an understandable way how these complement or are used with the manager's own internal credit assessment methods.***

### 3.1.5 Uses of external ratings to determine the quality of an asset's guarantor or of a fund's sponsor

Credit ratings also may be used to assess guarantors and other potential providers of credit support for certain assets. In the context of structured finance vehicles, external credit ratings may be considered where an evaluation of securities issued by the vehicle may include consideration of the credit quality of a guarantor or explicit support provider[22]. In case of MMFs,

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20 For instance, in one jurisdiction only if instruments subject to credit risk form a "*significant*" part of the portfolio, and where CRA ratings are given significant weighting by the manager in making credit assessments, would they be required to be disclosed. Furthermore, such disclosure is required only where investment is sought from investors who are neither professional nor sophisticated.

21 In this regard, please also refer to the IOSCO 2009 *Good Practices.*

22 For example, CRAs may consider the rating of the guarantor or support provider when rating securities issued by a structured finance vehicle. Please refer to Moody's Approach to Rating Asset-Backed Commercial Paper.
(available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_SF278537).

the financial strength of the sponsor may also be considered relevant to the decision to invest[23]. To the extent that the financial strength of a guarantor or support provider is a consideration in evaluating the creditworthiness of securities issued by a structured finance vehicle, asset managers should not rely exclusively on external credit ratings in assessing the creditworthiness of those entities.

**Questions for consultation**:

14. Could you describe your experience of instances where external credit ratings were mandated by investors? Is it possible to draw a relationship between an investor's specific profile and the investor's greater/lesser reliance on CRAs in a mandate's specifications? Please give examples.
15. In your experience, do prudential requirements impact demand for contractual reliance on external credit ratings?
16. What type of alternative credit information sources could be included in investment mandate agreements and fund investment objectives?
17. Please describe the process you use for identifying and comparing CRA methodologies.
18. If a fund manager relies on external credit ratings, is the information that the fund manager provides to you, as an investor, sufficient to allow you to understand the potential impact of a change in the external credit rating on the underlying portfolio of the fund? If not, what additional disclosures would be useful?
19. To what extent is the credit quality of a sponsor a relevant criterion in an investor's selection of a fund? Does it differ depending on the fund?
20. How important is the external credit rating of the sponsor of a structured finance vehicle if the vehicle does not have explicit support from its sponsor?
21. Following the downgrade of a guarantor, could you as an investment manager be

23 *See* Money Market Fund Reform; Investment Company Act Release No. 28807 (June 30, 2009) at n.54 and accompanying text (available at http://www.sec.gov/rules/proposed/2009/ic-28807.pdf). Certain CRAs consider the financial strength of the sponsor when rating a MMF. As reflected in their methodologies, in addition to other quantitative and qualitative factors, the sponsor of a MMF rated in the highest category generally has an investment grade rating. Please refer to Moody's *Moody's Revised Money Market Fund Rating Methodology and Symbols* of 10 March 2011, available at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_131303 (the expectation is that for MMFs rated in its top category, the sponsoring entity will be "*investment grade*" or of an equivalent profile); FitchRatings Global Money Market Fund Rating Criteria January 2014 (available at: https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=727497) (for a MMF rated in the top category, a fund sponsor typically would be rated (or deemed to be rated) investment grade). Qualitative considerations regarding sponsors of structured finance vehicles also may influence a CRA's rating, but not as strongly as other qualitative or quantitative inputs. For example, in one large CRA's rating methodology for asset-backed commercial paper ("ABCP"), the CRA notes that "the financial strength of the sponsor and the sponsor's commitment to the capital markets are important qualitative considerations."

forced to sell the securities issued by the structured finance vehicle? Please explain as to why or why not this may be the case.

## 3.2 Quality of counterparties and collateral

While in the context of asset selection, managers and investors tend to have reduced their reliance on external credit ratings both from the regulatory perspective and market practice; they still widely refer to them when it comes to determining the quality of collateral and counterparties, where references to external credit ratings remain both in private contracts and in prudential rules.

External credit ratings continue to be used in some jurisdictions' regulations and in private investment agreements to determine and monitor the credit quality of counterparty and collateral[24]. In practice, this may translate into a situation where an investment manager could close out one of its managed funds' positions, for instance with a derivative counterparty, from the moment the latter is affected by a credit rating downgrade. For example, a downgrade or the cancellation of the credit rating of the counterparty is included in the Additional Termination Event clause of the ISDA Master Agreement which outlines the standard terms applied to a derivatives transaction between two parties[25]. Under the clause, if a given institution's credit rating falls below a predetermined threshold or is withdrawn by one or more credit rating agencies, the counterparty has the right to close out all derivative contracts with this institution[26].

Moreover, external credit ratings may also be taken into consideration when it comes to determining the size of haircuts applicable to certain collateral. For instance, it is our understanding that the size of the haircuts applied by the European Central Bank (ECB) depends on the credit quality of the collateral as determined by external ratings[27].

With respect to regulatory requirements, the revision of asset eligibility rules in many jurisdictions has led to a reassessment of the use of ratings for collateral exchanged on the basis

24 According to the example cited above (see (iv) Box I), with regard to the credit quality of eligible counterparties to repo transactions, one relevant article of the relevant regulation provides that *"[…] Such (repo) transactions shall not be permitted with those entities, which in the quality of counterparties, do not possess a long-term (external) rating above or equal to A-"*. Another example can be found in the relative investment guidelines of a European UCITS fund whereby counterparties to swap derivative contracts must have a long-term rating above or equal to A-. The same applies for counterparties to repo or securities lending transactions.

25 The ISDA Master Agreement is the most commonly used agreement for OTC derivatives transactions. It is published by the International Swaps and Derivatives Association (ISDA), and is a document agreed between two parties that sets out standard terms that apply to all the transactions entered into between those parties.

26 On this, please refer to the article *Downgrade Termination Costs* of Fabio Mercurio, Roberto Caccia and Massimo Cutuli published in March 2012 in Risk.net magazine; available at http://www.risk.net/digital_assets/4143/risk_0312_mercurio2.pdf. In this article, the authors demonstrate that Ratings-based (RB) additional termination event (ATE) clauses in International Swaps and Derivatives Association agreements can have a significant impact on the valuation of derivatives portfolios when rating events occur.

27 See *The ECB Guidelines on Monetary Policy Instruments and Procedures of the Eurosystem*, September 2011, available at: https://www.ecb.europa.eu/ecb/legal/pdf/l_33120111214en000100951.pdf

of margining agreements in the context of derivative and securities financing transactions[28]. In addition, reforms are underway in some jurisdictions to introduce alternative criteria or methods[29] for managers to evaluate the quality of received/posted collateral away from external credit ratings. Such changes could mitigate the risk of pro-cyclical effects due to sudden credit downgrades of securities used to secure financial transactions[30].

When evaluating the quality of collateral, investment managers could consider whether the collateral fulfils some or all of the following tentative parameters, as appropriate[31]:

- Sufficiently liquid[32] (but at least as liquid as the eligible assets in case the counterparty does not honour its obligations and the collateral is enforced);
- Valued on a regular basis (e.g., valued on a daily basis and exhibiting a low price volatility);
- Issued by an entity unaffiliated with the counterparty and/or displaying a low correlation with it;
- Sufficiently diversified across issuers, markets, industries and/or regions;

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28 For instance, in Europe, Article 46 of EU Regulation No. 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) provides that a CCP shall accept highly liquid collateral with minimal credit and market risk to cover its initial and ongoing exposure to its clearing members. For financial instruments, the Delegated Regulation No 153/2013 expressly states in its Annexes I and II that when performing their internal assessments, CCPs shall employ a defined and objective methodology that shall not fully rely on external opinions (for further details, see Annex 1 of Regulation 153/2013).Available at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0041:0074:EN:PDF

29 For instance, in the U.S., recent regulatory amendments eliminated the requirement that if the CIS is looking to the issuer of securities collateralizing a repurchase agreement to satisfy certain requirements under the Investment Company Act of 1940, collateral other than cash or government securities must be rated in the highest category by the certain CRAs or be of comparable quality. Instead the amended rule requires that collateral other than cash or government securities must consist of securities that the fund's board of directors (or its delegate) determines are: (i) issued by an issuer that has an exceptionally strong capacity to meet its financial obligations; and (ii) sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days.

30 According to a comparative study authored by the European Central Bank (ECB), minimum credit ratings may be an *additional* requirement in establishing the quality of collateral under the framework of central banks and of CCPs. As an example, under the Eurosystem, collateral quality is independently assessed on the basis of the minimum probability of default (PD) calculation (required under the Basel rules for measuring regulatory capital), which is then compared with the ratings of an external CRA. The Eurosystem also allows the use of alternative credit assessment systems, such as in-house central bank credit assessment systems, counterparties' internal rating-based systems or third-party providers' rating tools. Other central banks typically require more than one rating from the external CRAs. For further information, please refer to the ECB study *Collateral Eligibility Requirements: A Comparative Study Across Specific Frameworks* published in July 2013; available at: http://www.ecb.europa.eu/pub/pdf/other/collateralframeworksen.pdf

31 In this sense, as an example, please also refer to the ESMA *Guidelines on ETFs and other UCITS* issued in December 2012; available at: http://www.esma.europa.eu/system/files/2012-832en_guidelines_on_etfs_and_other_ucits_issues.pdf

32 Liquidity is a function of several factors that those managing collateral would need to consider. In general, factors that may typically affect the liquidity, and hence the valuation, of collateral are demand pressures, inventory, availability of transparent pricing, etc.

- Governed by a clear legal regime allowing it to be enforced immediately (i.e. without the prior approval of the counterparty) and within well-defined limits for its potential re-investment;
- Subject to stress-testing to assess the liquidity risk where received collateral represents more than a minimum portion of a fund's net asset value (NAV);
- Application of a clear haircut policy across varying asset classes;
- In the case of MMFs, maximum weighted average maturity (WAM) and weighted average life (WAL) of the securities to be received.

***Possible good practice***

***Regulators could encourage investment managers, when assessing the credit quality of their counterparties collateral, not to rely solely on external credit ratings and to consider alternative quality parameters (e.g., liquidity, maturity, etc.)***

**Questions for consultation:**

22. How important to fund managers is the external credit rating in the choice of a fund's counterparty(ies)? What are the key factors usually taken into account when negotiating an agreement with one or more?
23. Following the credit rating downgrade of a key counterparty, depending on the contents of the relevant agreement, could you as an investment manager be forced to close out your respective positions? Please explain as to why or why not this may be the case.
24. How does an investment management company's size and resources relate to the investment manager's ability to perform an internal credit analysis of one or more counterparties?
25. Are there some strong references to external credit ratings which are channeled through the ECB guidelines, ISDA Master Agreements or CCPs guidelines?
26. Would you agree with some or all of the above parameters as valuable additional factors for the internal assessment of collateral quality?
27. Among the above parameters, which one(s) could be considered by counterparties to replace / supplement external credit ratings when evaluating the quality of collateral?
28. Are there other parameters that could be considered to facilitate the credit assessment of collateral received and/or posted by the investment manager, independently from external credit ratings?

## 3.3 Investment managers soliciting fund ratings

As discussed in the scope section, unlike external credit ratings of individual financial instruments and of their issuers, fund credit ratings are generally not used in rules and regulations. For certain types of investment portfolios (e.g., MMFs, bond funds, etc.), investment managers may use fund ratings to publicize the average credit quality of the portfolio components, and fund credit ratings may be used by investors to compare two or more separate portfolios. Investment managers are, in some cases, incentivized to request the credit rating of one or more of the funds they manage to meet investors' demands.

In this respect, European MMFs are an interesting example. Stakeholders have explained the development of MMF credit ratings in Europe by the added value provided to investors in the absence of a defined common regulatory framework[33]. Prior to the introduction of ESMA's guidelines on MMFs in 2010, there was no common definition of an MMF in Europe. Investors therefore used CRA credit ratings to ensure that a fund met minimum standards in terms of credit quality and liquidity and was subject to appropriate oversight. The Guidelines, by setting a common framework, appear to have contributed to reducing investor reliance on external ratings. These stakeholders have also pointed to a number of risks that could stem from the use of MMF credit ratings, particularly in an environment where the number of financial institutions with a sufficiently high credit rating has become more limited.

In this context, the likelihood of an MMF's downgrade and the pressure to maintain the credit rating have increased. The general approach of CRAs in rating MMFs is to focus primarily on the basis of preservation of capital and providing liquidity to shareholders[34]. The high credit quality of the underlying assets – with the resulting highest awarded credit rating by a CRA – are therefore essential requirements for these funds to be marketed in view of the above objectives. Thus, if individual securities are downgraded, or even placed under negative review, an MMF could have a strong incentive to sell those securities in order to keep its portfolio in line with the criteria set by the CRA notwithstanding the manager's own credit assessment of the underlying's credit quality[35].

Further, in some cases, investors may use the external credit rating as a proxy for the resilience of the fund rather than conducting their own due diligence. These investors may therefore have a strong incentive to redeem an MMF's shares if the MMF is downgraded or put on negative watch[36] As boards of institutional investors and corporate treasurers often require an MMF to

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33 Please refer to the comment letters from HSBC and IMMFA sent to the European Commission in the context of a consultation on the UCITS directive; available at: http://ec.europa.eu/internal_market/consultations/2012/ucits/registered-organisations/hsbc-global-asset-management_en.pdf , and: http://ec.europa.eu/internal_market/consultations/2012/ucits/registered-organisations/institutional-money-market-fund-association_en.pdf.

34 As an example, please refer to Moody's *Moody's Revised Money Market Fund Rating Methodology and Symbols* of March 2011, https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_131303.

35 In the U.S., the incentive to sell securities as a result of a credit ratings downgrade may not be a consequence of the impact on the fund's rating. Rule 2a-7 under the Investment Company Act governs the operations of U.S. MMFs. The rule requires an MMF's board of directors promptly to reassess whether a security that has been downgraded by a CRA continues to present minimal credit risks and take such action as the board determines is in the best interests of the fund and its shareholders.

36 See Fitch puts *Matrix-owned funds on review due to firm's financial resources,* published in *MoneyMarketing* on 12 December 2011; available at: http://www.moneymarketing.co.uk/fitch-puts-matrix-owned-funds-on-review-due-to-firms-financial-resources/1043059.article (including the following

have the highest possible credit rating for them to invest, MMFs are often either rated "AAA" or not rated, which may create a risk of sudden redemptions in a rated MMF if it no longer meets the requirements for the CRA credit rating. However, investor appetite for credit ratings of MMFs may be reduced with the strengthening of regulatory frameworks applicable to MMFs[37].

A CRA rating a global bond fund attaches significant weight to the average credit quality of the underlying portfolio, its sensitivity to market risk factors, such as duration, spread risk, currency fluctuations, etc., as well as to it past performance relative to a benchmark[38]. At this stage, it is C5's understanding that investors do not rely on credit ratings of different types of fund portfolios to the same extent. Specifically, between two types of fixed income portfolios, where one is labeled "*high yield*" (or "*speculative grade*") and the other "*investment grade*", end-investors would rely more heavily on the credit quality of underlying assets of the investment grade fund as assessed by CRAs. The reliance would be less true for a high yield portfolio where investors willingly take on greater risks and rely more heavily on a manager's individual skill.

IOSCO is seeking feedback from representatives of the investment management industry, as well as investors, to better understand fund rating implications.

**Questions for consultation**:

29. Why do investment managers seek to have their funds rated?
30. What is the trend regarding fund credit ratings? Are investment managers seeking fund credit ratings more often or less frequently?
31. Do investors use ratings differently in evaluating MMFs, investment grade bond funds and high yield bond funds?
32. To what extent, if any, do CRAs provide credit ratings for funds for which they also rate all or part of the portfolio?
33. In situations where the same CRA rates both the fund and its portfolio, if the CRA

statement from Fitch: "The sponsor's financial resources are no longer consistent with a 'AAAmmf' rating, even after taking into consideration the funds' conservative investment guidelines.").

37 The European Commission published in September 2013 a draft Regulation on Money Market Funds where it proposes to prevent an MMF from soliciting or financing an external credit rating "*to ensure that fund managers and investors stop relying on external credit ratings that could be detrimental to the functioning of the money market when downgrades occur*". For further details, please see: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013PC0615&from=EN

38 As an example, please refer to Fitch's *Global Bond Fund Rating Criteria* of August 2013, available at https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=715678. Unlike bond funds, equity funds – defined as those that invest either wholly or predominantly in common stock – that are rated are generally assessed on the basis of their relative performance over a specific period and on the quality of the manager, reflected in its financial profile, its client servicing ability, its investment infrastructure, etc. However, the present report only looks at fund rating to the extent that it reflects the creditworthiness of the underlying portfolio and could potentially create an undue reliance on CRA. As an example, please refer to Moody's *Methodology for Assessing the Investment Quality of Equity Funds* of February 2012, available upon request.

downgrades or puts under negative watch an underlying security, will the fund be more prone to sell this security in order to maintain its highest rating?

34. In the case of fund of fund structures, please describe how external credit ratings of funds are used and how these are taken into account by the investment manager. Please provide examples.
35. In the case of index funds, do you consider that changes to the external credit rating of individual index components may be relevant under certain circumstances in deciding whether the index may continue to be tracked by a fund?

## 3.4 Managing external credit rating changes

Notwithstanding an investment manager's (or even investor's) recourse to its own internal analysis on the creditworthiness of an instrument and/or its issuer, it is acknowledged that external credit ratings represent an important and objective benchmark for many market participants, particularly for those with fewer resources to devote to the development of internal credit rating scales or models. In this regard, the potential cliff effects that can result from a credit ratings downgrade may be of particular concern to regulators[39].

Where they rely more heavily on external credit ratings, investment managers should have appropriate internal procedures when a security is subject to an external credit rating downgrade. These procedures may include specific "*grace periods*" that allow them to delay divesting the related securities if it would be in the best interests of their investors. In other cases, investment managers may keep the security in the portfolio or decide not to acquire more of the asset. The questions below are designed to elicit more information regarding investment managers' (and where relevant, investors') reactions to external credit rating downgrades.

***Possible good practice***

***Where an investment manager (or CIS board, as appropriate) explicitly relies on external credit ratings among others to assess the creditworthiness of specific assets, a downgrade does not automatically trigger their immediate sale. Where the manager/board conducts its own credit assessment, a downgrade may trigger a review of the appropriateness of its internal assessment. In both cases, should the manager/board decide to divest, the transaction is conducted within a timeframe that is in the best interests of the investors.***

**Questions for consultation**:

36. How do fund investors generally react to a downgrade of a particular asset, or of a significant part of a portfolio?
37. Please elaborate on internal procedures that investment managers have implemented following a downgrade, when for instance managers may need to ensure that the credit quality of the portfolio is still sufficient to meet the stated fund standards or

39 In this regard, please refer to footnote n°10.

managers have set up a grace period before selling the downgraded securities. Are there differences in procedures depending on the type of fund?

38. Do investment managers' policies or investors' investment guidelines provide for specific "*grace periods*" that allow a manager time to address the situation that results from a downgrade? If so, what is the average "grace period" and how are investors informed of the manager's plans to restore a portfolio's desired credit quality?

39. As a follow-up to the question above, would investment managers behave differently in the event of a collateral downgrade, or of a downgrade affecting one main fund counterparty or an asset's guarantor (or sponsor)? Please explain, possibly with reference to some examples.

40. In the case of a fund's performance being benchmarked to a specific index, how does the fund manager react when a downgrade leads to an asset / issuer being removed from the index?

## Appendix A – List of Possible Good Practices

Investment managers make their own determinations as to the credit quality of a financial instrument before investing and throughout the holding period.

External credit ratings may form one element, among others, of the internal assessment process but do not constitute the sole factor supporting the credit analysis.

An internal assessment process that is commensurate with the type and proportion of debt instruments the investment manager may invest in, and a brief summary description of which is made available to investors, as appropriate.

An internal assessment process that is regularly updated and applied consistently.

Regulators could encourage investment managers to review their disclosures describing alternative sources of credit information in addition to external credit ratings

Regulators could encourage investment managers– as represented collectively through trade associations and/or SROs – to include in their credit assessments alternative (internal) sources of credit information in addition to external credit ratings.

Where external credit ratings are used, investment managers understand the methodologies, parameters and the basis on which the opinion of a CRA was produced, and have adequate means and expertise to identify the limitations of the methodology and assumptions used to form that opinion.

Regulators could encourage investment managers to disclose the use of external credit ratings and describe in an understandable way how these complement or are used with the manager's own internal credit assessment methods.

Regulators could encourage investment managers, when assessing the credit quality of their counterparties or collateral not to rely solely on external credit ratings and to consider alternative quality parameters (e.g., liquidity, maturity, etc.)

Where an investment manager (or CIS board, as appropriate) explicitly relies on external credit ratings among others to assess the credit worthiness of specific assets, a downgrade does not automatically trigger their immediate sale. Where the manager/board conducts its own credit assessment, a downgrade may trigger a review of the appropriateness of its internal assessment. In both cases, should the manager/board decide to divest, the transaction is conducted within a timeframe that is in the best interests of the investors.

## Appendix B – List of Questions for consultation

1. Do you agree with the above categorization of uses by investment managers of external credit ratings? Are there other ways in which investment managers use external credit ratings? Can you point to situations where you would consider there is no alternative to credit ratings?
2. What benefits do you as an investment manager see in the use of external credit ratings? How does your particular size, resources, capabilities, etc. affect the benefits you perceive?
3. How do investment managers adjust their internal portfolio risk models (e.g. diversification parameters, liquidity profile, VaR, etc.) to account for external credit rating changes to their portfolio securities? Among other risk factors (e.g. currency and interest rate changes), how relevant are external ratings in determining the ultimate risk level of a specific portfolio? Where possible, please suggest some examples as to why credit rating changes to the underlying securities may or may not be relevant.
4. As investors, depending on the type of investment vehicle and on your own capacity to carry out your own internal credit analysis, to what extent is the credit rating of a fund's portfolio holdings or of the fund itself, a determining factor in making your investment decision? Do you require the investment manager to reference one or more CRA ratings? If yes, is this your own choice or is it required by your specific institution?
5. Before investing, do you as an investor verify that an investment manager has procedures in place to perform its own credit analysis? Please elaborate on whether the approaches differ depending on the type of investment vehicle (e.g., a money market fund ("MMF") vis-à-vis a high yield bond fund).
6. Do you as an investor have the capabilities to monitor the credit quality of portfolio securities and/or follow-up on changes to external ratings that affect the portfolio securities or the fund in which you are invested? Could you briefly describe your procedures? 7
7. Is the above description of the two models of internal analysis of credit quality within investment management firms accurate? 8.
8. What factors would be effective in mitigating the conflict described in letter a)?
9. Do investment management companies adopt different internal assessment models depending on the type of investment management vehicle (e.g. MMFs, equity or bond funds, alternative or structured investment vehicles, etc.) they manage?
10. How do smaller investment managers use external credit ratings? What methods of credit assessment do small and medium managers use in addition to review of credit ratings?
11. Do you agree with some or all of the internal credit assessment procedures described above? Are there other procedures you use or would recommend?
12. To the extent that you have internalized your credit analysis, for what sort of

instruments/issuers are you better able to perform it? If external credit ratings remain as a point of reference, how are these accounted for in the internal analysis and what is their relative value in determining and monitoring the creditworthiness of an instrument or issuer?

13. In periods of market stress, are external credit ratings considered as one indicator of liquidity to be taken into account in the procedures of liquidity risk management and if so how?
14. Could you describe your experience of instances where external credit ratings were mandated by investors? Is it possible to draw a relationship between an investor's specific profile and the investor's greater/lesser reliance on CRAs credit ratings in a mandate's specifications? Please give examples.
15. In your experience, do prudential requirements impact demand for contractual reliance on external credit ratings?
16. What type of alternative credit information sources could be included in investment mandate agreements and fund investment objectives?
17. Please describe the process you use for identifying and comparing CRA methodologies.
18. If a fund manager relies on external credit ratings, is the information that the fund manager provides to you, as an investor, sufficient to allow you to understand the potential impact of a change in the external credit rating on the underlying portfolio of the fund? If not, what additional disclosures would be useful?
19. To what extent is the credit quality of a sponsor a relevant criterion in an investor's selection of a fund? Does it differ depending on the fund?
20. How important is the credit rating of the sponsor of a structured finance vehicle if the vehicle does not have explicit support from its sponsor?
21. Following the credit rating downgrade of a guarantor, could you as an investment manager be forced to sell the securities issued by the structured finance vehicle? Please explain as to why or why not this may be the case.
22. How important to fund managers is the external credit rating in the choice of a fund's counterparty(ies)? What are the key factors usually taken into account when negotiating an agreement with one or more?
23. Following the downgrade of a key counterparty, depending on the contents of the relevant agreement, could you as an investment manager be forced to close out your respective positions? Please explain as to why or why not this may be the case.
24. How does an investment management company's size and resources relate to the investment manager's ability to perform an internal credit analysis of one or more counterparties?
25. Are there some strong references to external credit ratings which are channeled through the ECB guidelines, ISDA Master Agreements or CCPs guidelines?
26. Would you agree with some or all of the above parameters as valuable additional factors

for the internal assessment of collateral quality?

27. Among the above parameters, which one(s) could be considered by counterparties to replace / supplement external credit ratings when evaluating the quality of collateral?

28. Are there other parameters that could be considered to facilitate the credit assessment of collateral received and/or posted by the investment manager, independently from external credit ratings?

29. Why do investment managers seek to have their funds rated?

30. What is the trend regarding fund credit ratings? Are investment managers seeking fund credit ratings more often or less frequently?

31. Do investors use ratings differently in evaluating MMFs, investment grade bond funds and high yield bond funds?

32. To what extent, if any, do CRAs provide credit ratings for funds for which they also rate all or part of the portfolio?

33. In situations where the same CRA rates both the fund and its portfolio, if the CRA downgrades or puts under negative watch an underlying security, will the fund be more prone to sell this security in order to maintain its highest rating?

34. In the case of fund of fund structures, please describe how external credit ratings of funds are used and how these are taken into account by the investment manager. Please provide examples.

35. In the case of index funds, do you consider that changes to the external credit rating of individual index components may be relevant under certain circumstances in deciding whether the index may continue to be tracked by a fund?

36. How do fund investors generally react to a downgrade of a particular asset, or of a significant part of a portfolio?

37. Please elaborate on internal procedures that investment managers have implemented following a downgrade, when for instance managers may need to ensure that the credit quality of the portfolio is still sufficient to meet the stated fund standards or managers have set up a grace period before selling the downgraded securities. Are there differences in procedures depending on the type of fund?

38. Do investment managers' policies or investors' investment guidelines provide for specific "*grace periods*" that allow a manager time to address the situation that results from a downgrade? If so, what is the average "grace period" and how are investors informed of the manager's plans to restore a portfolio's desired credit quality?

39. As a follow-up to the question above, would investment managers behave differently in the event of a collateral downgrade, or of a downgrade affecting one main fund counterparty or an asset's guarantor (or sponsor)? Please explain, possibly with reference to some examples.

40. In the case of a fund's performance being benchmarked to a specific index, how does the fund manager react when a downgrade leads to an asset / issuer being removed from the

index?