.BVI

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BVI position on IOSCO's Consultation Report on Good Practices on Reducing Reliance on CRAs in asset management
Reference: CR04/14

BVI[1] after having participated in the IOSCO hearing on the subject on 21 May 2014 in Washington D.C., gladly takes the opportunity to present its views on the proposed good practices on reducing reliance on credit rating agencies (CRAs) in asset management.

Key issues

Before turning to detailed remarks on the questions for consultation, we would like to draw IOSCO's attention to our key issues and concerns.

Most BVI members are asset managers providing management services to regulated and supervised collective investment undertakings such as UCITS or AIF under the European UCITS Directive 2009/65/EC or the AIFM Directive 2011/61/EU. Therefore, our answers are from the viewpoint of investment managers. With regard to the questions from the investor's perspective, we can only share our general knowledge gained from the collaboration with investors.

First of all, IOSCO's principles should be in line with existing law at the European Union level which is already addressing the issues in sufficient detail and quality. It is important to state that under the Regulation (EU) No 462/2013 of 21 May 2013 amending Regulation (EC) No 1060/2009 (the so called "CRA III Directive") a legal system which is designed to avoid over-reliance on credit ratings by financial institutions (such as investment management companies) is already in place. According to Article 5a of the CRA III Directive, investment management companies shall make their own credit risk assessment and shall not solely or mechanistically rely on credit ratings for assessing the creditworthiness of an entity or financial instrument. Moreover, based on the new CRA III Directive and as an addition to Article 5a an explicit prohibition of mechanistic reliance on ratings is introduced under the Directive 2013/14/EU of 21 May 2013 amending the UCITS Directive and the AIFM Directive in respect of over-reliance on credit ratings. The implementation of these rules into the German Investment Act will be introduced in 2014. More precisely, the new section states that a management company shall not solely or mechanistically rely on credit ratings issued by credit rating agencies as defined in Article 3(1)(b) of the CRA Regulation (EC) No 1060/2009. The general principle against over-reliance on credit ratings should therefore be integrated into the risk-management processes and systems of management and investment companies with regard to UCITS and managers of AIF, and adapted to their specificities. The new law furthermore requests that the national competent authority monitors the adequacy of the credit assessment processes of the investment management companies and assess the use of references to credit ratings taking into account the nature, scale and complexity of the funds' activities

[1] BVI represents the interests of the German investment fund and asset management industry. Its 82 members handle assets of more than EUR 2.2 trillion in both investment funds and mandates. BVI enforces improvements for fund-investors and promotes equal treatment for all investors in the financial markets. BVI`s investor education programmes support students and citizens to improve their financial knowledge. BVI`s members directly and indirectly manage the capital of 50 million private clients in 21 million households.
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and, where appropriate, encourage mitigation of the impact of such references, with a view to reducing sole and mechanistic reliance on such credit ratings.

In line with the EU-Directive 2013/14/EU, it is important to clarify that the individual assessment of creditworthiness of financial instruments or entities is part of the overall risk-management process of the investment management company and serves as a principle against over-reliance on credit ratings. This process involves, in the light of the principle of proportionality, the assessment of any risk of each relevant assets invested by the investment funds (including the creditworthiness) and the establishment of an internal risk limit system for any relevant risk (including credit risk) on asset and fund level. The basis of the investment decision process is the risk limit system specified by the independent risk management function in accordance with the overall risk assessment. Therefore, investment decisions made by persons performing portfolio management do not solely or mechanistically rely on credit ratings issued by credit rating agencies (please see for more detail our answer to question 7).

Our members assume that formulaic reliance on external CRAs in fund rules or other investor mandates may be dropped whenever the relevant legislator or national competent authorities deletes applicable references to ratings (in the EU e.g. rating requirements under the CRD IV regime, Solvency II regime, ESMA guidelines on money market funds). Therefore, the responsible legislators and national authorities around the globe should be explicitly required to review and remove, where appropriate, all such references to credit ratings in legal acts or existing guidelines and recommendations.

Investors' expectations regarding investment process on fund level will not change as long as legal requirements linking investment restrictions with ratings apply. Additional disclosure regime for the benefit of the investor will not reverse this situation. Therefore, a general good practice to disclose credit information used by the investment management companies or internal policies is too far reaching and unfeasible.

Moreover, we request IOSCO to avoid implementing excessive requirements regarding the internal credit assessment process. The internal credit assessment should be in line with the nature, scale and complexity of the investment management companies' activities (especially the type of asset category rated by CRAs or the proportion of rated assets invested by the investment fund). In particular, IOSCO's principles should be set in a manner that no further expense or costs for rating data are incurred (such as guidance for the application of special methods to assess the creditworthiness or costs for the monitoring process to identify downgrades by any CRA). It should be the decision of the investment management company, which method, rating or CRA is relevant for the internal credit assessment.

Specific comments

With regard to the questions for consultation raised by IOSCO, we would like to remark the following:

Chapter 1 – Scope

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?

Yes, we agree. Our members refer to external credit ratings to the following business processes:

- Definition of fixed income asset categories in which they invest
- Implementing the investment process on the basis of the risk limits specified by risk management function
- Management, limitation and monitoring of issuer risks, counterparty risk or investment limits
- Measurement and limitation of relevant risks,
- Reporting as a result of supervision requirements (e.g. reporting about fund's investments vis-à-vis certain investors group such as banks or insurance undertakings)

We recognize that there are some situations where there is no alternative to external credit ratings. It may be possible that investment management companies introduce themselves references/eligibility criteria based on CRA ratings into the fund rules. The reason for this is that in such cases usually the supervisory authority requires that certain are not eligible if it is not rated in investment grade range by a minimum number of external CRAs. This is the case with EU based money market funds. Moreover, depending on such supervisory criteria applying to institutional investors in funds, investment management companies may restrict itself voluntarily in the fund rules in order to allow such professional investors to invest in such fund.

However, in case an investment management company has introduced references/eligibility criteria based on CRA ratings into the fund rules, the German supervisory authority (BaFin) reviews these fund rules and among other things checks the adequacy of these criteria in order to approve the fund rules. This follows from the requirement expressed in the CRA III Directive.

In case of an inadequate usage of CRA ratings, the German authority requests the investment management company to correct the fund rules within a certain period of time. If the investment management company does not carry out the changes, the German authority shall have power to issue all orders in the course of supervision which are necessary and appropriate to keep the business operations of an investment management company in accordance with the German Investment Act, the regulations issued on the basis of this Act and the fund rules or the articles of association. Furthermore and if necessary, the German authority may use administrative fines, revoke the license of the fund manager or instead of a revocation of the license, may demand the dismissal of the responsible managing directors and prohibit them from exercising their activities. However, we are not aware of any cases in which the authority had to made use of these powers.

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?

We share IOSCO's view that, in general, external credit ratings are useful and reliable quantitative and qualitative indicators to assess the probability of default or expected loss of a rated investment. The benefit lies in independence and neutrality of the CRAs and in transparency of methodology and process. Investment management companies have the option to use external ratings in many ways (as stated previously under Question 1) to support their own credit research process and communication of product characteristics with respect to credit quality. The external rating can also be an indicator for the liquidity of a security, as e.g. investment grade issuers can be purchased by a larger amount of market participants.

We cannot give a general statement, how size, resources, capabilities, etc. of an investment management company could affect the benefits of the use of external credit ratings. This will depend on many factors (such as the purposes for which it will be used, investment strategy, risk allocation, cost-

benefit ratio). However, the new requirements on the European level request that the competent authority assess the use of references to external credit ratings taking into account the nature, scale and complexity of the investment management companies' activities and, where appropriate, encourage mitigation of the impact of such references, with a view to reducing sole and mechanistic reliance on such credit ratings. In our view, this is an appropriate approach to supervise the use of references to external credit ratings.

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.

We refer to our answer to Question 7 and the legal requirements to implement a risk management process under the UCITS and AIFM Directive and the amending under the Directive 2013/14/EU.

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?

We cannot give IOSCO an answer from the investor's perspective. However, in practice, there are no credit ratings of the fund itself in Germany. Credit ratings on Funds are obtained usually only on money market funds established in markets such as Irland, Luxembourg, and the US.

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).

Not applicable.

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?

From the (German insurance company) investor's point of view, when investing in investment funds, already at present the insurance undertakings must demonstrate to the supervisory authority in the course of their reporting that the general investment rules have been complied with. Moreover, in Germany, insurance undertakings are obliged to ensure that the requirements regarding the use of ratings and own credit assessment are fully kept by the investment fund manager (e. g. with a written confirmation by the investment management company that the investment management company is in line with the applicable requirements in the asset management area). This approach already gives adequate consideration that only investment management companies which manage investment funds under the UCITS or AIFM regime may make investment decisions independently and in the best interest of the funds they manage or the investors of the funds they manage. Investors of investment

funds do not have the opportunity to make investment decisions regarding the investment fund's assets.

Chapter 2 – Internal credit assessment

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

We strongly disagree with the described two internal models for assessing creditworthiness, especially with the proposed approach that, as a general rule, managers should disclose to their investors the internal model used.

It should be clarified that internal analysis of credit quality is part of the risk-management process. The assessment of creditworthiness of a financial instrument or entity is designed to identify risks involved in the investments made by investment funds. According the EU-law[2], **the general principle against over-reliance on credit ratings should therefore be integrated into the risk-management processes and systems of investment management companies with regard to UCITS, and AIFMs, and adapted to their specificities.**

The risk management function is considered as functionally and hierarchically separated from the operating units, including the portfolio management function. The portfolio management may only make investment decisions within limits specified by the risk management function or within internal and legal investment limits (such as defined by fund rules). The measurement and monitoring of the risk limit system is a legal task of the risk management function. Therefore, the risk management process runs in parallel with the investment decision process, which implies that the risk management function and persons performs portfolio management have to communicate with each other.

In practice, the risk management function is obliged to establish and implement quantitative or qualitative risk limits, or both, for each investment fund managed by the investment management company, taking into account all relevant risks. These involve in particular credit risks. Moreover, investment management companies may only deal with counterparties for which a counterparty limit system is in place (including in relation to the creditworthiness of the contracting party and the group membership). All transactions with a counterparty count in their full amount towards the (credit risk) limit on fund level or company level. Moreover, investment management companies are obliged to define limits for cash positions at banks in view of their creditworthiness and group membership.

The functionary separation of risk assessment (including the assessment of the creditworthiness of financial instruments or entities) as a task of the risk management function and the investment decision process as a task of portfolio management is designed to exclude such potential conflict of interest as described by IOSCO under the model a). In light of the foregoing, it is important to state that the internal assessment of creditworthiness is part of the risk management process.

Furthermore the custodian bank required under the UCITS directive shall ensure that the investment limits applicable to the relevant fund according to law and the fund rules are complied with. Moreover,

[2] Directive 2013/14/EU of the European Parliament and of the Council of 21 May 2013 amending Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of over-reliance on credit ratings.

investment management companies are obliged to ensure a high standard of diligence in the selection and monitoring of investments. They may only make decisions, if they have appropriate professional expertise and knowledge of the assets in which investment funds are invested. In order to ensure that investment decisions are carried out in compliance with the investment strategy and risk limits of the investment fund's managed, investment management companies have to establish and implement written policies and procedures on due diligence.

Finally, on the basis of the above, it is not necessary that investment management companies should disclose to their investors the internal model used, since they are obliged to disclose the principles of their internal risk management process.

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

See our answer to question 7. According to the implemented approach under the AIFM and UCITS Directive, any conflict of interests is excluded. Otherwise, investment management companies are obliged to establish safeguards against conflicts of interests which shall ensure that the risk management function is subject to an appropriate independent review to ensure that decisions are being arrived at independently, the risk management function is represented in the governing body or the supervisory function, where it has been established, at least with the same authority as the portfolio management function or any conflicting duties are properly segregated.[3]

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?

In principle and regardless of the type of the asset, the internal assessment process of the creditworthiness of assets invested by investment funds is equal in each investment management company because this assessment is part of the risk management process (see our answer to question 7). This process is limited to eligible assets under the UCITS or AIFM regime such as ratings on the issuer level or asset level in fields of bonds issued by the government or other public borrowers, corporate bonds, bank bonds (including debentures) or structured financing.

However, differences can arise of the differing requirements under EU or national law. For example, managers of money market funds are obliged to ensure that the management company performs its own documented assessment of the credit quality of money market instruments that allows it to consider a money market instrument as high quality.[4] Where one or more CRAs have provided a rating of the instrument, the management company's internal assessment should have regard to, inter alia, those credit ratings. While there should be no mechanistic reliance on such external ratings, a downgrade below the two highest short-term credit ratings by any CRA that has rated the instrument should lead the manager to undertake a new assessment of the credit quality of the money market instrument to ensure it continues to be of high quality. This means, that in any case of downgrade the investment management company is however obliged to consider an external rating by *any* CRA, resulting in further costs for these rating data. We request IOSCO to clarify that such requirements are too far reaching.

[3] Cf. Article 43 of the Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.
[4] Cf. ESMA's Opinion, 22 August 2014, Ref.: ESMA/2014/1103.

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?

As described under Question 2, regulation of the use of references to external credit ratings should take into account the nature, scale and complexity of the investment management companies' activities and, where appropriate, encourage mitigation of the impact of such references, with a view to reducing sole and mechanistic reliance on such credit ratings.

As far as an individual assessment of the creditworthiness of a rated asset or entity is not necessary (e.g. in cases there the investment fund is invested in rated assets with impeccable credit ratings in an insignificant manner), investment management companies evaluate external ratings by a comparison of the base of economic or business indicators or market data (e.g. comparison between current market price and the next available market price resulting from interest rate and spread volatilities).

Another method is that investment management companies do not only rely to an external rating, but they consider, where available, in an internal assessment several external ratings. Moreover, they evaluate the rating of an asset by a comparison of the rating report disclosed by the CRA.

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?

No. We disagree with all proposed credit assessment procedures described on page 11 of the consultation paper. In detail:

- In our view, the proposed procedure to perform the assessment on the basis of an *internal assessment scale* and through the application of a rigorous methodology validated by the management board (described under the first bullet point) is too far reaching. We request IOSCO to clarifying that it should be the decision of the investment management company which method is relevant for the internal credit assessment. An internal assessment scale should not be the benchmark for the internal credit assessment and could only be one element of an internal credit assessment. A money fund manager for example, may not even have a proper scale in place as a potential investment is either deemed “eligible” or “not eligible”. A relative value consideration / scale may not appropriate with money market funds which aim to avoid all credit risk. As described above, the internal credit assessment is part of the risk management processes with different criteria required by law. In particular, the sole responsibility for the assessment of (credit) risks, the development and maintenance of the methods and procedures necessary for this purpose lies with the investment management company.

- Any reference to recommendations by an advisor should be deleted. Investment advice is an investment service which is subject to authorization and which is performed independent of the activities of the investment management company. Any asset recommended by an advisor still has to enter into the internal credit assessment process of the fund because the decision about whether to invest or not remains with the investment management company'.

- We disagree with the proposed procedure to make available to investors a (separate) brief summary description of these internal assessment procedures focusing on salient information beyond the extent to which such a description is already required in the fund prospectus. This proposal goes beyond the applicable statutory requirements under the CRA III Directive and the Directive 2013/14/EU. As described above (please see our answer to Question 7), investment

management companies are obliged to disclose the principles of their internal risk management process which involves a credit assessment process. Moreover, the competent authority is obliged to monitor the adequacy of the credit assessment processes of the investment management companies and to assess the use of references to credit ratings. These are adequate measures to protect investor's interests.

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?

Please refer to our answer to Question 10.

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?

Credit ratings could be an indicator for the liquidity of a security, as e.g. Investment grade issuers can be purchased by a larger amount of market participants.

However, an appropriate liquidity risk management process for the investment funds (including stress tests) is already in place. It should be suitable for recording, measuring, overseeing and managing liquidity risks in accordance with the requirements under the AIFMD or the UCITS Directive. The liquidity of the individual assets and the effects on the liquidity of the investment fund are to be monitored. The liquidity of the investment fund must always concord with the redemption obligations and other delivery and payment obligations. The company has to establish procedures guaranteeing that any emerging need for increased liquidity is recognised at an early stage. When establishing such an early-warning system any available information on the investor structure should be taken into account. The company is required to set out procedures for dealing with cash-flow problems. These should determine possible alternative courses of action for suspending the redemption of units and define communication channels. The procedures should be reviewed and if necessary modified on a regular basis.

Chapter 3 – Uses of external credit ratings by investment managers

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.

We could not give an overview on this point because investment management companies only rely to external credit ratings from a user perspective. However, there is a relationship between an investor's specific profile and the legal requirements to invest their capital (such as investments in products within investment grade range). Therefore, our members assume that reliance to external CRAs in fund rules or business processes may be dropped where the legislator or national competent authorities would delete their requirements with references to ratings (such as under the CRD IV regime, Solvency II regime, ESMA guidelines on money market funds).

15. In your experience, do prudential requirements impact demand for contractual reliance on external credit ratings?

Yes. Please see our answer to the Question 14.

16. What type of alternative credit information sources could be included in investment mandate agreements and fund investment objectives?

In addition to our answer to Question 11, we disagree with the proposed possible good practice that regulators could encourage investment managers to review their disclosure describing alternative sources of credit information in addition to external credit ratings. In particular, we disagree with the described examples on page 16 of the Consultation Paper (all of the three bullet points). Investors' expectations will not change as long as legal requirements with strict investment restrictions regarding rating reliance apply. Any improved disclosure regime does not reverse this fact. Therefore, a general good practice reviewing any disclosure of credit information used by the investment management company is too far reaching.

Moreover, any review process will involve that requirement with the obligation to disclose describing alternative sources of credit information in addition to external credit ratings is already in place. This does not comply with legal requirements or any current practice. As described under Question 1, in case of an inadequate usage of CRA ratings, the authority should request the investment management company to correct the fund rules within a certain period of time.

Furthermore, we request IOSCO to clarify that it is the decision of the investment management company which alternative credit information sources are used in fund rules or used for internal credit assessments. However, where necessary, in cases with reliance on external ratings by CRAs in fund rules we propose to use a wording which states that in such cases the investment management company is only obliged to review the external ratings for plausibility. That does not however exclude the possibility that the investment management company could provide information on a voluntary basis to the investor (such as reports about the current practice or in the context of investment committee meetings).

We request IOSCO to amend the proposed principle in such a way that a national competent authority will monitor the adequacy of the credit assessment processes of the investment management companies and assess the use of references to credit ratings taking into account the nature, scale and complexity of the funds' activities and, where appropriate, encourage mitigation of the impact of such references, with a view to reducing sole and mechanistic reliance on such credit ratings.

17. Please describe the process you use for identifying and comparing CRA methodologies.

Please see our answer to Question 10.

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?

Please see the current procedure in the field of investments by insurance undertakings in Germany (our answer to Question 6). Insurance undertakings are obliged to ensure that the requirements regarding the use of ratings and own credit assessment are respected by the investment fund manager (e. g. by providing a written confirmation of the investment management company to the insurance company investor).

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?

No comment.

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?

According to the Delegated Regulation (EU) No 231/2013[5], specific requirements for fund managers investing in securitisation positions are already in place.[6] They have to verify the existence of a retained material net economic interest as a precondition to investment. Furthermore, the AIFM needs to insure that the sponsor and originator have certain features and the AIFM itself has to comply with a set of qualitative requirements. As a result of the Regulation, investment management companies need full information on the securitization positions of the funds they manage, including loan level, cash flow and details of the pre-payment of underlying loans.

21. Following the 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.

The risk arising from the downgrade of a guarantor and the corrective action made by the investment management company depends on the specific case. Therefore, no general statement can be made.

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?

External credit rating is only one factor amongst several which determines the choice of counterparty. Other key factors are mainly, but not limited to, balance sheet assessment (e.g. capital adequacy, earnings, liquidity, asset quality) and qualitative factors like track record and reputation of the management or systemic vulnerability. Moreover, as described under question 7, investment management companies may only deal with counterparties for which a counterparty limit system is in place (including in relation to the creditworthiness of the contracting party and the group membership). All transactions with a counterparty count in their full amount towards the (credit) risk limit on fund level or company level. Moreover, investment management companies are obliged to define limits for cash positions at banks in view of their creditworthiness and group membership.

[5] C.f. Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision.
[6] In Germany, this Regulation also applies to UCITS' management companies.

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.

The risk arising from the credit rating downgrade of a key counterparty and the corrective action made by the investment management company depends on the specific case. Therefore, no general statement can be made.

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?

Identifying counterparty risk (including credit risk) is a general task of each risk management function established by investment management companies. Therefore, investment management companies should have, as part of the risk management task, adequate procedures appropriate to the nature, scale and complexity of its business to analyse (credit) risks arising from counterparties.

25. Are there some strong references to external credit ratings which are channeled through the ECB guidelines, ISDA Master Agreements or CCPs guidelines?

We refer to the final report of the three ESAs (EBA, EIOPA, ESMA) at the European level on mechanistic references to credit ratings in the ESAs' guidelines and recommendations (JC 2014 004, 6 February 2014). According to this report, the ESMA guidelines on money market funds should be amended regarding the references to credit ratings. However, as described above, the amended guidelines are still designed to consider an external rating by *any* CRA in cases of downgrade. We request IOSCO clarifying that such requirements are too far reaching.

Moreover, according to this report, ESAs do not consider it appropriate to repeal or amend the guidelines to remove the references to external ratings in cases where specific rules of the CRR or the Solvency Directive apply. Therefore, the legislator, the ESAs or national authorities should also be required to review and remove, where appropriate, all such references to credit ratings in legal acts or existing guidelines and recommendations. Otherwise, it should be clarified that the ESAs will interpret these rules in the light of the CRA III requirements.

26. Would you agree with some or all of the above parameters as valuable additional factors for the internal assessment of collateral quality?

In principle, we agree with all of the above parameters as valuable additional factors for the internal assessment of collateral quality. These principles are in line with ESMA's guidelines on ETF and other UCITS issues (Ref. ESMA/2012/832E, 18 December 2012).

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?

There is a connection between the assessment of the counterparty and quality of received collateral. The better the outcome of the counterparty analysis, the smaller the haircut of the 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?

No. In our view, the proposed parameters are sufficient to facilitate the credit assessment of collateral received and/or posted by the investment manager.

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

Credit ratings on bond and money market funds are not customary practice in Germany. In Europe credit ratings are mainly requested by (CNAV) money market funds in order to demonstrate zero credit risk to their mainly institutional clients.

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

We do not see an increased trend in requiring credit ratings on bond and money market funds in Europe.

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

Credit ratings on money market funds are most important as investors such as corporate treasurers want to exclude any credit risk from their investments, and therefore usually use AAA rated funds only.

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

The three major CRAs usually require that rated funds invest only in instruments rated by the respective CRA. The CRA may give a private credit assessment on unrated holdings to the fund in order to allow for an investment by the fund management.

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?

The CRAs provide for detailed rules how to maintain a minimum credit quality which is corresponding to the rating of the rated fund. These rules may require that investments below a minimum rating need to be sold to prevent an e.g. AAA rated fund to loose this designation. However, for example, Moody’s uses an expected loss approach which would allow the fund to balance a downgrade within the allowed spectrum of investments with new investments in higher rated securities.

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.

We are not aware of any rated funds of funds. Unrated funds may invested in rated funds, usually money fund units, like in any other rated cash investment.

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?

Bond funds, including bond ETF, may base their composition of holdings on bond indices which apply specific rating and credit quality thresholds, e.g. “investment grade”. Downgrade of a security to below investment grade which results in a specific issuer becoming an ineligible index component provider may lead to a change in the investments of the fund too, However, the situation is not different from a bond fund which does not base its performance on tracking a specific bond index but which simply holds itself out to the public as investing in “investment grade” securities.

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

This depends on what the rating is used for. In cases where legal requirements apply (e.g. investments in assets less than investment grade shall be prohibited), investment management company is obliged to sell the asset downgraded below investment grade, if the part of the infected assets exceed the de minimis limit of three percent of the funds’ portfolio in case of German insurance company investors in funds. Otherwise, in cases where the de minimis limit of 3 percent of the funds’ portfolio is not exceeded, the investment management company is obliged to sell the asset downgraded below investment grade within six months. Should the sale not be possible within the six month period, the investor has further six month to decide redeeming the funds’ units in which the investor is invested. However, we observe too, that institutional investors are increasingly more flexible with allowing continued holdings of downgraded assets in order to prevent losses due to fire sales.

In the risk management process, any downgrade could influence the assessment of the risk of each rated asset. In this case, it is task of the risk management function to measure the risk, to set limits, to monitor or to react reducing the overall risk of the fund (where infected). This process includes information to the persons performs portfolio management.

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?

Please see our answer to question 36. There are no 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?

Yes, please see our answer to question 36. The described procedures are typically regulated in internal investment managers’ policies.

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.

Collateral is supposed to pose no credit risk and therefore downgraded collateral is likely to have to be replaced immediately. Funds often would switch out of the counterparty whose credit quality has been questioned. For example, swap based index replicating funds (synthetic ETF) have clear rules in place when to replace the main swap provider(s) of the fund in case of a credit event. The credit quality of asset guarantor is usually the decisive element in the credit evaluation of such asset and therefore will lead to the same reactions as a downgrade of the issuer of a similar asset below the required minimum level of credit quality.

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?

Only in case of index replicating funds a downgrade and removal from the index may lead to a quasi automatic asset sale by the fund.