Frankfurt am Main,
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BVI comments regarding ESAs' discussion paper
The Use of Credit Ratings by Financial Intermediaries
Article 5(a) of the CRA Regulation
(JC/DP/2014/01)

BVI[1] gladly takes the opportunity to present its views on the use of credit ratings by financial intermediaries. Our members are investment management companies and asset managers (such as investment firms) 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 management companies and investment firms.

I. Key issues

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

First of all, we support the proposal to design guidelines on reducing contractual reliance on ratings. This will ensure consistence supervisory practices within the EU Member states as well as legal certainty for the implementation of the requirements of the CRA III Regulation. We also welcome the approach to analyse the use of credit ratings in different sectors such as credit institutions, insurance area (including reinsurance undertakings and IORPs), investment firms, investment management companies and central counterparties. All of these entities have completely different business models which have an impact of the use of credit ratings and their own assessment processes of the creditworthiness of rated financial instruments or entities. Therefore, the new ESAs' guidelines should be flexible enough so as to take account of the specificity of these areas.

In this context, we greatly appreciate that the discussion paper highlights that the use of credit ratings in the asset management industry is only one factor among others. At the latest, through the publication of 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 a legal system is in place which is designed to avoid over-reliance on credit ratings by investment management companies. The implementation of these rules into the German Investment Act has been completed since December 2014. According to these requirements, 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 as-

[1] BVI represents the interests of the German investment fund and asset management industry. Its 86 members manage assets in excess of EUR 2.4 trillion in UCITS, AIFs and assets outside investment funds. As such, BVI is committed to promoting a level playing field for all investors. BVI members manage, directly or indirectly, the assets of 50 million private clients over 21 million households. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.

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sessment. Therefore, investment decisions made by persons performing portfolio management do not solely or mechanistically rely on credit ratings issued by credit rating agencies.

Moreover, in Germany, a supervisory practice on reducing over reliance in contractual agreements (such as fund rules or other investor mandates) is already in place. According to the Directive 2013/14/EU and the German implementation, the German supervisory authority (BaFin) shall assess the use of references to credit ratings in the funds' investment policies 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 practice, the BaFin reviews fund rules and among other things checks the adequacy of these criteria in order to approve the fund rules. In case of an inadequate usage of CRA ratings, the BaFin 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 BaFin 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 make use of these powers.

However, our members assume that formulaic reliance on external CRAs in contractual agreements 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 competent national authorities should be explicitly required under the new ESAs' guidelines to review and remove, where appropriate, all such references to credit ratings in existing guidelines and recommendations.

Finally, we request the ESAs to implement the principle of proportionality as part of the new guidelines on reducing contractual reliance on ratings. The requirements for the implementation of internal credit assessments or alternatives to external ratings 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, the new guidelines 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.

II. Specific comments

Questions for Sectoral Competent Authorities

Because the following question has an impact on the use of credit ratings by investment management companies, we answer to this question as follows:

***Q7**. Does the existence of funds/ETFs/Index-tracking UCITS and benchmarks whose composition depend on securities' ratings represent a concern? Is it necessary to mitigate contractual reliance on CRA ratings in this situation?*

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In general, the existence of any benchmark whose composition depends on securities' ratings does not represent a concern. These benchmarks are only one factor to measure the performance of the fund. The same principles apply for investment decisions and risk management process as when the fund has no benchmark. Therefore, from the point of view of the investment manager there is no direct contractual link to the rating reliance of the composition of the benchmark. The only exception may be index trading funds which may not easily deviate from their benchmark.

Moreover, funds whose composition depends on securities' ratings are only the result of supervisory or legal requirements (such as under the CRD IV regime, Solvency II regime, ESMA guidelines on money market funds or national circulars of supervisory authorities). This kind of reliance on external CRAs in contractual agreements may be dropped whenever the relevant legislator or national competent authorities deletes applicable references to ratings. However, not only every legal or supervisory requirement to invest in securities which depend on a rating (such as to invest only in assets with an investment grade rating) lead to a sole and mechanistic reliance on credit ratings in fund rules (for more details please see our answer to question 9.ii).

Questions for Financial Intermediaries

***Q9.** To what extent do your business lines use external ratings? Please specify by activity.*

Our members refer to external credit ratings to the following business processes:

- Definition of fixed income asset categories in which they invest (e.g. external credit ratings are used to map market-data like specific spreads for market-risk-calculation of fixed-income instruments)
- 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)

***Q9. i)** What are the main reasons to use external ratings in contractual agreements?*

In principle, external credit-ratings are a "common language" for the description of credit risk. However, 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 assets are not eligible if they are not rated in investment grade range by a minimum number of external CRAs. This is for example 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.

***Q9. ii)** Are there elements in your contractual agreements that limit or mitigate the risk of sole and mechanistic reliance on external ratings?*

1. There is no sole and mechanistic reliance on external ratings in the investment decision process.

As pointed out above and under paragraph 102 of the discussion paper, asset managers may use credit ratings as one parameter when making their investment decisions. The individual assessment of creditworthiness of financial instruments or entities is part of the overall risk-management process of the investment management company. 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).

Moreover, 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.

Against this background, external ratings can only be one factor among others. There is no need to limit or mitigate a risk of sole and mechanistic reliance on external ratings in the investment decision process of asset managers.

2. The review of rating reliance in fund rules should be part of a case-by-case assessment.

Rating reliance in contractual agreements (such as fund rules) should be monitored in a more differentiated way:

a. Investment grade as a condition for the eligibility of fund's assets

A provision in fund rules which requires that fund's assets are only eligible if they are rated by an external rating agency within investment grade range, in our view, do not qualify as a sole and mechanistic reliance on credit ratings. In accordance with the definition of sole and mechanistic reliance given by the Joint Committee, in these cases, the specific investment decision is not only the consequence of a rule solely based on credit ratings because the fund manager has the discretion based on a separated due diligence process and in consideration of the given risk limits in which specific asset (rated as investment grade) the fund should be invested. Therefore, in such cases it is not necessary to amend the fund rules to reduce reliance on credit ratings. Moreover, there is no need to implement elements in contractual agreements that limit or mitigate the risk of sole and mechanistic reliance on external ratings.

b. Selling commitment as consequence of a downgrade

A provision in fund's rules which requires a selling commitment as consequence of a downgrade could in principle be a sole and mechanistic reliance on credit ratings. However, the reliance on credit ratings in such cases should be decided on a case-by-case basis and on the basis of the following criteria:

- Does the investment management company have an own discretion in deciding to sell or to hold the asset in the fund's portfolio? This will depend on whether the provision in the fund rules requires an explicit reference to a selling commitment.

  This is not the case when fund rules only require that the eligible assets shall be having a rating within an investment grade range. In such cases it is not necessary to amend the fund rules and to implement further elements to reduce rating reliance because the fund manager has the discretion based on a separated due diligence process and in line with the risk management requirements to sell or to hold the fund's asset.

- Do the fund rules state an obligation to sell the downgraded asset after a reasonable period of time? Sole and mechanistic reliance on ratings in such cases will also depend on whether the provision in the fund rules requires an explicit reference to a selling commitment. In the case that the fund manager has discretion in deciding to sell or to hold the assets in the fund's portfolio, there is no need to implement elements in contractual agreements that limit or mitigate the risk of sole and mechanistic reliance on external ratings. However, the discretion should be part of the provision of the fund rules.

- What is the proportion of the fund's portfolio which is infected by rating reliance? According to the Directive 2013/14/EU, national competent authorities shall taking into account the nature, scale and complexity of the investment funds' activities an assess the use of references to credit ratings in the funds' investment policies and, where appropriate, encourage mitigation of the impact of such references. For that reason sole and mechanistic reliance on ratings in fund rules may be justified

Q10. *What in your view are the main advantages or disadvantages of using external ratings?*

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.

The main disadvantage is that once a significant downgrade is made public, it may generate a sudden, over-amplified and late reaction on the markets. However, we cannot give a general statement, how size, resources, capabilities, etc. of an investment management company could affect the benefits or disadvantages 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.

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Q11. *Do you conduct any analysis of the underlying methodologies of the ratings you rely on? If so what in your view are the strengths and weaknesses of the methodology?*

In view of the circumstances that external ratings can only be one factor among others in the investment decision process or risk management process of an asset manager, there is in principle no need for more alternative approaches such as analysis of the underlying methodologies of the ratings. This applies even more in light of the fact that the exact details of rating methodologies or for a single rating decision are mostly not public or our members can only use these information in return for a fee. We therefore request the ESAs that the new guidelines should be set in a manner that no further expense or costs for rating data are incurred. It should be the decision of the investment management company, which method, rating or CRA is relevant for the internal credit assessment.

However, our understanding is that in the area of asset management the overall risk management process of the investment management company including due diligence processes of the portfolio manager fulfill the requirements of an internal credit quality assessment set out in Article 5a of the CRA III Regulation. In this context, we welcome the proposed alternative solution under paragraph 114 of the discussion paper that only in cases there such an internal credit quality assessment of instruments and issuers does not take place further analysis should be implemented. However, we prefer to look at alternative benchmarks like credit spreads or other market signals as part of an alternative solution. The proposed plausibility checks should only be one criterion among others of such alternative solutions in cases there an internal assessment is not already in place.

Particularly, such plausibility checks can be voluntary performed in the case of larger in size companies who have their own credit research units. For example, one of our large members uses a variety of input factors additional to external ratings for asset selection, but they do not systematically analyze the processes of CRAs since there is no direct link to the active investment decisions - nevertheless the fundamentals of underlying methodologies are object of the analysis in many cases.

Finally, we request the ESAs to reconsider the alternative solution described under paragraph 113. According to the ESAs' proposal investment management companies should execute, when appropriate, periodic back-tests, as well as periodic stress tests and scenario analyses related to the on-going risks occasioned by market conditions the could prejudice the collective investment scheme. This proposal goes far beyond necessary and justified measures because under the UCITS and AIFM regime back-tests and stress tests are already in place. As part of the risk management process investment management companies conduct (i) periodic back-tests in order to review the validity of risk measurement arrangements which include model-based forecasts and estimates and (ii) periodic appropriate stress tests and scenario analyses to address risks arising from potential changes in market conditions that might adversely impact the investment fund.

Q12. *Can you provide examples of past experience where external credit ratings provided an inaccurate credit worthiness assessment? If so, what actions were taken in response to mitigate similar occurrences?*

Examples are the default of Lehman and Iceland banks before the relevant crisis. However, our members reduced their exposures to those instruments and counterparties based on their risk management process (including internal assessment of the creditworthiness of such instruments).

***Q13.** What internal risk analyses do you currently employ? What business lines are these employed in? To what extent do they utilise external ratings? What are the main advantages of these internal analyses?*

Internal risk analyses employed by investment management companies vary upon their size, as well as the nature, scale and complexity of their activities. However, according to the legal requirements under the UCITS and AIFM regime, the following overall risk management process (including credit risk assessment) is already in place.

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.

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.

***Q14.** Please specify what alternative references or benchmarks your internal risk analyses make use of.*

Our members utilize credit-spreads, financial information and reports of the entities that are assessed, market data on transactions and prices, stress tests and concentration-limits as alternative references.

***Q15.** Are these alternative measures point-in-time or through-the-cycle compared with external ratings?*

The measures uses are mostly point in time on a daily basis, but they can also be compared with external ratings on a through-the-cycle basis.

***Q16.** In what areas is reducing reliance on external ratings necessary or at least desirable?*

In general, asset manager rely on external ratings only as one parameter of their overall risk assessment process. For further details as to how asset manager mitigate any rating reliance, please see our response in Q 9 ii.

Q17. *What in your view are the main challenges preventing you from reducing reliance on external ratings in your business?*

The main challenge is that professional investors such as banks or insurance undertakings still have strong requirements for use of ratings as a common independent measure for credit risk (such as under the CRD IV and Solvency II regime). As a result of the look-through approach regarding fund's investments by such entities the investment process including investment guidelines of an investment management company must be designed in such a way that the asset manager could also fulfill these requirements. However, it should be clarified that in such cases the investment management company is only required to fulfill its own internal credit assessment as part of the investment management process.

Q18. *How could the reduction of contractual references to credit ratings influence, in your opinion, the transmission of systemic risk?*

In light of the fact that there is only a minimum rating reliance in cases of a selling commitment as consequent of a downgrade (please see our response to Q 9 ii), only these kind of cases could be able to influence the transmission of systemic risk in the asset manager sector. However, we consider it as the original responsibility of the competent authority to review and remove, where appropriate, all references to credit ratings in existing guidelines and recommendations which contain a selling commitment as consequent of a downgrade. By amending fund rules in such a way that there is no sole and mechanistic reliance, our members will be pleased to support reducing rating reliance in such cases.

Q19. *Are there any additional points you would like to highlight with regards to contractual reliance on external ratings?*

Institutional investors requiring contractually the use of ratings, e.g. insurance companies need to receive from their asset manager periodic reports on the investments, which may include the ratings of the bonds. It needs to be clarified that the European Rating Platform to be established in 2017 by ESMA provides for such "reuse" of rating symbols by asset managers on behalf of their clients.