International
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ICMA

ASSET MANAGEMENT AND INVESTORS COUNCIL

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

London, September 5, 2014

Sent by email

Dear Mr Ben Salem,

Good Practice on Reducing Reliance on Credit Rating Agencies in Asset Management

The ICMA Asset Management and Investors Council ('AMIC') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation.

The AMIC composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. The AMIC's focus is on issues which are of concerned to its broad membership, rather than having a specific product focus.

The members of the AMIC welcome the opportunity to discuss IOSCO Consultation Paper on Good Practices on Reducing Reliance on CRAs in asset management. AMIC members have been active in the discussions in reducing reliance on credit rating agencies. However the Council is keen to highlight the 'public-good' aspects of credit ratings.

The AMIC will make general comments in response to the consultation paper. The questions go into details into internal procedures used by asset managers and institutional investors – each firm is better placed to share its own experience.

The consultation paper points to concerns that financial institutions and institutional investors may be relying too much on external ratings and questions to a certain extent internal credit risk assessments and the soundness of procedures in place. This overreliance can be explained by the fact that ratings have been increasingly woven into international, European and national laws, regulation and private contracts as highlighted by IOSCO. As legal requirements for ratings have proliferated, rating agencies have evolved in effect from information providers to purveyors of 'regulatory licences'. It is also worth noting that while the ratings of structured products have been widely criticised, corporate ratings have held up much better during the recent crisis.

This means that for firms issuing fixed income securities, ratings are still an important component of capital markets.

Credit rating agencies provide an assessment of the creditworthiness of a corporation or security, based on the issuer's quality of assets, existing liabilities, borrowing history, and overall business performance. Investors depend on the ratings to predict the likelihood of default on financial obligations and the expected repayment in the event of default. As corporations require more capital and issue debt paper among the broader, anonymous public, standardised information about the creditworthiness of issuers investors do not know themselves or with whom they do not have a personal relationship needs to be made available. Credit rating agencies offer the issuing company the opportunity to use and communicate non-public information externally, without disclosing its precise content. For instance, 'investment grade' is nowadays part of the daily language and it should not be forbidden to use it simply because it refers to CRAs rating scales. This is a critical aspect of a functioning international capital market. Credit rating agencies aggregate information about the credit quality of various types of borrowers and their financial obligations; allowing such borrowers access to global and domestic markets, and to attract investment funds.

One of the main concerns, as was already highlighted in the IOSCO Code, is the assurance of quality and integrity in the rating process, so that the credit rating agencies can fulfil their task of dissolving information asymmetry in the market. A methodical and transparent procedure of compiling the rating product has an important role in ensuring consistent quality and integrity of ratings. Each prognosis can only be as good as the data upon which it is based. The assurance of the quality of a rating also requires that the agencies satisfy high professional standards in the training and further education of their personnel.

In addition the quality of the rating is also perceived differently depending on who is reading the rating. To an issuer, the best rating is an AAA rating. To an investor who holds a bond, it will be a rating that is never reduced. To potential buyers of the bond, it is a rating that accurately reflects or possibly understates default probabilities and that is comparable across issuers and industries.

Whilst it is true that investors will consider external credit ratings before investing and throughout the life of their investments – and will establish guidelines to direct investment managers as to the types of instruments that investors wish their fund or managed account to be invested in - most institutional investors do not rely exclusively on ratings. While it is true that credit ratings are part of the mosaic of information considered as part of the investment process, they are generally not an appropriate sole source for making decisions. Liquidity risk, for instance, is becoming a more important part of investment decision making – a risk not covered by ratings and assessments conducted by credit rating agencies. However institutional investors do vary in the amount of time and money they can afford to spend on the analysis of credit and liquidity risks. Accordingly they have mixed views regarding the timeline according to which references to credit ratings should be removed from regulations.

Moreover, for the individual investor who does not have the capacity or time to investigate, monitor and evaluate the quality of available financial instruments, credit ratings provide simple, easy to use information that can be used as part of the investment decision-making process. Knowing the relative risk attached to different financial instruments allows investors to better and more easily adjust the global risk profile of their investment portfolios to their own investment preferences. However, credit ratings are also useful for professional portfolio managers, as they can serve as the basis for contractual agreements with clients that in advance specify criteria for investment decisions. The AMIC believes that there is some value in having in-house credit analysis functions. However the Council recognises that this possibility is only offered to the bigger players in the market, and those smaller investors may be at a disadvantage. Making the distinction and the degree of sophistication is therefore key to ensure the functioning of the asset management industry.

Many institutional investors are legally obliged to hold only securities of some minimum rating, or may have to hold larger reserves when investing in bonds of lower ratings. Ratings are also used in private contracts, for example to define the investment objectives of bond mutual funds. Accordingly the AMIC believes that regulatory use of ratings has exacerbated pro-cyclicality in the financial system as a whole. However, in order to reduce private reliance on ratings, credible alternatives or substitutes should be developed, particularly for institutions that lack resources to assess independently the huge number of available fixed income instruments. The AMIC believes that it is perfectly rational for individual firms and institutional investors to be guided by a rating when making their investment decisions, as long as the quality and integrity of ratings is kept.

The AMIC is of the view that the IOSCO good practices are relevant as long as they maintain the public-good aspects of credit ratings and avoid unintended consequences such as increased costs and reduced access to capital markets. The current regulatory framework is so reliant on ratings that significant changes can only be conceived to take place over time. Mandates to use ratings have become part of the fabric of financial markets, and cannot be unpicked instantaneously.

The AMIC would be happy to discuss further with you the points made in this letter. The Secretary of the AMIC, Nathalie Aubry-Stacey, can be reached at Nathalie.aubry-stacey@icmagroup.org should you need further information.

Yours sincerely,

Robert Parker
AMIC Chairman