AGA/EP – n°4352/Div

Joint Committee of the European Supervisory Authorities

Paris, 27 February 2015

AFG response to the ESA's Discussion Paper on The Use of Credit Ratings by Financial Intermediaries Article 5(a) of the CRA Regulation

General comments

The Association Française de la Gestion financière (AFG)[1] is grateful for the opportunity to answer to the Joint Committee of the European Supervisory consultation on the use of credit ratings by financial intermediaries.

[1] The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. 600 management companies are based in France. AFG members manage 3,000 billion euros, making the Paris fund industry a leader in Europe for the financial management of collective investments (with 1,500 billion euros managed from France, i.e. 19% of all EU assets managed in the form of investment funds). In the field of collective investment, our industry includes – beside UCITS – the whole range of AIFs, such as: employee savings schemes, regulated hedge funds/funds of hedge funds, private equity funds, real estate funds and socially responsible investment funds. AFG is an active member of the European Fund and Asset Management Association (EFAMA) and of PensionsEurope. AFG is also an active member of the International Investment Funds Association (IIFA).

<u>Responses to the questions of the consultation document</u>

Questions for Financial Intermediaries

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

In the asset management (AM) industry, ratings are commonly used in different sectors: investment management, risk management as well as marketing and sales.

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

AFG shares the analysis provided in the discussion paper (DP), where it is evidenced that ratings are referred to in order to share a common language with clients and counterparties especially when defining the **investment universe, the eligible collateral or the level of haircut**.

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

As mentioned §103 of the discussion paper, the prospectus of investment funds often mentions external ratings to define minimum thresholds creditworthiness for investments. Mandates can be far more specific. In most instances, the asset manager enjoys a **grace period** in case of breach following a downgrade: the prospectus allows for 3 months delay to close the position or may authorize the manager to keep it till maturity. In any case the decision is taken with consideration of the best interest of the investors. Furthermore, there is **no mechanistic reliance on ratings** in the active asset management, since rating is only one source of information and investment decisions are based on a more diversified process where credit assessment is not limited to reference to external ratings.

Our members consider rating as a tool at their disposal among other tools in the managers' toolkit to assess credit quality. In the meantime, AFG has always fought against overreliance and did not rejoice when European CESR' Guidelines on MMFs of 2010 followed US CNAV MMFs' example and introduced mechanistic reliance to ratings for all types of MMFs.

Moreover, Solvency 2, even if does not refer directly to CRAs ratings, requires a complete report on the rating of each of the main 3 CRAs. It is another perfect example of regulatory impact on the demand for reliance on external ratings. CRD for banks is another one and many other institutions have local regulations that refer to CRA's ratings.

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

Main advantages of using external ratings:

- World wide vision
- Share a **common language** with clients and counterparties;
- Benefit from the expertise of **seasoned analysts** that produce ratings;
- Access extensive reports published together with the rating where rationale for the rating is explained and main factors, positive and negative, are evidenced;

- Receive a warning when ratings are put under watch or reviewed.

Main disadvantages of using external ratings:

- Risk to mechanistically and solely rely on external rating;
- Existing **conflict of interest** since the CRA is paid for by the issuer that requires the rating (this proved disgraceful with structured transactions);
- Risk of error, negligence and wrong rating.
- **Cost** for the investor to have access to the publications, in an oligopolistic market of CRA.

It should be mentioned that ratings can be used to capture value that results from a miss-rating for those investors that accept to consider investment according to their credit assessment and irrespective of the CRA's opinion.

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?

The AM (Asset Manager) is a client of the CRA that provides ratings as well as extensive reports that justify them. The CRA charges a subscription fee to the AM… and is paid by the issuer on the other side. The CRA is licensed and supervised by a competent authority, ESMA in Europe. The AM is entitled to consider that ratings are professionally realized and it **should not be required to investigate methodologies and procedures of the CRAs.** That does not prevent us from having a view on the quality of the work of the CRAs we have subscriptions with.

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?

Immediately, one thinks of the errors in rating securitizations that were obvious ex post. With sovereign risks also, especially in Europe, CRAs appeared not to be very convincing.

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?

N/A

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

Credit analysts are not supposed to work on second-hand data. They have access to financial information and reports of the entities they analyse as well as market data on transactions and prices. Brokers and independent research analysts might contribute to build their own opinion but will not determine it.

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

The procedure does not work on the basis of comparison of opinions, but on a dedicated process to build a personal view based on personal work. At some point in time internal documents will refer to external ratings as they will mention key figures of the issuer. Diverging ratings by different CRAs would be a topic to discuss in due course.

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

AFG totally agrees that the aim of any regulation should be to reduce systemic risk and in case of ratings avoid mechanistic and sole reliance on them for different types of decisions. Excessive reliance can lead to identical behaviour by many actors at the same time creating, in case of a negative opinion, massive sales and discouraging any buyer. In the AM industry, our perception is that this risk is properly addressed and we feel that further action should be conducted in two areas:

- **Better educate clients** who continue to refer to ratings in their mandate and consider as a breach the fact to hold a position in a security that has been downgraded to a level lower than their investment threshold; sometimes they have too stringent guidelines by their board or their regulator;
- Amend the methodology for **index calculation**, in order to avoid mechanistic and immediate exclusion of an underlying that is downgraded below the threshold for eligibility in the index.

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

Credit assessment is a real job and requires specific skills. It represents a **significant investment** in human resources, technology and research which may be difficult to reach for small entities. In fact, the independent research can complete or replace rating. Unfortunately, the technical advice of Esma about the level 2 provisions on MIF II could call into question one part of the financing of the research.

Anyway, it is not usage of external that presents any risk, not even limited reliance but overreliance on ratings. It is not an objective to reduce reliance on rating, but it is one to eliminate excessive reliance that has properly been described as "mechanistically and solely" relying on ratings.

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

We think that it would not be good for an asset manager not to mention ratings in the prospectus or the reports of its funds. It is about the only way to give important and easy to understand and to compare information on credit risk. In AFG's view it would be detrimental to the investors to ban any reference to external ratings and paradoxically it could exacerbate systemic risk by lack of clear information.

However, we consider that measures should be taken to **eliminate immediate and systematic comportments in relationship to ratings**. Grace period, delay for implementing changes, prior announcement of decisions, reference to average price over a certain period… are ways to make sure that a decision on a rating will not instantly turn to large and numerous orders.

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

AFG is very conscious of the responsibility of asset manager towards its clients. Clear and understandable information is an absolute necessity to develop a strong relationship with them on the soundest bases of transparency and confidence. Expertise and performance will help to build on this basis and comfort the relationship. Asset management industry is strictly regulated and its actors and products are closely supervised. In that framework we think that reference to external ratings in our documentation, be it prospectus or reporting, cannot at the moment be replaced by any credible alternative.

We are very much concerned by the prospect that CCPs and more generally our counterparties take a restrictive view in determining eligible collateral and applicable haircuts. A reference to external ratings in that field is helpful and easy to follow and understand; it does not leave room for personal interpretation. The risk does not lie with reference to ratings but with mechanistic reliance in case of a “rating event” that would not be a “credit event”. We think that it would be highly detrimental to the liquidity and efficiency of the market that collateral would eventually be limited to cash (at a very high cost for end investors in the case of negative interest rates) and high quality government securities. We hope that CCP rules and contractual negotiation with counterparties will accept largely diversified collateral with appropriate haircuts, even if based on a reference to external ratings.

If you need any further information, please don’t hesitate to contact myself, at +33.1.44.94.94.06 (e.pagniez@afg.asso.fr) or Adina Gurau Audibert, at +33.1.44.94.94.31 (a.gurau.audibert@afg.asso.fr).

Sincerely Yours,

Eric PAGNIEZ