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**AFG comments on**
**Alternatives to the Use of Credit Ratings to Assess Creditworthiness**

## General comments

The Association Française de la Gestion financière (AFG)[1] is grateful for the opportunity given to comment on IOSCO's consultation on Alternatives to the Use of Credit Ratings to Assess Creditworthiness.

AFG would like to specify that in the asset management industry, external ratings are commonly used. They are used in several sectors: investment management, risk management as well as marketing and sales. Ratings are also used 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.
In order to facilitate the monitoring and comparison of funds on a transversal and harmonised basis on the market, we believe that management companies should be allowed to use ratings from agencies in their reportings, as such ratings offer a well-known standardised comparability and confidence.

[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).

The decision to increase, decrease or keep stable a position following an event on a rating is in any case taken with consideration of the best interest of the unithlders. 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.

Essentially, our members consider external ratings and **<u>external independent research</u>** 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.

With regards to their specificities, asset management companies support the use of an internal assessment process; however, their processes and methodologies are and should remain diverse and clearly do not have the objective of "replacing" external ratings. Indeed, we strongly advocate that **fighting overreliance does not mean "replacing" CRAs with alternative internal models**. (we are not doing the same job; we are not scoring all companies).

We believe that each management company should be able to create its own methodology and set up organisation (that can be validated by the competent authority). Such a methodology should be a tool at the disposal of the manager, **who should be able to delegate it.**

Asset managers recognise the value of external independent research (not necessarily produced by CRAs) that can be used internally in the analysis done on some issuers that for one reason or another are not closely/permanently/systematically monitored internally.

AFG believes it is important to thoroughly analyse/set and acknowledge the **scope of these principles**. They are already applied in the banking world, but they are clearly not 100% transposable to the asset management world and even less to smaller asset managers. Does it make sense to have proportionality on the subject between asset managers, or between industries?

Asset management companies are mature, highly organised and supervised entities. Investment rules and risks are strictly organised and followed up through committees. Assessment of the credit risk with the objective of discerning the potential for return is an activity closely linked to an asset manager core activity. The objective of an analyst's work performing within the asset management industry is not the same as the one of an analyst working for a banking entity, where avoiding potential losses is the target that explains why this activity is situated within banking risk departments.

If AFG perfectly agrees with the principle linked to the development of appropriate policies and procedures to ensure that decision-making is not unduly affected by operations from other areas of the firm, we have **strong reservations against the business unit separation principle**. There is no stringent need to prescribe a unique organisation "in silos", which constitutes a too strong operational measure for all actors (without a proven material benefit over other types of organisations that coexist today).

**<u>AFG's comments on the 13 proposals of sound practices of the consultation document</u>**

***1. Establish an independent credit assessment function that is clearly separated from other business units, including the development of appropriate policies and procedures to ensure that decision-making is not unduly affected by operations from other areas of the firm.***

If AFG perfectly agrees with the principle with regards to the development of appropriate policies and procedures to ensure that decision-making is not unduly affected by operations from other areas of the firm, we have strong reservations against the first part of the principle. There is no stringent need to ask for such a strong operational measure for all actors. Currently, a lot of asset managers do not have separate business units as managers may cumulate the two functions: analyst and manager. This type of organisation still preserves against potential conflicts of interest, as rules and governance are in place to ensure that for instance a specific sector analyst can be a generalist manager. We strongly believe that the principle should be more pragmatic and accept for a same result a larger spectrum of organisations (matrix organisations should be possible, not only siloing, as long as potential conflicts are dealt with through specific governance).

In not, implementing this type of organisation may be difficult and too costly for less large asset managers without any proven benefit. In addition, stated as such « clearly separated from other business units », it should be indicated that for us there are some inextricable questions in terms of boundaries: where is the limit? Indeed, for some asset managers, the credit research team is not clearly separated from the Fixed Income team, but they do not depend on portfolio managers. We believe that what matters in this field is to be very clear on:

- The objectives assigned to credit research
- The processes assigned to credit research
- The quality assessment measures vs. the objectives
- All this packaged method could be subject to auditing.

We would then reformulate the principle, so as to attain the same objective with a more pragmatic organisation solution that acknowledges for the variety of practices that contribute to the richness of the credit research in general and in the best interest of unit holders (as adapted to our activity):
**"*1. <u>Establish a credit assessment function that has clear mandate as well as governance with regards to interactions with the other business units,</u> including the development of appropriate policies and procedures to ensure that decision-making is not unduly affected by operations from other areas of the firm."***

***2. Involve senior management in order to ensure the successful implementation of a robust credit assessment process, including promotion of a risk-sensitive culture throughout the organization. Such involvement would entail oversight of the credit risk assessment process by a dedicated risk***

***management team that reports to high-level management, such as a separate independent credit committee.***

If AFG agrees with the utility of involving senior management, AFG would like nevertheless to clearly state that analysts in asset management do not have the same function as in the banking world. Indeed, in asset management the question is more “where is value?”, whereas in the banking units the question is more “where is risk?”. That’s why within banks analysts are closer to risk department (and mindset), whereas in asset management they are closer to the investment management mindset. It would be dangerous to put analysts within risk management, as this will have consequences in terms of investment process, as analysts would then put weight on different areas, not always in the best interest of unit holders.

Besides, our members believe that asking for: « *Such involvement would entail oversight of the credit risk assessment process by a dedicated risk management team*” and “*a separate independent credit committee*” could be highly problematic to implement as subject to interpretations. For us, Principle 13 is enough. If this principle were to stay, we would reformulate it so as to cover also non banking organisations by keeping the first part only:

**“*2. Involve senior management in order to ensure the successful implementation of a robust credit assessment process.”***

***3. Establish a coherent oversight structure to ensure that the credit assessment process is properly implemented and adhered to, including the establishment of reporting lines and responsibilities that are clearly articulated and followed.***

We believe this principle might not be necessary, as internal audit normally is able to perform this function.

***4. Take steps to ensure that a firm’s governing committee receives an appropriate level of information on the amount of credit risk to which the firm is exposed. This may include policy exceptions, limit breaches, stress testing analysis concentrations, watch lists, and top exposures, among other things.***

For asset managers this principle should concern portfolios, not regulatory capital which would rather be performed by internal audit.

We would recall that asset managers’ organisations are linked to their particular activity which is done for third party money investment management throughout collective funds or clients’ mandates.

***5. Invest in staff and other resources necessary to develop a robust internal credit assessment management system that appropriately reflects the nature, scale, and complexity of its business. This includes having in-house the necessary staff expertise and technological ability to analyze effectively the firm’s portfolio and to stay abreast of market indicators.***

We agree, however the formulation "the firm's portfolio" is not really adapted to as, as we manage portfolios on behalf of our clients.

We would reformulate:
***"5. Invest in staff and other resources necessary to develop a robust internal credit assessment management system that appropriately reflects the nature, scale, and complexity of its business. This includes having in-house the necessary staff expertise and technological ability to analyze effectively the firm's <u>or clients' portfolios</u> and to stay abreast of market indicators."***

***6. Avoid exposure to particular credit risks whenever the firm does not have the internal capability to independently and adequately assess the exposure.***

The interpretation of this recommendation may cause serious problems if it is understood so that the capacity to independently judge a credit risk should be performed by the internal credit analysis. Indeed, credit analysts do not follow all names of an index and not all positions in portfolios. External ratings as well as external independent research may be useful in some cases, where there is not an internal capacity.

**Leaving this principle as such is not acceptable to us.**

Maybe this provision should be subject to a minimum size threshold or equivalent provisions so that to **capture material exposures on core/relevant type of investment/business only**.

Our members think that the process involved should be proportionate depending on a series of parameters, for instance:

- The conditions of use of the output
- The amount of investment
- The level of risk
- The type of portfolio
- The management objectives, in terms of:
    - Investment horizon
    - Investment turnover
    - Benchmarked vs. absolute

We would recall that asset managers' organisations are linked to their particular activity which is done for third party money investment management throughout collective funds or clients' mandates.

We would like to insist on the value of external independent research (not necessarily produced by CRAs) that can be used internally in the analysis done on some issuers that for one reason or another are not closely/permanently/systematically monitored internally.

Furthermore, it is commonly accepted that passive ETF investments are exempted from individual knowledge of credit risk they take, which would simply be impossible when considering the very large number of constituents in some indices.

We thus suggest at a minimum to drop the term "internal" in the principle as the important point is the capacity of judgment and the word may be misinterpreted as a ban on external sources of credit analysis.

***7. Take creditworthiness assessment capabilities into account when considering the firm's business growth plans and deciding how to structure its portfolios or whether to take on additional leverage.***

The reference to leverage is unclear with regards to our activity.

***8. Incorporate a wide variety of qualitative measures into robust credit assessment processes in addition to quantitative measures. This can help a market intermediary firm avoid excessive concentration risk in certain areas and provide a more holistic view of creditworthiness than simply relying on quantitative factors alone.***

We agree in general with this principle and do not have particular comments.

***9. Prescribe risk levels and investment appetites for the assessment of creditworthiness that focus on the fundamental value of the instrument to set limits and risk. These levels might distinguish between various categories, such as industry or on a geographical basis, and be reflected in the policies and procedures that set out the operating standards that must be followed by teams or individuals responsible for the assessment of credit risk.***

We are not sure at all that there should be only one model inspired from the banking organization where the risk has a veto right and establishes limits. Several organizations should be possible. We believe that analysts may also give recommendations and that the final decision should be up to the investment management. There is a question on the ultimate investment responsibility.

It can be done by the (professional) client, but in any case the asset manager must indeed make use of its own judgment on these limits and risks.

***10. Subject non-investment grade financial products to enhanced scrutiny, including bifurcation of the internal ratings of investment and non-investment grade securities, e.g., a separate review process.***

We would recall that asset managers' organisations are linked to their particular activity which is done for third party money investment management throughout collective funds or clients' mandates.

AFG members believe that making reference to IG/HY defined by CRAs in the context is not very appropriate. We would also suggest to rather draft this principle as:
***"10. Enhance scrutiny on more risky positions"*.**

***11. Avoid mechanistically relying on external CRA ratings. View such ratings as only one factor among several that may be used in a comprehensive credit assessment process. Carefully consider the effect of using external credit ratings as parameters to assess the creditworthiness of investments or to decide whether to invest or disinvest. Recognize and understand the possible limitations of CRA ratings and become familiar with CRA credit risk assessment methodologies. For example, CRA ratings could be a lagging indicator of more general credit risks and do not always reflect the most recent factors affecting creditworthiness.***

We agree with this important principle. We remind that we should be able to keep a common external reference/common opposable language to communicate with clients and counterparties. This does not mean we should have to systematically challenge CRAs on their methodologies (this is not how analysts define their work).

Thus, we would reformulate so that the principle be applicable to all sectors:

***"11. Avoid mechanistically relying on external CRA ratings. View such ratings as only one factor among several that may be used in a comprehensive credit assessment process. Carefully consider the effect of using external credit ratings as parameters to assess the creditworthiness of investments or to decide whether to invest or disinvest."***

***12. Strive to update and improve continually the firm's credit risk assessment practices to help ensure that they remain abreast of developments that could have a material adverse effect on the firm's portfolios and counterparty relationships.***

We agree with this principle.

***13. Ensure internal audit or another independent party performs regular reviews of credit policies and procedures.***

We agree with this principle.

If you need any further information, please don't hesitate to contact Adina Gurau Audibert (a.gurau.audibert@afg.asso.fr) or Eric Pagniez (e.pagniez@afg.asso.fr).

Sincerely Yours,

Eric Pagniez