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June 16, 2015

IOSCO Issues Final Report on Reducing Reliance on Credit Rating Agencies in Asset Management

[29094]

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TO: FIXED-INCOME ADVISORY COMMITTEE No. 21-15
ICI GLOBAL REGULATED FUNDS COMMITTEE No. 33-15
INVESTMENT ADVISER MEMBERS No. 16-15
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 21-15
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 12-15
INTERNATIONAL MEMBERS No. 22-15
SEC RULES MEMBERS No. 40-15
SMALL FUNDS MEMBERS No. 28-15 RE: IOSCO ISSUES FINAL REPORT ON REDUCING RELIANCE ON CREDIT RATING AGENCIES IN ASSET MANAGEMENT

On June 8, the International Organization of Securities Commissions ("IOSCO") published its final report titled "Good Practices on Reducing Reliance on CRAs in Asset Management" (the "Report"). [1] The Report follows IOSCO's 2014 consultation report of the same name (the "Consultation"). [2] Addressed to national regulators, asset managers, and investors, the Report "suggests specific practices that asset managers could undertake to reduce any potential over-reliance on external credit ratings in the asset management space."

The Report discusses how asset managers internally assess credit, along with several topics related to their uses of external credit ratings (issued by credit rating agencies, or "CRAs"), including asset managers':

- Access to underlying credit rating information;
- Disclosures on uses of external credit ratings;
- Assessment of the quality of counterparties and collateral; and
- Management of external credit rating changes.

IOSCO's final list of good practices directed to asset managers is as follows:

- Asset managers make their own determinations as to the credit quality of a financial instrument before investing and throughout the holding period.
- Asset managers have the appropriate expertise and processes in place to perform

credit risk assessment appropriate to the nature, scale and complexity of any investment strategy they implement and the type and proportion of debt instruments they invest in, and should refrain from investing in products / issuers when they do not have enough information to perform an appropriate credit risk assessment.
- External credit ratings may form one element, among others, of the internal assessment process but do not constitute the sole factor supporting the credit analysis.
- The manager's internal assessment process is regularly updated and applied consistently.
- Where external credit ratings are used, asset managers understand the methodologies, parameters and the basis on which the assessment of a CRA was produced, and have adequate means and expertise to identify the limitations of the methodology and assumptions used to form that assessment.
- Asset managers review their disclosures describing alternative sources of credit information in addition to external credit ratings and make available to investors, as appropriate, a brief summary description of their internal credit assessment process, including how external credit ratings may be used to complement or as part of the manager's own internal credit assessment methods.
- When assessing the credit quality of their counterparties or collateral, asset managers do not rely solely on external credit ratings and consider alternative quality parameters (e.g., liquidity, valuation, correlation, etc.).
- Where external credit ratings are used, a downgrade does not automatically trigger the immediate sale of the asset. Should the manager/board decide to divest, the transaction is conducted within a timeframe that is in the best interests of the investors.

The Report also discusses investor reliance on external credit ratings, including references to external credit ratings in individual investment mandates and investor use of fund ratings.

The Report's descriptions of asset managers' and investors' use of external credit ratings and the good practices themselves are not substantially different from those found in the Consultation. IOSCO recognizes in the Report's conclusion that "asset managers do not appear to have a mechanistic approach towards external credit ratings, but generally tend to have a robust internal credit assessment process in which external credit ratings usually form only one element among others to be taken into consideration before making an investment decision." IOSCO then provides a contrasting and less positive assessment of investors' reliance on credit ratings, however, noting that various forms of reliance on external credit ratings remain on the investor side. [3] To address these concerns, IOSCO recommends "considering potential ways to reduce possible investor overreliance on external ratings as a result of references in regulatory requirements." We will keep you informed of further developments in this area.

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endnotes

[1] Available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD488.pdf.

[2] See Institute Memorandum No. 28189, dated June 16, 2014, for a summary of the Consultation. ICI Global submitted a comment letter in response, available at http://www.iciglobal.org/pdf/28365.pdf. Our letter supported IOSCO's efforts to set forth good practices for asset managers to consider with respect to their use of credit ratings. However, we recommended that, rather than seeking to broadly discourage reliance per se, IOSCO focus on offering suggestions for reducing inappropriate over-reliance on credit ratings.

[3] For instance, the Report notes, apparently with some discomfort, that "[s]ome investors use ratings in investment mandates to set strict restrictions on the range of permitted investments."