MEMO# 28315

August 15, 2014

Draft Letter in Response to IOSCO's Consultation Report on Reducing Reliance on Credit Rating Agencies

[28315]

August 15, 2014

TO: FIXED-INCOME ADVISORY COMMITTEE No. 13-14
ICI GLOBAL REGULATED FUNDS COMMITTEE No. 7-14
INTERNATIONAL COMMITTEE No. 26-14
INVESTMENT ADVISERS COMMITTEE No. 6-14
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 20-14
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 16-14
SEC RULES COMMITTEE No. 33-14
SMALL FUNDS COMMITTEE No. 20-14 RE: DRAFT LETTER IN RESPONSE TO IOSCO’S CONSULTATION REPORT ON REDUCING RELIANCE ON CREDIT RATING AGENCIES

Attached is our draft comment letter in response to the consultation report issued by the International Organization of Securities Commissions (“IOSCO”) titled “Good Practices on Reducing Reliance on CRAs in asset management” (the “Consultation”). [1] The Consultation, prepared by IOSCO Committee 5 on Investment Management, seeks information about the views and practices of investment managers, institutional investors, and other interested parties, with a view to developing, later this year, a final set of good practices on reducing reliance on external credit ratings in the asset management industry.

Informed to a large extent by our member calls, the draft letter supports IOSCO’s efforts to set forth good practices for investment managers to consider with respect to their use of credit ratings. However, we recommend that, rather than seeking to broadly discourage reliance per se, IOSCO focus on offering suggestions for reducing inappropriate over-reliance on credit ratings.   As you will see, we pose questions to and ask for information from members in the body of the draft, including the following:

- Is there anything more concrete we can say in the letter regarding the importance of credit risk to the overall risk profile of a fund (see page 3)? And how good of a proxy for changes in credit risk are changes to credit ratings of underlying holdings?
- Please let us know if you have any suggestions for expanding/revising the paragraph

in the letter regarding the sources of information that investment managers rely upon in conducting their credit analysis. Also, (i) please let us know how ratings changes affect and are accounted for within your internal risk models, and (ii) please let us know if your credit risk models differ depending on the type of fund or investment (e.g., money market funds, bonds funds, structured investment vehicles, etc.).

- Please confirm that the discussion regarding differences in internal models for credit assessment, and what drives them, is accurate.
- Please let us know if you use credit ratings in assessing counterparties in ways not otherwise described in the letter, and how important credit ratings are in your selection and continued engagement with counterparties.
- The letter includes a discussion of how fund advisers manage collateral. Please let us know if this discussion would accurately depict practices in non-U.S. jurisdictions as well.
- Please confirm that the letter's discussion of credit evaluations of guarantors and other providers of credit support is accurate. Also, please let us know if you make use of credit ratings for guarantors and/or sponsors in unique ways not otherwise discussed in the letter, and whether credit rating downgrades result in any actions on your part (e.g., whether a downgrade of a guarantor or sponsor would cause you to sell the investment).
- The letter suggests that, notwithstanding recent SEC form amendments, we expect that [many/most] of our U.S. fund members will continue to present credit quality information for portfolio holdings in annual and semi-annual reports by reference to CRA credit ratings. Please confirm.
- The letter includes a discussion of pricing services' use of credit ratings. Please let us know if this would accurately depict practices in non-U.S. jurisdictions as well.
- Please let us know if there are other common uses of credit ratings not addressed in the letter or IOSCO's Consultation.
- The letter discusses how, in the U.S., regulation would not require a fund to sell a downgraded security (although a particular fund policy, depending on how restrictive, might). Please let us know if this would be true in non-U.S. jurisdictions as well.
- If an underlying holding of a performance benchmark index were to be downgraded and removed from that index, would this have an effect on your assessment of the security if you held it? Also, for those of you with index bond funds, would changes to the credit ratings of the index's underlying holdings cause you to reevaluate the continued use of that index?

Because of this letter's focus on credit analysis practices, we very much welcome your comments. If you have any comments on the draft letter and/or responses to the items posed above, please contact me at matt.thornton@ici.org or (202) 371-5406 by no later than Wednesday, August 27 (close of business). The deadline for submitting the comment letter is Friday, September 5.

Matthew Thornton
Assistant Counsel

Attachment

endnotes

[1] Available at www.iosco.org/library/pubdocs/pdf/IOSCOPD442.pdf. See Institute Memorandum No. 28189, dated June 16, 2014, for a summary of the Consultation.
