APFI Response to ESMA: Ref 27.02.15/APFI

Dear ESMA,

Discussion Paper: 'The Use of Credit Ratings by Financial Intermediaries Article 5(a) of the CRA Regulation'

The Association of Professional Fund Investors ('APFI') has gratefully responded to your invitation to provide comments. The APFI believes that fund investor bodies (such as the APFI) should also be properly involved in these discussions rather than ostensibly driven by trade bodies representing fund manufacturers. As an overriding backdrop the APFI seeks a credit rating regime among asset firms, fund managers and mutual funds that provides:

a) Fair transparent assessment and indication of credit risk for all fund investors
b) Fair competition between large and smaller asset managers
c) Fairness to cross border fund investors and consistency cross broader
d) Credit comparisons are fair and representative

Questions for Financial Intermediaries

Q9. To what extent do your business lines use external ratings? Please specify by activity. Q9 i) What are the main reasons to use external ratings in contractual agreements?

A) External credit ratings are regularly used by fund investors to set credit risk policy limits and for the setting of investment mandate restrictions for fund managers. E.g. The most common being the allowable exposure to High Yield bonds (sub-investment grade)

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

A) A common safeguard is the use of dual or multiple credit ratings. Most fund managers also use interval ratings systems, supplemented by external credit ratings.

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

A) The criticisms of external ratings were well populated following the credit crisis of 2007-2009, that agencies can appear aloof and unaccountable for ratings issued (addressed in part by Glass-Steagle). Credit ratings may imply or be misinterpreted as market ratings, agencies follow review schedules which can create lag between rating and current financial position, analyst error, slowness to respond to events, ambiguous application of outlook ratings, poor past practices in the treatment of packaged and collateralised debt.

The main advantages are the high level of market scrutiny and helps support broader market efficiency by setting common ratings that are universally used. Agencies often have more dedicated resources to generate and maintain ratings whereas many internal ratings are formulaic and quantitative driven.

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?

A) We do not have a clear view on the respective methodologies between agencies, which ; while regularly published, often belie less transparency and ambiguity. We instead assess the timeliness, nimbleness and accuracy of ratings on an empirical basis. We not the high proliferation of agencies globally makes forensic assessment of methodologies impractical for most market participants.

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?

A) The most obvious examples stem from the treatment of CDOs and CMBS through 2007. We approach assessment illiquid debt, private debt and CLVs with some caution. We also believe the treatment of done sovereign issuers has appeared to draw in political factors and confuse interpretation. E.g. US, France and UK over last few years.

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?

A) Fund investors often rely on the risk systems of outsourced fund managers while stating thresholds into risk frameworks.

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

A) N/a

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

A) N/a

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

A) Not response.

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

A) The key challenge would be the absence of a common set of credit rating standards among fund managers. We also believe these measures would unfair benefit large well resourced asset firms over smaller firms and thereby damage competition in this sector.

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

A) We expect the assessment of credit risk would become less controlled and may have significant impact on both active and passive funds. E.g. Screened ETFs.

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

A) No, thank you.

About the APFI:

History Founded in 2011, the Association of Professional Fund Investors was created by and for its membership. It enables professional fund investors to share ideas, ensure best practices and network with their peers.

Our Aim APFI is dedicated to the advancement of the interests of professional fund investors and voicing the collective perspective of its members concerning key topics and trends within the global asset management industry.

Our Focus At its core, APFI serves as a forum for its members to drive the development and the exchange of global best practices in the areas of research, analysis, due diligence and selection of asset management products. APFI seeks to build strong collegiate relationships among its members through a global networking framework. APFI advances the voice and perspective of the professional investor to industry dialogues on product development, regulatory and distribution topics concerning the global asset management industry. For more information go to: www.profundinvestors.com

For and on behalf of the APFI, Jon 'JB' Beckett, Chartered MCSI

Association of Professional Fund Investors