BLACKROCK

February 27, 2015

Joint Committee of the European Supervisory Authorities

European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London E14 5AA, UK

European Securities and Markets Authority
103 rue de Grenelle
75345 Paris Cedex 07, France

European Insurance and Occupational Pensions Authority
Westhafenplatz 1
60327 Frankfurt am Main, Germany

Submitted via electronic submission

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

Dear Sirs,

BlackRock is pleased to have the opportunity to respond to the discussion paper 'The Use of Credit Ratings by Financial Intermediaries'.

BlackRock is a premier provider of asset management, risk management, and advisory services to institutional, intermediary, and individual clients worldwide. As of 31 December 2014, the assets BlackRock manages on behalf of its clients totalled €3.83 trillion across equity, fixed income, cash management, alternative investment and multi-investment and advisory strategies including the iShares® exchange traded funds.

BlackRock has a pan-European client base serviced from 22 offices across the continent. Public and private sector pension plans, insurance companies, third-party distributors and mutual funds, endowments, foundations, charities, corporations, official institutions, banks and individuals invest with BlackRock.

BlackRock represents the interests of its clients by acting in every case as their agent. It is from this perspective that we engage on all matters of public policy. BlackRock supports policy change and regulatory reform globally where it increases transparency, protects investors, facilitates responsible growth of capital markets and, based on thorough cost-benefit analysis, preserves consumer choice.

We welcome the opportunity to address, and comment on, the issues raised by this consultation and we will continue to the use of credit ratings by financial intermediaries with the ESAs on any specific issues that may assist in improving the final guidelines.

BlackRock agrees with the principle that asset managers must not mechanistically rely on credit rating agency ("CRA") ratings for assessing the creditworthiness of assets, however, we also believe that CRA reform should focus on preserving the utility of credit ratings.

In our experience, credit ratings have value for asset owners. Asset owners (the "end clients") include pension plans, insurance companies, official institutions, banks, foundation endowments, family offices, and individual investors. Third party credit ratings provide asset managers and assets owners with a common language as they represent independent and standardized opinions of credit risk across asset classes. Minimum investment criteria that reference third party ratings provide direction to asset managers as to what securities the asset owner considers appropriate for inclusion in a portfolio. Average credit ratings or similar calculations using independent ratings facilitate asset owners' comparison of the risk and return of different portfolios. Credit rating agencies also provide a level of independent monitoring and analysis that is difficult for these asset owners to pursue on their own. We therefore believe that the use of credit ratings in investment guidelines should be preserved. Their absence would leave asset owners exposed solely to the asset manager's assessment, for example, of whether a security is investment grade or high yield and would undermine the asset owners' ability to consider the risks undertaken within a portfolio, and to compare risk and performance across portfolios.

BlackRock also considers that much of the debate around "cliff" effects associated with downgrades conflates how asset managers use credit ratings with how asset owners use them. Each asset owner has its own investment objectives, time horizon, risk tolerance, etc., which shape how it may react to the downgrade of a particular security. In addition, asset managers have specifically built in flexibility into Investment Management Agreements (IMAs) and fund prospectuses so that they do not have to act mechanistically should a downgrade breach the investment guidelines but instead act in the best interests of the asset owner. Finally, according to McKinsey & Company, more than three-quarters of world financial assets are managed directly by the asset owner with the remaining one quarter outsourced to asset managers[1]. The focus on references to credit ratings in the contracts between asset owners and asset managers (IMAs or fund prospectuses) pertains to a proportion of these outsourced assets. We believe that this should be taken into consideration when considering any potential transmission of systemic risk arising from the reference to credit ratings in private contracts. In conclusion, we do not believe that eliminating the reference to credit ratings in private contracts is appropriate to achieve the intended financial stability objectives of credit rating reform.

We appreciate the opportunity to address and comment on the issues raised by the discussion paper and would welcome further discussion on any of the points that we have raised.

Yours faithfully,

Joanna Cound
Managing Director
Government Relations and Public Policy
joanna.cound@blackrock.com
+44 207 743 5579

Jeremy Agnew
Managing Director
Legal and Compliance
jeremy.agnew@blackrock.com
+44 207 743 4303

1 Source: McKinsey & Company. "Strong Performance but Health Still Fragile: Global Asset Management in 2013. Will the Goose Keep Laying Golden Eggs?"

Responses to questions

Questions for Financial Intermediaries

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

External credit ratings are used by asset management firms as an input to guide asset selection, guide the selection of eligible collateral, and assess a counterparty's overall financial health. However, they are just one component that an asset management firm should consider in the course of determining and monitoring the creditworthiness of an instrument or issuer. We perform our own credit analysis on a wide range of issuers and instruments, including investment grade and high yield credits as well as sovereigns and rates.

With respect to asset selection, credit ratings often define the "universe" of securities that active asset managers can choose from, based on their contracts with asset owner clients. Credit ratings provide a common language to communicate with asset owners in terms that are universally understood. Within that universe, asset managers undertake their own in-depth credit analysis typically using several other metrics to determine whether a security is fit to be included in a given portfolio. As such, credit ratings are just one component that an asset manager should consider in the course of conducting credit analysis on a security. They serve as an initial screen for asset managers and do not replace their responsibility to conduct their own credit analysis both prior to a security's inclusion in a portfolio and throughout the holding period.

BlackRock also considers credit ratings as one input into the selection of high quality securities as eligible collateral. Other factors include the type of collateral being taken (i.e. foreign security of a particular country, a long dated security, etc.) as well as the country of risk.

With respect to counterparty risk, BlackRock has a dedicated counterparty and concentration risk team that conducts reviews of the creditworthiness of all counterparty legal entities for approval before trading, and monitors these on an ongoing basis. The review and monitoring process looks to a number of public sources to analyse counterparties on a quantitative and qualitative basis.

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

Protection for asset owners: BlackRock maintains extensive credit research and risk management resources covering many sectors and tenors of the yield curve allowing us prudently and rationally to assess the credit risk of issuers or specific debt issues. It is our clients, however, who benefit from external credit ratings as they use them to compare portfolios and to communicate their minimum requirements to their asset management firm. References to third party credit ratings in investment guidelines should be preserved: external credit ratings provide asset owners with an important protection as they act as a benchmark or a reference point and represent independent and standardized opinions of credit across asset classes. Average credit ratings or similar calculations, using independent ratings, facilitate asset owners' comparison of portfolios managed by different asset managers. Moreover, the absence of independent ratings would leave asset owners exposed solely to an asset management firm's assessment of, for instance, whether a security is investment grade or high yield.

Common language: Because external credit ratings act as an independent benchmark, they also provide a common language for communication between asset owners and asset managers in terms that are universally understood. References to third party ratings in investment guidelines and fund prospectuses play an important role in ensuring that asset owners' expectations with respect to how their assets are to be managed are clearly communicated. Minimum investment criteria that reference third party ratings provide direction to asset management firms as to what securities the asset owner considers appropriate for inclusion in a portfolio. Even sophisticated institutional investors use credit ratings as a standardised means of discussing credit risk.

Regulations: We believe that prudential regulations such as Basel III for banks and Solvency II for insurance companies will significantly increase asset owner demand for contractual reliance on external credit ratings for capital and liquidity purposes. We do not believe that this will be mitigated in the short or medium term given the long gestation and implementation periods for both Basel III and Solvency II. Another example of external credit ratings being mandated by asset owners due to regulation is provided by the Versicherungsaufsichtsgesetz (German Act on the Supervision of Insurance Undertakings commonly referred to as the “VAG Rules”). This includes a requirement that German insurance companies do not invest in unrated securities and, in the case of asset backed securities and mortgage backed securities such securities must be investment grade of higher. Moreover, it is not possible under the VAG rules to rely entirely on “internal” credit assessments. Typically, two investment grade ratings are required and at least one of those ratings must be from an external regulated credit rating agency.

ISDA Master Agreements: Our International Swaps and Derivatives Association (ISDA) Master Agreements typically include provisions linked to the external credit ratings of our dealer counterparties. It would not be acceptable to our dealer counterparties to link contractual rights (such as margin or termination rights) to subjective measures such as the manager’s internal ratings of the dealer.

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

As an asset manager, BlackRock must act in accordance with the IMAs and fund prospectuses. Asset managers are responsible for acting in the best interests of their clients based on the predetermined criteria and guidelines specified in a given IMA or a prospectus.

The decision to sell a particular asset will be based on the asset manager’s own credit evaluation and monitoring processes and policies and the clients’ objectives as reflected in the parameters of the IMA or, in the case of funds, in the prospectus. Any requirements for external ratings for particular assets will generally apply at the time of the purchase of the relevant assets. If the asset is subsequently downgraded, it will be a decision for the asset manager, acting in the best interest of the investors, as to whether and how to dispose of the asset. Where there is no contractual obligation in the IMAs or prospectuses to rely on external credit ratings or if a change in the external rating does not contravene the IMA or the prospectus, then we would consider this change only as a factor (which we may find relevant or irrelevant) among many other factors determining the ultimate risk level of a specific portfolio.

In the event that an IMA or a fund prospectus requires that the assets maintain a particular credit rating and an asset is subsequently downgraded below a minimum level set in the relevant document, flexibility is generally built into the IMA or fund prospectus to avoid, for example, unnecessarily liquidating securities and potentially realizing a loss. In the event that a portfolio holding is downgraded below its credit quality guidelines, typically BlackRock will notify the client or fund board and provide an evaluation and a plan of action. The asset manager will generally be permitted by the asset owner to hold or sell the security based on the view of the asset manager’s credit research team and current market conditions.

We would also stress that the purpose of our credit risk analysis is to protect our clients and one of the ways in which we try do so is by acting in advance of the credit rating agencies where we believe that this is in the best interests of our clients. The ongoing monitoring process informs the portfolio manager regarding the characteristics of assets which could give rise to internal heightened scrutiny in advance of a downgrade by a CRA. Indeed, our money market credit analyst team acts on average eight months prior to a credit rating downgrade of securities held in our money market funds. In the past 9 years, out of the 93 issuers on the cash approved lists, 91 were acted on in advance of the downgrade.

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

As stated in our answer to Question 9, asset owners benefit primarily from the use of the external credit ratings, as they use them to compare the performance of individual asset management firms and to communicate their minimum requirements to their asset management firm. The absence of independent ratings would leave asset owners exposed solely to the manager's assessment of credit risk; for example, of whether a security is "investment grade" or "high yield".

In addition, credit rating agencies provide a level of independent monitoring and analysis that is difficult for asset owners to pursue on their own. For example, credit rating agencies are recipients of material non-public information on issuers, such as future financing plans, to which asset owners are not privy. A ban on external ratings or limitation of their use in private contracts would also be punitive on asset owners as they will otherwise have to commission such ratings at their own expense.

Credit rating agencies also provide a useful service from the asset management perspective. CRA's "negative watch" actions remain a valuable additional data point and input into our credit analysis and ongoing credit monitoring process. For securitisations in particular, CRAs provide almost a "gatekeeping" service for the market in performing an independent review of the underlying transactions documents. As an additional element of transparency, we would advocate that data underlying ratings decisions should be disclosed to investors. This would allow investors better insight into a rating agency process and the accuracy of its data analysis, thereby creating incentives to enhance the credit ratings process. For a main fund trading counterparty, the downgrade of a credit rating should lead the asset manager to consider their on-going ability to meet their obligations for all open transactions. A downgrade does not immediately indicate that the counterparty will default and as such the asset manager would be expected to have undertaken their own assessment of each trading counterparty. Similarly, an asset manager should react in short order to reassess the eligibility of a downgraded collateral security as the collateral held by a fund is required to be of high quality and liquidity and the fund has to rely on the ability to sell that security at any time with minimum price volatility when the fund may be a forced seller in the market.

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?

Yes.

Each CRA that BlackRock uses has their unique specific process of assigning credit ratings to particular sectors. For example, there will be an established methodology for rating sovereigns, banks, auto asset-backed securities ("ABS"), and residential mortgage-backed securities ("RMBS"). The algorithms that each CRA uses will establish a whole series of quantitative and qualitative factors that each firm or structured finance vehicle is measured by and why specific ratings are assigned to each.

We *must* understand each CRA's methodologies in rating that particular asset class as well as the particularities of each. It is not very significant if one CRA's methodology is better than another's for a given asset class; what is most important is that we know the reasoning used by the CRA in assigning the rating. A CRA should be required to publicly disclose any material modification to a credit rating methodology or the intention to modify a rating methodology at the time when the decision to make a modification is made.

Whilst truly proprietary information must be kept confidential, we would recommend all other information received by the ratings agencies during the ratings process be disclosed. This is particularly important for securitized assets. Ideally, the industry would move to standardized disclosure for each type of collateral for the initial pool of assets in the securitized instruments, and issuers and/or servicers would update information regarding the performance of the assets in the pool over the life of the transaction to facilitate ongoing surveillance of the securities. This enhanced transparency would allow investors to review the data underlying CRAs' ratings opinions, allowing better insight into a CRA's process and the accuracy of its data analysis. This provision will also facilitate regulatory oversight and incentivise a more robust and objective credit rating process.

In the case of our Money Market Funds (MMFs) business, where credit analysts have to meet strict requirements in their assessment of the assets' quality from the CRAs, we would make a deep assessment of the CRAs' methodologies and compare them with each other. Taking Moody's and S&P as examples, when we decided many years ago about the eligibility of using their ratings, we not only mapped out the procedures they used to get to the end result, we also assessed the historical track record of each of these CRAs pertaining to the accuracy of their past ratings through several credit cycles (via the use of ratings transition matrices; by assessing these CRAs ability to estimate default rates of the asset class; etc.). By using historical data from several credit cycles, we independently assessed each CRA's ability to forecast material downgrades and default during the most distressed periods. We followed the procedure below:

- Review criteria of sector methodologies.
- Review the variables each agency uses for business position and financial condition.
- Compare and contrast factor weightings in the criteria methodologies.
- Analyze comparability of rating medians by rating factor.
- Review the rating administrative process (e.g., what does a rating outlook mean; timeline for outlook; watchlisting; rating action; historic predilection regarding outlook and watchlisting – percentage of observations leading to action in line or in opposition to outlook and watchlisting).
- Review annual filing by CRAs regarding rating actions and validation or lack thereof of those actions (i.e., determining whether a downgrade subsequently results in further deterioration in business position or financial condition).

In the case of long term bond funds, which have more flexibility to invest in fixed income securities with a lower and more variable external rating profile than what is required for Triple-A rated MMFs, we would not review the CRAs' administrator process on a regular basis. We are mainly a data receiver and would only take the CRAs' ratings into consideration as additional information in our internal credit assessment as long as this does not contravene client mandates.

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?

Credit troubles in securitisations, which began prior to the 2007-2008 financial crisis, largely stemmed from "originate to distribute" business models where a focus on volume rather than quality resulted in poor underwriting and lending decisions. This was exacerbated by "ratings shopping" among issuers – a practice where sponsors solicit feedback from rating agencies prior to engaging the agency to rate the issue – coupled with some investors relying too heavily upon credit ratings as an indicator of the empirical risk of securities. The result was poor-quality securitisations created and purchased. With falling prices, many vehicles breached market value triggers, forcing further asset sales. As securities became less liquid, the result was higher losses for investors, who were unable to realise what they believed to be their fair value. These types of structured vehicles no longer exist. Additionally, structures such as securitised product CDOs, which allowed for the re-securitisation of lower-rated securities into more highly rated bonds, proved to be very opaque due to multiple layers of risk, which led to somewhat unanticipated losses on highly rated securities. These types of structures are also now obsolete.

The experience in Europe differs in many ways. The term ABS and RMBS securities whose underlying loans were made to European consumers did not suffer from the same levels of poor performance, material ratings downgrades or defaults that were experienced in the US. In fact, during and following the market distress from 2007 to 2008, defaults on loans remained low in Europe compared with the US. This difference can, at least in part, be attributed to the Consumer Credit Codes established by EU governments, which provided consumers with an incentive to meet their obligations in full.

BlackRock notes that one of the key issues that led to abuses in the lead up to the crisis was that upcoming modifications to ratings methodologies were sometimes known by issuers before their effective date, which in some instances provided a distorted incentive to time the issuance of securities to obtain a better rating. This example was particularly prevalent in the ratings of structured finance securities. In many instances, this situation led to information asymmetries and improper ratings that had a negative impact on investors and ultimately the capital markets. This provision in the CRA Code of Conduct should be revised so as to prohibit this situation from arising again in the future.

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?

For each asset we invest in, BlackRock has both a team dedicated to in depth internal credit analysis and a team making the investment decision (the portfolio managers). These two different teams interact on an ongoing basis on potential investments. The credit analysts give recommendations to the portfolio managers. For Triple-A rated MMFs, portfolio managers can only invest in issues of issuers included on the MMF Approved Lists established by the credit analysts. In the case of our bond funds, the portfolio managers can also use on external sources of credit research, such as broker/dealers and banks, and have the discretion to accept or reject these recommendations.

BlackRock adopts different internal assessment models based on a variety of factors for each type of investment management vehicle. We outline below a description of our internal assessment models for MMFs and long term bond funds.

Money Market Funds (MMFs)
MMF credit analysts have to rely on external credit ratings from the starting point for MMF credit analysis as they define the universe on which the analyst performs further research and analysis. Requirements can come from the CRA that is rating the MMF itself (S&P or Moody's in our table below), the industry body (Institutional Money Market Funds Association (IMMFA) in our table below) and/or regulations (Rule 2a-7 under the Investment Company Act of 1940 in the US, ESMA guidelines in the EU in our table below).

Summary of Requirements for MMFs based on external credit ratings

Criteria	S&P	Moody's	Rule 2a-7	IMMFA	ESMA
Liquidity	Min. 50% A-1+ & A-1 < 5 days		Min. 10% in 1 day, Min 30% in 7 day; no more than 15% illiquid	Min. 10% < 1 day Min 20% < 5 days	
Fund rating	AAAm	Aaa-mf		AAA rated by 1+ rating agency	High quality instruments (≥ A-2, P-2 or F2 or IG for sovereign debt in Standard MMFs) or deposits[2]
Credit quality within funds			>97% of all investments rated 1st Tier[3]	Min. A1 or P1 or F1. 2nd Tier exposures are prohibited period	Min. A1 or P1 or F1

Diversification	Max 5% per issuer, except for: •Max. 10% in o/n bank deposits rated >A-1 or A+ •Max. 10% in another S&P rated fund •Max. 33% in Sovereign related/guaranteed entity rated > AA- •Collateralised Repo issuer limits: A1+: 50% (o/n) / 10% (2-5 days) / 5% > 5d		Generally (taxable fund): 5% of its total assets in securities issued by the issuer of the security, provided, however, that such a fund may invest up to 25% of its total assets in the first tier securities of a single issuer for a period of up to three business days after the acquisition thereof	Max. 5% per issuer ,except for: • Can be up to 10% for up to 5 BD • Max. 25% with repo counterparties unless counterparty is a AAA sovereign or sovereign-guaranteed	

Source: BLK

2 ESAs consulted the industry in 2013 on whether to remove the reference to CRA ratings to define high quality instruments so this might change in the future.

3 The SEC is currently reviewing the reference to credit ratings in the Rule 2a-7 and has a rule proposal to remove the references out for comment.

While a MMF credit analyst must conduct long tailed analysis of each and every issuer (top-down analysis which includes the fiscal health of the issuer's sovereign; the industry risk of the issuer, and firm-specific assessment strength); the prime variable that the analyst must review is the liquidity profile of that issuer. This entails the following:

- What is the size and quality of the liquidity buffer the bank or non-financial corporation has?
- Does the bank or non-financial corporation have the capacity to draw on these liquidity reserves if needed to meet all debt maturities during the next 397 days if operating cash flow is not high enough to be able to meet those maturities as they fall due? This includes not only a deep assessment of the firms' liquidity structure but also an assessment of money market conditions overall that are placing immediate stress upon the issuer.
- What are the amounts and the timing of debt maturities over the next 397 days?
- Does the bank or non-financial firm have unhedged floating rate debt that could rapidly elevate annual debt service costs and that may need to be met by liquidating a portion of the liquidity buffer during the next 397 days?

Long term bond funds or funds that can invest in bonds that have a residual maturity of > than 397 days

These funds have more flexibility to invest in bonds or other fixed income securities with a lower and more variable external rating profile than is required of Triple-A rated MMFs. Many of these bond funds only have an investment grade standard at the time of purchase of a bond. Since these funds are floating NAV funds, principal stability, while important, is no longer the top priority for the portfolio management team as it is for constant NAV MMFs. The fundamental or long-tailed analysis of each of the bonds in the long term bond fund now includes a 'relative value' assessment which entails the aggregation of:

- An analysis of the issuer's credit spread (bond's nominal yield - risk-free rate at a certain tenor) relative to other issuers in that same industry but also relative to other comparatively rated issuers for that specific term that are currently being traded. The "cheapness" or "richness" of a particular bond can only be determined by conducting a deep fundamental analysis of the issuer, other issuers in that industry, and the industry overall. Another term for this is 'spread duration' analysis.
- An analysis of the overall duration of the bond measuring how that bond's price would change if the level of interest rates fluctuate during the term of the bond (by a parallel shift in the Treasury yield curve for example). This is a general measure of the 'interest rate risk' of a bond.

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

Please see answer to Q13.

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

Our internal credit risk assessment is continuous and dynamic. Different measures are used, both point-in-time and through-the cycle.

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

BlackRock agrees that asset managers should not mechanistically rely on external credit ratings, that these should only be one input to the investment process and not a substitute for the comprehensive credit analysis carried out by the asset management firms. We would support a review of national and European regulation to assess whether references to external credit ratings are restricting the asset allocations of asset owners in inappropriate ways. However, we would warn about restricting the use of CRA ratings in IMAs or fund prospectuses as this would undermine asset owners' ability to better understand and consider the risks and to compare risk and performance across portfolios.

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

We do not believe that we are reliant on external ratings as we invest considerable resources in our internal credit analysis. BlackRock also has a dedicated counterparty and concentration risk team that conducts reviews of the creditworthiness of all counterparty legal entities for approval before trading and monitors these on an ongoing basis. The review and monitoring process looks to a number of public sources to analyse counterparties on a quantitative and qualitative basis.
However, to the extent that credit ratings form the starting point of our internal analysis, this normally reflects the requirement of asset owners to fulfil their regulatory obligations or their appetite for a certain risk profile which expressed in external credit ratings. These requirements can be written into the investment approval processes and documentation of the asset owner – for example, the investment guidelines of many asset owners specify that they can only invest in MMFs that are Triple-A rated by one or more credit rating agencies.

In the specific case of fixed income index funds (tracking the performance of a particular index) the portfolio manager is likely to be required to remove an asset from the portfolio should this asset be taken out of the index following a CRA downgrade irrespective of any internal credit assessment. However, there are fairly few standard fixed income indices which are specifically tied to external credit ratings (aside from the investment grade/non-investment grade distinction). Most index funds do not add any additional ratings constraints (e.g. "the fund must maintain an average credit rating of AA") since a downward migration of external credit ratings might make that fund impossible to manage if the constituents no longer meet such criteria.

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

Much of the debate around "cliff" effects associated with downgrades conflates how asset managers use credit ratings with how asset owners use them. Each asset owner has its own investment objectives, time horizon, risk tolerance, etc., which shape how it may react to the downgrade of a particular security.

In addition, asset managers have specifically built in flexibility into IMAs and fund prospectuses precisely so that they do not have to act mechanistically should a downgrade breach the investment guidelines but instead act in the best interests of the asset owner (which may be to continue to hold a security rather than to effect a forced sale).

Finally, according to McKinsey & Company, more than three-quarters of world financial assets are managed directly by the asset owner with the remaining one quarter outsourced to asset managers[1]. The focus on references to credit ratings in the contracts between asset owners and asset managers (IMAs or fund prospectuses) pertains to a proportion of these outsourced assets.

We believe that it is important to take all these factors into consideration when considering any potential transmission of systemic risk arising from the reference to credit ratings in private contracts.

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

We believe that care must be taken to differentiate how asset owners use credit ratings as opposed to how asset management firms use them; much of the debate around "cliff" effects associated with downgrades conflates the two. Given the diversity and heterogeneity of types of asset owners, it is very difficult to make generalizations about their reactions to a change on external credit ratings. Each asset owner has its own investment objectives, time horizon, risk tolerance, etc., which shape how it may react to the downgrade of a particular security.

We are supportive of efforts to enhance disclosure of the underlying data provided to the CRAs to asset owners and asset management firms. We feel that disclosure of all material information on which the rating is based (subject to proprietary and confidential sensitivities) and rating criteria is important. This is particularly true for securitized asset transactions.

1 Source: McKinsey & Company. "Strong Performance but Health Still Fragile: Global Asset Management in 2013. Will the Goose Keep Laying Golden Eggs?"