

27/02/15

AXA Investment Managers' response to Joint Committee's Discussion Paper on the Use of Credit Ratings by Financial Intermediaries

Dear Messrs. Maijoor, Bernardino and Enria,

AXA Investment Managers (AXA IM) is glad to respond to the Joint Committee's Discussion Paper on the use of credit ratings by financial intermediaries.

Through its global reach - over 10,000 clients, 1,700 funds and mandates, 21 locations and € 623 billion of assets under management - as well as its asset management mix (c. € 400 billion of assets invested in fixed income financial instruments), AXA IM has developed a deep knowledge of the use of credit ratings over decades.

General Comments

1. For long, AXA IM has been developing a comprehensive internal analysis organization and process regarding issuers' assessment as well as the assessment of the securities which are part of AXA IM's investment universe. It applies in particular to investment decisions, portfolio analysis during securities holding periods and risk management.

Therefore, external ratings and external analyses from credit rating agencies are not per se the single or mechanistic criterion for managing portfolios.

In addition to AXA IM own Credit Research Department, AXA IM portfolio managers make also use of sell-side information as well external specialized analysis companies for some specific assets.

It seems important today that all asset management companies, in order to be able to ensure their duties, put in place models similar to the one which was proposed by IOSCO last year through its consultation on *"Good Practices on Reducing Reliance on CRAs in asset management"*.

2. External ratings are the single common and objective language to which market participants – investors, asset managers, issuers, etc. – can refer to and on which they can communicate in order to describe clear investment constraints. From this perspective, to date there is no alternative. It must be kept in mind that this common language has a direct impact on financing cost for many institutional investors for which investment cost is linked to ratings.
3. Beyond a general framework similar to the one proposed by IOSCO, we think that it would not be appropriate to require further detailed analysis processes: analysis processes and analysis themselves must not be revised in a too strait-jacket way. For instance, a downgrade in external ratings must not systematically trigger a



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credit analysis back-testing: in line with CRA legislation, an external rating downgrade represents a new piece of information which has to be taken into account by asset managers and analysts but should not automatically impose a revision of existing assessments (as in particular it could generate systemic risks through herd behaviors on markets).

4. The responsibility of asset management companies must remain different from the one of credit rating agencies: asset management companies do not have the same objective and the same means as credit rating agencies. The obligation of asset management companies remains an obligation of means, based on best practices. In the same manner, internal assessments are always evolving processes, which cannot be considered as similar to the proprietary models of credit rating agencies.

Specific Comments

Questions for Financial Intermediaries

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

Our business lines use external ratings to a large extent. In particular, given our clients need a reference and have several providers potentially it is a common shared language.

In addition, external ratings are part of our comprehensive internal processes and are used as one of our external sources of information.

In particular, AXA Investment Managers has developed its own credit research process, as detailed below.

AXA IM's Fundamental Credit Research

1. Main Objectives and Principles

AXA IM's fundamental credit research team, composed of 34 persons worldwide, contributes in a significant way to the decision making process covering AXA IM's credit investments. The credit research team analyses the quality of bond issuers with key objectives being to a) analyse the credit quality of new issuers b) propose new investment opportunities and c) anticipate credit developments of existing positions.

The focus is on in-depth fundamental credit analysis, covering all factors that may influence the credit quality of the issuers covered on a short-, medium- and/or long-term perspective. The fundamental research does not take into account any relative value consideration.

The vast majority of names covered by the credit research team are "Investment Grade" (IG) issuers, although some "High Yield" (HY) issuers will also be analysed, principally in the case where investments have been made at a time

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when the credit(s) were rated IG. As a consequence, the maturity of these latter credits tend to be relatively short in most cases.

In addition to name-by-name fundamental analysis, the credit research team provides sector trends, which are used to assess the issuers in a larger setting and facilitate portfolio managers' sector allocation.

The analysis is independent from that of any external credit rating agency, even though it captures the expectations of external rating agency developments. The credit rating system is proprietary to AXA IM's credit research team and clearly differentiated from that of the rating agencies.

2. Resources

The credit research team currently consists of analysts based in Paris (France), Greenwich (US) and London (UK). The financial analysts cover banks and other financial institutions whereas the corporate analysts cover non-financial corporate issuers. The analysts assess the credit quality across the capital structure (from secured to subordinated instruments). Each analyst is specialised on one or several sectors/geographies in order to ensure in-depth knowledge of his/her principal coverage. In addition, each analyst acts as a "back-up" on sectors covered by other members of the credit research team, which ensures consistency of recommendations and ratings across the investment universe.

The credit research team uses a wide range of sources to conduct its research, including but not limited to, direct contact with issuers through group and one-on-one meetings, company press releases and other publicly available information, credit rating agencies and brokers' reports along with data available via Bloomberg.

3. Communication

The credit research team strives to communicate in the most efficient and relevant manner to all its internal clients, principally to AXA IM's portfolio managers.

Interactive oral communication is favoured as the credit research teams in the three locations (Paris, Greenwich and London) are located on the same floor as portfolio managers, which facilitates informal discussions on a specific issuer, sector or theme between analysts and portfolio managers. In addition, the credit research team actively participates in quarterly forecasting and bi-annual sector review meetings.

More formal communication is done in writing. The credit research team uses its own proprietary research system, CeReS (Credit Research System) to publish all in-depth analyses. This system allows for storage and search of all publications since launch. In addition, each publication in CeReS creates an automatic alert to all internal clients.

Finally, the credit analysts communicate regularly on an ad hoc and complementary basis via e-mail and the Bloomberg chat system (IB).

Save for some exceptions, all written communication by the credit research team is done in English.



4. Fundamental credit research process

A. *Principal factors considered*

The principal factors considered when analysing an issuer correspond to the points typically covered by in-depth fundamental credit research in the bond market. These factors include but are not limited to:

For a “Corporate” issuer:

- Deep understanding of the issuer’s business lines, underlying market trends, risks related to its clients/suppliers, competitive environment, technological and regulatory developments
- Relevance of the issuer’s business strategy, quality & experience of management and general governance, shareholder composition and stability over time (in close collaboration with the Responsible Investment Team of AXA IM)
- Financial accounts of the issuer, principally income statement, balance sheet and cash flow statement, which are adjusted by the analysts (notably with regards to operating leases, unfunded pension and other long-term liabilities)
- Credit ratio analysis, including profitability, interest coverage and leverage metrics including any industry specific metrics
- Liquidity of the issuer, including short term debt refinancing capacity based on funds available through cash flow generation and undrawn committed credit lines
- Event risk related to potential mergers, acquisitions or disposals that may impact the future group structure and/or financial policies of the issuer
- Litigation risk
- Maturity and seniority of debt including structural subordination issues, documentation including change of control clauses, coupon step-ups/step-downs, call features
- Understanding of credit rating agencies’ views of the issuer in order to anticipate any external rating changes

For a “Financial” issuer:

- Definition of the business profile of the financial institution (e.g. retail bank, investment bank, universal bank) and the understanding of the various business lines
- Geographic diversification and positioning of the bank in the countries in which the bank operates
- Relevance of the issuer’s business strategy, quality & experience of management and general governance, shareholder composition and stability over time (in close collaboration with the Responsible Investment Team of AXA IM)
- Impact on the issuer from regulatory constraints related to the financial sector as well as individual jurisdictions
- Determination of issuing entity, seniority of debt and related risks such as non-payment of coupon and loss-absorbing capacity, maturity (including call features)
- Financial accounts of the issuer, principally income statement and balance sheet
- Credit ratio analysis, including capitalisation, profitability, asset quality and liquidity
- Litigation risk



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- Understanding of credit rating agencies' views of the issuer in order to anticipate any external rating changes
- For covered bonds (in addition to the credit quality of the issuer) the legal framework of each jurisdiction as well as the cover pool quality of each programme.

B. Proprietary rating system

The credit research team rates the issuers through a series of proprietary indicators that are clearly different from those used by rating agencies. These indicators have been selected following discussion with portfolio managers in order to best respond to their needs. The proprietary indicators are determined following an in-depth fundamental analysis of each issuer and are reviewed regularly (cf 4.C). Their purpose is to summarise the analyst's overall opinion of the issuer in terms of credit quality as well as specific trends and risks related to the issuer.

These indicators include:

- A forward looking through-the-cycle score, reflecting the medium- to long term credit quality of the issuer. The scores range from IG1 (best) to IG5 (worst) for issuers considered as « investment grade type ». In addition, two lower steps (HY1 and HY2) may be utilised for issuers considered as « non-investment grade type ». Taking into consideration the credit research team's focus principally on IG issuers, the vast majority of issuers covered will be rated IG1 to IG5. For covered bonds, the scores range from CB1 (best) to CB5 (worst)
- A 12-month outlook, reflecting the expected near-term development of the credit quality of the issuer (up to 1 year). The near-term outlook can be expressed as Positive, Stable, Negative or Developing, with the latter used only in case of high uncertainty with regards to the direction of near-term credit trends
- Event risk reflecting any potential change in credit quality (positive or negative) related to an event such as merger or acquisition, material change in shareholding structure or support etc. Event risk can be expressed as High Positive, Low Positive, Negligible, Negative or High Negative. The time horizon considered is ~12 months
- Rating agency risk reflecting any potential change in external credit ratings on a one year time horizon. Rating agency risk can be expressed as High Positive, Low Positive, Neutral, Negative, High Negative or Fallen Angel risk, with the latter used to highlight a risk of downgrade to non-investment grade by any external credit rating agency
- A colour recommendation that integrates all above indicators with exception of the forward looking through the cycle score. The colour code can be expressed as Green (Stable or improving), Yellow (Stable or slightly deteriorating), Orange (Deteriorating and/or significant event risk) or Red (Rapidly deteriorating and/or significant event risk). The time horizon considered is ~12 months.

These indicators are used by the credit research team's internal clients to assist in the investment selection and credit monitoring process, with the degree and way of utilisation largely depending on investment styles and objectives of the different credit portfolios.



For issuers to which AXA IM has sizeable exposures in its credit portfolios, the credit research team is committed to making annual updates. Sector trends are also communicated on a quarterly basis.

For each issuer covered, the analysts publish an updated detailed view on an annual basis (<18 months), with more frequent updates encouraged in the event of significant credit developments. In addition, the main indicators as expressed by the credit research team are integrated into AXA IM's proprietary front office tool SynView, which facilitates the screening of investment portfolios from a credit quality perspective.

For all major sectors covered, the analysts publish 3- to 12-month fundamental outlooks on a quarterly basis. In addition, sector views are expressed through interactive sector reviews organised twice per year together with portfolio managers.

The credit research process, including the methodology and scoring system has been broadly stable over the past few years, with recent changes being of evolutionary nature.

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

The main reason to refer to external ratings in IMAs or dedicated funds are clients' requirements and needs, often driven by their own specific regulations.

For instance, regulation for some of our clients like insurance companies use external ratings for capital calibration. It is therefore a key point for a client who cannot assess the internal ratings of all its providers.

On top of it, external approved ratings are the only ratings accepted by regulators to get the assets eligible to the balance sheet or to get an appropriate capital charge in Solvency 2 standard formula for instance.

So, some significant client segments cannot accept even a mitigation of use of external ratings in their agreements with their asset managers: their own regulations require them.

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

Yes. Our investment policies do not rely mechanistically on external ratings. External ratings are part of the external sources of information used by our portfolio managers, but investment policies are based on the internal assessment of all these external sources of information, in order to build AXA IM's own capacity of assessing the risks.

Mitigation wording refers to the implementation of an AXA IM internal credit or market risk, and to the discretionary decision of the manager to buy or sell assets notwithstanding the external rating.

AXA IM has updated all its French funds' documentation (prospectuses) in 2014 to mitigate mechanistic reliance on external ratings: in the section of prospectuses related to the investment strategy, the reference to ratings is listed



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within a list of other criteria forming the investment universe. A wording based on CRA European legislation is inserted: *"The selection of credit instruments is not exclusively and mechanically based on their publicly available credit ratings but also on an internal credit or market risk analysis. The decision to buy or sell assets is also based on other analysis criteria of the Investment Manager."*

The French AMF was very supportive of this initiative for which AXA IM was a first-mover.

AXA IM is also in the process of adding the same mitigation sentence for its Luxembourg funds' documentation.

New investment management agreements always expressly mitigate the risk of mechanistic reliance on external ratings by a similar wording.

For the agreements signed prior to the CRA Regulation, some have been amended to insert such a mitigation, either because the investor's regulator required so (all the agreements signed with Italian pension funds have been amended accordingly), or because investment guidelines are regularly revisited.

However, it has to be noticed that this initiative on fund prospectuses is mostly relevant vis-à-vis retail investors. For professional clients which may need (in particular through sectorial regulations) or wish a reference to external ratings, it is not relevant.

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

Regarding the use of external ratings, their main advantage is that they are a marketplace reference known by all market participants.

In particular, professional clients with multiple assets need a reference point such as external ratings.

Their main disadvantage is that once a significant downgrade is made public, it may generate a sudden, over-amplified and late reaction on the markets – if the related problem had not been anticipated beforehand.

It is the reason why it is crucial for asset management companies to elaborate their own judgment, based on an overall assessment.

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, AXA Investment Managers conducts analysis of the underlying methodologies of the ratings we rely on. 34 persons worldwide, based in Paris (FR), London (UK) and Greenwich (US) contribute to this work of "Credit Research" (see Q9 above).

Understanding the underlying methodologies of ratings and external analyses we rely on is essential. We can carry it out as we are analyses' professionals ourselves.

In particular, as such methodologies – and changes in methodologies – have an impact both on markets and on our clients, AXA IM is always scrutinizing methodology evolutions. Such evolutions are incorporated in our own internal analyses afterwards.



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?

Regarding the subprime case, the press has recently disclosed that a major credit rating agency would have accepted to pay an amend to the US authorities for having under-vaulated that risk.

However, in some cases where the key information were hidden, whatever the quality of a research team is, the forecasts and assessments will not be of high quality.

Warning signals may exist, which may be detected by asset managers themselves. For instance, AXA IM had identified the governance issue of Banco Espirito Santo.

When trying to differentiate external ratings from internal ones, we could remind that credit rating agencies suffer from a conflict of interest vis-à-vis the major issuers which pay them. From this perspective, internal ratings are less conflicted because the information is not publicly disclosed.

As a conclusion, the issue is not so much related to the quality of agencies' work vs. internal rating research teams, but more related to the respective objectives of external agencies vs. asset managers as well as related to the way the information is made available:

- Agencies' communication is done under their own formats and pace. There is a potential risk that they follow tactic approaches in order to preserve their clients or reputation
- Our internal research is produced on an going basis, in interaction with portfolio managers: this communication between our analysts and our portfolio managers is essential for the best understanding of risks and for an internal challenge between portfolio managers and analysts. We are ultimately concentrated on the core asset management objective, which is to make the best choices within a specific investment universe.

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?

Three types of players are involved internally :

- Portfolio managers, who carry out both short term assessments ('value' analyses) and long term assessments ('credit' analyses)
- Credit analysts
- Risk officers.

As already mentioned, credit rating agencies provide both analyses and external ratings, which are part of the list of sources of information that we take into account. But these sources of information are complemented by other sources of information – such as spreads for instance – and by internal analysis.

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

Internal risk analyses make use of:

- Internal research scores provided by the Credit Research team
- Credit spreads levels and their variations over time
- Additional information, such as government support, obligor's short term liquidity, obligor's balance sheet size and structure, obligor's stock performance.

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

Yes, these alternative measures are compared with external ratings, on a through-the-cycle basis.

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

Reducing reliance on external ratings is necessary.

In addition, from a pure business and competitiveness perspective, in order for an asset manager to differentiate from the others and to get better performance – by not being a follower on the markets and in order to optimize arbitrage – the internal research is crucial, beyond the mere external ratings and spreads.

The quality of an asset manager relies among others on the quality of its internal research.

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

External ratings are still important to be taken into account, as they are references taken into account by all market participants. However, we think that regulations should be more consistent on the use of internal ratings and not only external ratings.

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

It is important to keep some leeway in order to avoid over-reaction in case of sudden downgrade: what is important is to keep the professional client informed in such a context, to manage the portfolio in the best interest of the client.

In fact, it is important to share the analyses with the client, in order to take enough time to analyze the situation in case of stress: we have to avoid potentially counter-productive fore-selling, by optimizing the risk/price mix.

It is why our mandates include, beyond objectives and limits, the way the relationship with the client must be managed in case of stress periods leading to off-limits situations. What is important is to define in agreement with the client an ex ante process for managing such exceptional situations.



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

Regarding our experience in France, while the current AMF systematic request on the fund approval with language forbidding the use of external rating is relevant for retail clients, it is not relevant for professional clients who may need or desire the use of external ratings.

We remain, our teams and myself, at your disposal for any further contribution or meeting on this fundamental topic. Please don't hesitate to contact Stéphane Janin, our Head of Global Regulatory Development (stephane.janin@axa-im.com, +33 1 44 45 93 64) or myself (andrea.rossi@axa-im.com, +33 1 44 45 74 14).

Best regards,

Andrea Rossi
Chief Executive Officer