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27 February 2015

**Discussion Paper: The Use of Credit Ratings by Financial Intermediaries. Article 5(a) of the CRA Regulations.**

Schroders manages €354.4 billion on behalf of institutional and retail investors, financial institutions and high net worth clients from around the world, invested in a broad range of asset classes across equities, fixed income, multi-asset and alternatives. We are grateful for the opportunity to comment on the questions posed to financial intermediaries in the discussion paper.

Yours faithfully

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Sheila Nicoll

Head of public Policy

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

External ratings are used in a number of business areas and are currently included in a number of external client facing documents:

* Minimum counterparty rating quality for deposits and term exposure via foreign exchange and other derivatives both for our investment management and wealth management clients.
* Within ISDA/ Credit Support Annex (CSA) documentation when we enter into derivative transactions.
* Within investment management agreements from clients and again referring to minimum counterparty ratings.

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

The main reasons they are used within ISDA/CSA are so that there is an ability to terminate any outstanding transactions if the counterparty falls below an agreed independent credit quality (i.e. rating) and to set minimum collateral standards that can be set independently of the provider or receiver.

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

Whilst we can cease trading with a particular counterparty based on internal assessments before there is any ratings action most ISDA/CSA documentation relies on external ratings as one of the triggers to terminate contracts.

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

An advantage of using external ratings for our clients is that they are a benchmark that clients can understand when comparing one counterparty with another and while they may not understand the ratings methodologies they do use them as a standard benchmark.

A disadvantage in relation to bank ratings is that there is little apparent differentiation between a G-SIFI rated ‘A’ and a small regional bank also rated ‘A’. The level of support (via its investor base) and their supervision (i.e. being subject to national regulatory regimes compared to ECB oversight) will be totally different. See also our answer to question 11 below.

**Q.11 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, we review the underlying methodologies published by the 3 main agencies, and a strength is that the rating reviews are usually comprehensive for most banks and especially the many trading and holding entities.

We consider a weakness to be in terms of the reviews of bank subsidiaries and whether the rating they hold is based in the parent entity or on a completely unsupported basis. Furthermore, and in terms of our investment management process, we are wary of the methodologies used particularly in the area of subordinated debt issued by both financials and non-financials. We consider them potentially unstable and prone to revision and we are very sensitive to methodologies that follow their own logic and ignore economic realities. So we never rely on a rating agency methodology that doesn’t appear intuitively robust to our teams.

**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?**

Historically a prime example would be Icelandic Triple ‘A’ rated Icelandic banks. In terms of actions we would refer you to our answer to question 11.

**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?**

Our assessment of corporate and sovereign credit risk is based on independent research, examining both the business and financial risk of each company using internal and open-source data. Public credit ratings are used as a sense check and provide a valuable piece of market information but other inputs perform similar functions (e.g. yield spread of the instrument above the relevant government bond curve).

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

We use various financial market information such as Common Equity Tier 1 (CET1) capital, non-performing loan data, total capital, going forward leverage as well as loan coverage ratios. Our internal investment processes also model industry dynamics into sales, cash flows and debt/cash flow ratios.

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

Through the cycle information is difficult to obtain. In any event, we consider that structural and technological changes make attempts at projections over a 3-5 year timescale prone to quick decay and so make our own investment conviction forecasts over 18 months at most.

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

We consider it would be desirable to see a reduction of external rating requirements in investment management agreements. Such terms on occasion may constrain investment decisions particularly with investment grade mandates where it has been shown that at the height of economic cycles default risk is underestimated, resulting in pro-cyclical behaviour.

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

For many clients there is a need for more education on why we are moving away from a benchmarking system that they currently understand. Additionally, for those clients acting on behalf of others the use of credit ratings provides a degree of comfort they are meeting their fiduciary duty to their clients in the absence of alternatives. So agreeing a credible alternative that is seen as independent and allows for easy comparisons across counterparties/products will be a major challenge.

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

The biggest reduction would be through market and client education as whilst clients think they understand ratings they only understand them to compare one bank with the next. But moving clients away from reliance on credit ratings to a more internal system will be a big challenge as it is harder for them to compare the offerings and solutions proposed by one financial institution to another without sophisticated credit risk knowledge.

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

We would echo the point made at paragraph 60 of the Discussion Paper that without an independent benchmark that is accepted by market participants we believe that it will be difficult for market participants to move away from including external credit ratings in contractual documentation as a means to provide for a termination right and to agree a minimum credit quality for collateral assets.