Amundi
ASSET MANAGEMENT

Good practices on reducing reliance on CRAs in asset management

A consultation report issued by IOSCO (September 5, 2014)

Amundi is the leading asset manager (AM) in Europe and ranks 10th worldwide, with more than 820 billion € under management at the end of June 2014. Amundi serves a large variety of clienteles in many different countries and developed expertise in many different investment strategies. Bond portfolio management, including high yield and Money market funds, are among the major areas of development and, as a consequence, Amundi is directly concerned with the use of external ratings provided by Credit rating agencies (CRAs).

Amundi is thankful for this opportunity to share its experience and express its views on the reasonable use of external rating. Amundi agrees that external credit ratings were so much relied upon by market participants that it participated to the financial crisis of the late 2000s and it supports the efforts undertaken by regulators to, first, put CRAs under adequate supervision and, second, limit reference to ratings and fight overreliance or mechanistic reliance on them. However, Amundi is very concerned that the balance might go too far on the opposite side and does not want ratings to serve as scapegoat for a crisis that had many other features.

Before turning to the answers to the questions of the consultation, Amundi would like to summarize its main message:

- CRA's ratings are useful for AMs and especially when it comes to communicate with stake-holders who will share this **common language** to easily define the profile of credit risk of an investment : it is the case with clients, both professional and retail, as well as with controllers, both in-house or external, and with regulators;

- "Common language" is limited to credit rating of an issue, maybe an issuer; **ratings of funds, securitization or structured products are not of the same nature** ; in order to avoid confusion they should not use the same scale, starting from triple A;

- External ratings should not be (and are not) the only source to assess credit risk; an AM has a duty towards its clients to invest according to the mandate they agreed upon and to act with professionalism ; when it comes to assessing the credit risk of an instrument, the AM

Siège social : 90, boulevard Pasteur - 75015 Paris - France
Adresse postale : 90, boulevard Pasteur - CS 21 564 - 75730 Paris Cedex 15 - France
Tél. : +33 (0)1 76 33 30 30 - amundi.com
Société Anonyme au capital de 596 262 615 euros - 437 574 452 RCS Paris
Société de Gestion de Portefeuille agréée par l'AMF (Autorité des Marchés Financiers)
n° GP 04000036.

must get information from different sources and build its own opinion, not exclusively relying on an external rating;

- The AM is a client of the CRA that provides ratings as well as extensive reports that justify them; the CRA charges a subscription fee to the AM… and is paid by the issuer on the other side; the CRA is licensed and supervised by a competent authority, ESMA in Europe; the AM is entitled to consider that ratings are professionally realized and it **should not be required to investigate methodologies and procedures of the CRAs;**

- An AM will probably take notice of a **change of rating and consider it as a warning** to check whether there is a need to reassess its own opinion; but that type of procedure very much depends on the number of in-house analysts there are or the mandate signed with clients and it shouldn't be part of the regulation but left to the organizational level of the AM in order to keep the necessary flexibility;

- Furthermore, an AM should not be required to subscribe to all existing rating services to trace all an any changes; we are very much concerned that ESMA seems to make that suggestion for managers of money market funds.

XxX

Responses to the questions of the consultation

1. Do you agree with the above categorization of uses by investment managers of external credit ratings? Are there other ways in which investment managers use external credit ratings? Can you point to situations where you would consider there is no alternative to credit ratings?

Yes, Amundi agrees with the 4 uses listed in the paper, including risk management. In other words reference to CRA's ratings is common in all three main functions of an asset manager : investment management (investment, collateral and counterparty selection as well as research) , risk management and marketing/ sales. When rating is used in order to facilitate communication on the basis of a "common language" it is very difficult to think of any efficient alternative to the use of CRA's ratings.

2. What benefits do you as an investment manager see in the use of external credit ratings? How does your particular size, resources, capabilities, etc. affect the benefits you perceive?

The first aim of ratings is to help with the assessment of credit quality. Amundi is a large firm with a proven expertise in bond portfolio management. It has two teams of in-house credit analysts : 21 working within the investment management department and 8 dedicated to the risk function. Amundi is therefore well equipped to fully assess the credit quality of the instruments it invests in and it does not mechanistically rely on external ratings to build its opinion before investing : ratings and rating reports are one source of information to be used in the decision process. Of course smaller firms may have difficulties to reach the same level of organization and would rely more heavily on external ratings. Proportionality is clearly identified as a key concept in the discussion paper. Even a large firm like Amundi cannot cover all segments of the market and will use external

ratings as a significant reference, for example in a phase of testing a new investment solution.

But the main advantage of a reference to CRAs ratings is undoubtedly the possibility to easily communicate with the investment community and even the public at large. For example, “Investment grade” is nowadays part of the daily language and it should not be prohibited to use it simply because it refers to CRAs rating scales.

3. How do investment managers adjust their internal portfolio risk models (e.g. diversification parameters, liquidity profile, VaR, etc.) to account for external credit rating changes to their portfolio securities? Among other risk factors (e.g. currency and interest rate changes), how relevant are external ratings in determining the ultimate risk level of a specific portfolio? Where possible, please suggest some examples as to why credit rating changes to the underlying securities may or may not be relevant.

Amundi’s internal models do refer to external ratings. Reporting documents do the same in order to share a common language with clients. Monitoring of diversification rules are better understood by fund holders if based on external ratings. Liquidity tests as well do identify levels of liquidity with reference to external ratings in order to properly communicate with traders that are best positioned to assess liquidity on this basis. VaR and TE models also rely on a segmentation based on currency/ sector/ rating to determine the appropriate reference curve. We do not foresee any improvement in the communication with stakeholders if we were to abandon reference to ratings, on the contrary we feel it would bring confusion.

Questions 4 to 6: addressed to investors and not investment managers.

7. Is the above description of the two models of internal analysis of credit quality within investment management firms accurate?

Yes. the distinct functions of credit analysis on one side and portfolio management on the other are held by different people or by analyst/managers who are entitled to undertake both functions.

8. What factors would be effective in mitigating the conflict described in letter a)?

When such portfolio manager/analysts have both responsibilities they might be in a position of conflict of interest but :

- A split of functions may lead to a dilution of responsibilities that might as well not be in favour of the investors’ interest
- There are easy ways to limit the risk of conflict of interest through, for example, a standing committee that would confirm the opinion of the manager/analyst.

9. Do investment management companies adopt different internal assessment models depending on the type of investment management vehicle (e.g. MMFs, equity or bond funds, alternative or structured investment vehicles, etc.) they manage?

Investment management companies may use one or both of these two models depending on their size in a given segment of the market and the scarcity of experienced people in a specific field. Sometimes, especially on less liquid securities, a credit analyst will be in a better position to discuss with other analysts and traders if he directly makes the decision to invest or not.

10. How do smaller investment managers use external credit ratings? What methods of

credit assessment do small and medium managers use in addition to review of credit ratings?

As a general comment it should be stressed that when relying on external ratings, an investment manager does not refer to a maximum of three letters plus one sign. CRAs do publish extensive reports when issuing or updating ratings. There is a lot of information available in order to challenge and qualify the final rating. An investment manager may classify differently the main factors, positive and negative, listed by the CRA and eventually decide to accept or not the investment idea. The good usage of rating should not be discouraged.

11. Do you agree with some or all of the internal credit assessment procedures described above? Are there other procedures you use or would recommend?

Amundi does not agree with all the points listed page 11, but does not object to the possible good practice as it is written. Two comments:

- It is too burdensome, in points 2 and 3, to ask for the methodology to be based on "all the relevant information available" and "ensure" the quality of this information. As for any opinion it will be limited on an "obligation to do best" to reach a funded rationale justifying the opinion. The analyst can only assess information that is available to him through public disclosure or through subscription and he will act in good faith when determining the sources for proper documentation and searching relevant information. In-house analysts are not CRA's analyst and they do not sell their opinion but use it internally to implement investment strategies consistent with the risk profile and the objectives of their clients.

- Point 6 can be read as requiring the asset manager to reproduce the process elaborated by the CRA when attributing the rating. It should be rewritten in order to make clear that what is expected from the asset manager is not to control the procedures established by the CRAs (which are closely supervised by ESMA in Europe) but to evaluate the report published by the CRA and not simply rely on the rating itself.

12. To the extent that you have internalized your credit analysis, for what sort of instruments/issuers are you better able to perform it? If external credit ratings remain as a point of reference, how are these accounted for in the internal analysis and what is their relative value in determining and monitoring the creditworthiness of an instrument or issuer?

Access to information is the key to credit assessment. Thus only secretive issuers and confidential structures may be difficult to assess. The right approach in such a case would be to abstain and not to invest. Otherwise, public information on Government finances or listed companies are generally available. Afterwards it is a question of competence (thus investment in human resources and technology) to proceed with the analysis with reference to the context of each issue and reach a relevant opinion on the credit quality. Credit assessment should not be conducted through a scoring and the computation of a weighted average of different marks for different criteria. Thus it is not possible to speak of "relative value" of external ratings in the credit assessment process.

13. In periods of market stress, are external credit ratings considered as one indicator of liquidity to be taken into account in the procedures of liquidity risk management and if so how?

Liquidity is not directly correlated to level of risk and, hence, rating. However in times of crisis and

stress we generally experience a flight to quality that favours higher ratings. It is in our opinion insufficient to draw the conclusion that the higher the rating, the better the liquidity. On the contrary, when investors suspect that a category of securities is overvalued they often consider that rating is irrelevant and prefer to get rid of all their positions. This “domino effect” on structured products or peripheral govies in Europe was obvious : at times when investors did not want any investment on such instruments, even highly rated issues were illiquid.

In its monitoring of portfolios liquidity Amundi considers the level of rating as one of the criteria that define the sub categories of instruments. The price impact of a sale and the size rapidly tradable in the market are determined at a granular level for sub categories of bonds according to the type of issuer and the rating.

14. Could you describe your experience of instances where external credit ratings were mandated by investors? Is it possible to draw a relationship between an investor’s specific profile and the investor’s greater/lesser reliance on CRAs credit ratings in a mandate’s specifications? Please give examples.

It is quite frequent that investors express their view on the level of credit risk that they accept in terms of ratings. The examples provided in Box 1 are realistic. It may depend from (i) their regulation (and the success of CRAs in the US goes back to the first inclusion of ratings in regulatory texts of the New Deal, back in the thirties), (ii) from their own internal regulation or (iii) from their will to share a common language with their investment managers, their in-house teams and their internal financial committee. In Europe, regulators have introduced reference to ratings exactly at the moment when it appeared that it was dangerous from a systemic risk point of view. One must confess that CRAs have developed on the basis of the most common human feature: apathy that prompts people to avoid making their individual homework and use standard common reference.

15. In your experience, do prudential requirements impact demand for contractual reliance on external credit ratings?

Yes, Solvency 2 that does not refer directly to CRAs ratings but nevertheless requires a complete report on the rating of each of the main 3 CRAs is a perfect example of regulatory impact on the demand for reliance on external ratings. CRD for banks is another one and many other institutions have local regulations that refer to CRA’s ratings. Not to mention Money Market Funds, where regulators suggest that an asset manager should subscribe to all rating services in Europe to be aware of any and all changes..

16.What type of alternative credit information sources could be included in investment mandate agreements and fund investment objectives?

As investment manager, we are happy to refer to our own internal assessment of credit risk. But, despite the existing demand on the part of some institutional investors, we do not wish to publish it and to act as a ECAI or a CRA. In the framework of a specific mandate agreement, we may consider to discuss extensively our methodology and to report conclusions and changes in opinion to our larger clients on a contractual basis of confidentiality. We feel it is possible to share a “common language” with clients in a confident face to face dialogue.

For open funds, we feel that the recent discussion conducted by ISOCO on the need for public education on financial matters should include a research of a common reference to identify credit

risk that we are lacking at the moment.

17. Please describe the process you use for identifying and comparing CRA methodologies.

We are surprised to see that IOSCO may consider that investment managers should compare CRAs methodologies. Reports circulated by CRAs to their subscribers do provide relevant information on hypotheses and methodology that justify their ratings. When they put a rating under watch, they communicate also on the possible change in rating and explain the reasons for the reassessment. There is clarity in the process and we do not consider that we should spend time on identifying and comparing methodologies.

However, the rating of some complex structured products may pose real questions. And more than a traditional credit risk assessment based on economics of the issuer it includes views on legal structure and documentation, involvement of guarantors … There is in that field no standard and scientific approach and experience has shown that what is important is not to compare methodologies but examine the underlying documentation and make a personal assessment.

18. If a fund manager relies on external credit ratings, is the information that the fund manager provides to you, as an investor, sufficient to allow you to understand the potential impact of a change in the external credit rating on the underlying portfolio of the fund? If not, what additional disclosures would be useful?

We hope, yes.

19. To what extent is the credit quality of a sponsor a relevant criterion in an investor's selection of a fund? Does it differ depending on the fund?

It is surprising to mention that a fund might be sponsored by its promoter at a time when everybody agrees that a funds is an independent entity. More specifically the European Commission prepared a project of regulation of MMF that prevents any support by the sponsor of a MMF. We feel that this apparent contradiction should be addressed and suggest that IOSCO work on the definition of a " authorized sponsorship".

20. How important is the credit rating of the sponsor of a structured finance vehicle if the vehicle does not have explicit support from its sponsor?

For an investment manager, the credit rating of the sponsor of a structured product lacking explicit support is not relevant. The expertise and professionalism of the sponsor has, on the other hand, to be taken into consideration.

21. Following the credit rating downgrade of a guarantor, could you as an investment manager be forced to sell the securities issued by the structured finance vehicle? Please explain as to why or why not this may be the case.

This question of the automatic sale in case of a downgrade of the rating is further discussed below (questions 36 to 40) and is identical for an issuer or a guarantor of a straight bond or a structured product.

22. How important to fund managers is the external credit rating in the choice of a fund's counterparty(ies)? What are the key factors usually taken into account when negotiating an agreement with one or more?

Amundi does not consider that the credit rating of a counterparty is essential to its agreement. It looks more like a prerequisite that it ought to be high in order to confirm the internal analysis that the counterparty is of excellent quality. But a counterparty will never be accepted on the basis of its rating only. Selection of a new counterparty is a process that requires some time for the documentation to be discussed and allows a thorough risk analysis. It is conducted in-house and as mentioned there are 8 credit analysts within the risk department at Amundi. A number of criteria are used in the assessment including financial, legal, guarantees and collateral policy or client servicing aspects before deciding to accept a new counterparty.

23. Following the downgrade of a key counterparty, depending on the contents of the relevant agreement, could you as an investment manager be forced to close out your respective positions? Please explain as to why or why not this may be the case.

This question of the arbitrary end to relationship with a counterparty in case of a downgrade of its rating is further discussed below (questions 36 to 40) and is identical for an issuer or a guarantor or a counterparty.

24. How does an investment management company's size and resources relate to the investment manager's ability to perform an internal credit analysis of one or more counterparties?

The relationship that is established with a counterparty is of a different nature than the one resulting from the purchase of a bond. It implies the signature of specific contracts and master agreements and requires appropriate back office communications. In this respect it sounds strange to argue that size of the investment management company would impact its ability to assess the creditworthiness of the proposed counterparty, that is only one aspect of the selection process that the asset manager has to complete.

25. Are there some strong references to external credit ratings which are channeled through the ECB guidelines, ISDA Master Agreements or CCPs guidelines?

Our clients, counterparties and clearing members do refer to these regulations and translate them in guidelines for us to comply with.

26.Would you agree with some or all of the above parameters as valuable additional factors for the internal assessment of collateral quality?

The numerous consultations that were conducted on the derivative markets, more specifically EMIR in Europe, were a good opportunity to develop views on the characteristics of the collateral. Liquidity (that implies regular price reference), credit quality enhanced by appropriate haircuts, avoidance of wrong way risk, availability for the beneficiary in case of default of the provider but protection in case of default of the beneficiary…are real concerns that we largely share. However, Amundi would like to express two remarks in addition to the link between credit quality and haircut that will be developed in the following question :

- Collateral is designed to reduce risk in open positions, especially derivatives contracts; the risk of these positions comes firstly from the volatility of the underlying of the derivative, secondly (not to mention the necessary operational capacity to value positions daily and exchange margins) from the quality of the counterparty, thirdly from the quality of the collateral and fourthly from the diversification of the collateral. We feel that regulators should be reminded of this scale of risks. Thus, Amundi does not consider that the fourth

listed criterion is relevant. It might be counterproductive to require diversification as it might be at the cost of a lower quality and a lesser liquidity of the collateral. We think that it might often be the case and we advocate that it is safer to receive as collateral 100% of a first quality government bond instead of being obliged to spread the risk on several issuers, most of them of lesser quality.

- Furthermore, Amundi considers that it is not improving the investor's protection to require MMFs to accept as collateral only short term papers to match the WAL and WAM expected from MMFs. It will probably reinforce the scarcity of eligible collateral at a time when issuers of short term instruments (especially banks with the new LCR regulation) will tend to reduce their new issues. At the end of the day it will prompt MMFs managers to prefer deposit with full counterparty risk instead of secure collateralized reverse Repo.

With respect to the proposed "good practice", we suggest to add a first paragraph that would mention investment managers' obligation to conduct a thorough selection process when choosing and monitoring counterparties and specifically mention that they should not rely on external ratings as only criterion for credit risk assessment

27. Among the above parameters, which one(s) could be considered by counterparties to replace / supplement external credit ratings when evaluating the quality of collateral?

Amundi agrees that the reference to external rating is not of prime importance when assessing the quality of collateral. The quality of the counterparty comes first. The quality and the liquidity of the collateral should be consider from a pragmatic viewpoint. It would highly disadvantage investors if the fund they invest in cannot put eligible collateral to secure ordinary derivative transactions. It may happen if CCPs or counterparties in general very much limit the list of eligible collateral. A fund that would not invest in government bonds and be totally invested would not be in a position to provide eligible collateral. Thus, eligible collateral should be defined on a large basis, provided that an appropriate haircut be introduced to match both the quality and the liquidity differentials.

28. Are there other parameters that could be considered to facilitate the credit assessment of collateral received and/or posted by the investment manager, independently from external credit ratings?

From an operational perspective, it is very important that regulation does not limit the trading possibilities of funds simply because of poorly calibrated requirements on collateral. When a trade, on a reverse repo for example, takes place it is possible to take into consideration a limited number of stable and easy to monitor criteria to determine the collateral. If diversification or average maturity rules were introduced, trades and confirmation of trades would become a nightmare…without real benefit for the investor.

29.Why do investment managers seek to have their funds rated?

The driver to ask for a fund to be rated is the demand of the clientele. For example, in France it is not common practice to rate funds. On the other hand, Treasurers of international firms require that MMFs they subscribe in be rated.

30.What is the trend regarding fund credit ratings? Are investment managers seeking fund credit ratings more often or less frequently?

Amundi's analysis is that the general misgiving that CRAs did not work adequately when rating

structured deals in the late 2000's have not encouraged the dissemination of funds ratings. Furthermore, the rating of a fund is more a label than a credit rating. The opinion is on the ability of the investment manager to provide liquidity and avoid capital loss for the investor. This is apparently inconsistent with the idea many investors have of what a fund is : a share in an investment portfolio subject to market fluctuations. Only CNAV MMFs can be defined differently and as a consequence most of funds ratings apply to them.

31. Do investors use ratings differently in evaluating MMFs, investment grade bond funds and high yield bond funds? For investors to answer.

32. To what extent, if any, do CRAs provide credit ratings for funds for which they also rate all or part of the portfolio?

According to our understanding, CRAs require that the portfolio of a fund they rate be very largely or almost exclusively invested in instrument they rate themselves. Thus, they limit very much the investment capacity of the fund.

33. In situations where the same CRA rates both the fund and its portfolio, if the CRA downgrades or puts under negative watch an underlying security, will the fund be more prone to sell this security in order to maintain its highest rating?

It depends on the position in the investment matrix defined by the CRA for the rating of the funds. For MMFs the CRA considers, the quality rating, the maturity and the percentage of the instrument. If after downgrading the instrument is still eligible and fits in the appropriate limits, it is OK. If not the rating of the fund will come under watch and the propensity to sell will become very high.

34. In the case of fund of fund structures, please describe how external credit ratings of funds are used and how these are taken into account by the investment manager. Please provide examples.

The due diligences conducted by the managers of funds of funds are generally much more diversified than the analysis conducted by the CRAs when rating a fund. The risk profile of a fund, the quality of the management team, the efficiency of the risk control, the stability and diversification of clientele…are considered from the point of view of the impact of the introduction of the funds in a given portfolio of funds and not on an absolute basis. Thus, we consider that the rating of a fund is not an essential information when managing a fund of funds.

35. In the case of index funds, do you consider that changes to the external credit rating of individual index components may be relevant under certain circumstances in deciding whether the index may continue to be tracked by a fund?

Yes, in the process of an index fund, as opposed to a fund with a benchmark (see question 40), the manager usually pledges to follow or replicate the index with a very low tracking error. Not to adjust when a component of the index is changed would put him at risk and be considered as a breach.

36. How do fund investors generally react to a downgrade of a particular asset, or of a significant part of a portfolio?

We hope that investors feel that Investment manager keeps them regularly informed through monthly reporting and other communication channels.

37. Please elaborate on internal procedures that investment managers have implemented

following a downgrade, when for instance managers may need to ensure that the credit quality of the portfolio is still sufficient to meet the stated fund standards or managers have set up a grace period before selling the downgraded securities. Are there differences in procedures depending on the type of fund?

Irrespective of the size of the investment manager, there must be procedures to deal with credit rating downgrades. If there is, like at Amundi, an in-house credit analysis team, the down grade will generally be considered relevant to decide whether a reassessment of credit is needed or not. It should not be automatic, especially when the internal credit analyst anticipated such a move. If the down grading creates a breach, the risk department will ask the manager to justify the position he takes (keep or sell), generally based on the assessment made by the analyst. If the analyst decides to take a more restrictive view on an issuer or an instrument the manager will stop any new investment and either stabilize the total exposure to a lower level or be forced to sell to reach a zero position. A grace period to comply will be discussed and the proximity of the reimbursement will be taken into consideration to decide or not to sell part or all the position. The position as long as it is held will appear as a “justified breach” and closely monitored. This type of process implies consultation between credit analysts, risk controllers and portfolio managers. A regular committee will usually be responsible for keeping track of all decisions and to monitoring their implementation. In the case of funds and mandates dedicated to one investor, instant communication will be established with the client and, depending on the terms of the Investment Management Agreement, he might ask for reconsideration.

38. Do investment managers’ policies or investors’ investment guidelines provide for specific “grace periods” that allow a manager time to address the situation that results from a downgrade? If so, what is the average “grace period” and how are investors informed of the manager’s plans to restore a portfolio’s desired credit quality?

Information on grace period can be found in some prospectuses and may be considered as a standard provision in mandate agreements. Delay however is not standardized. The decision makers should not be limited by a given period that would reintroduce a cliff effect when time approaches to the end. The idea is to keep flexible on a period of, say, one to three months and maintain the position on constant watch, ready for action.

39. As a follow-up to the question above, would investment managers behave differently in the event of a collateral downgrade, or of a downgrade affecting one main fund counterparty or an asset’s guarantor (or sponsor)? Please explain, possibly with reference to some examples.

Even if the importance of external rating in the assessment of quality (not limited to credit quality) is much lower, the same process would generally apply to the counterparty risk and the quality of the collateral. On this specific case of collateral, quality goes hand in hand with haircut, and there is one parameter more to face the situation and feel comfortable with delay.

40. In the case of a fund’s performance being benchmarked to a specific index, how does the fund manager react when a downgrade leads to an asset / issuer being removed from the index?

The case of a benchmarked fund differs from that of an index fund mentioned in question 35. It is not different from all other funds, except that the tracking error that results from the discrepancy between the benchmark and the portfolio will be closely monitored and might lead to a

recommendation to adjust the portfolio sooner.

Contact at Amundi:

Frédéric BOMPAIRE
Public Affairs
90, boulevard Pasteur
F75015 PARIS

Tél :+33 (0)1 7637 9144
frederic.bompaire@amundi.com