

# **Good Practices on Reducing Reliance on CRAs in Asset Management**

## **Final Report**



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# Contents

<b>Introduction.....</b>	<b>1</b>
<b>Uses of external credit ratings by investment managers.....</b>	<b>4</b>
1. Internal credit assessment .....	4
2. Asset managers’ access to underlying credit rating information .....	7
3. Asset managers’ disclosures on uses of external credit ratings .....	8
4. Quality of counterparties and collateral.....	9
5. Managing external credit rating changes .....	11
6. Investor reliance on external credit ratings .....	12
<b>Appendix A – List of Good Practices .....</b>	<b>17</b>
<b>Appendix B – Relevant FSB Principles for investment managers in detail .....</b>	<b>18</b>
<b>Appendix C. Examples of references to external credit ratings in fund investment mandates or in national SRO standards.....</b>	<b>20</b>

## Introduction

Credit rating agencies (CRAs) play a prominent role in the global financial markets. CRAs provide external credit ratings of individual financial instruments and issuers that express a view on the instrument or entity's overall creditworthiness (hereafter "*credit ratings*")<sup>1</sup>. The role of CRAs has come under regulatory scrutiny, partly as a result of the over-reliance placed by some market participants, including some asset managers and institutional investors, on CRA ratings in their assessments of both financial instruments and issuers in the run-up to the 2007-2008 financial crisis. Although approaches may differ across jurisdictions, asset managers often use the services of CRAs as a factor in forming an assessment on the creditworthiness of a particular issuer before purchasing securities, selecting counterparties, or choosing the best collateral to secure transactions. For their part, investors often refer to CRA ratings to determine their investment universe or when guiding asset managers on the basis of a tailored investment mandate.

To tackle the concerns on over-reliance, in October 2010, the Financial Stability Board (FSB) published its report on *Principles for Reducing Reliance on CRA Ratings* ("FSB 2010 *Principles*")<sup>2</sup>. The goal of the *Principles* is to reduce the "hard wiring" of ratings into laws, regulations, and market practices and end mechanistic reliance on ratings by banks, institutional investors, and other market participants. The *Principles* note the potential financial stability-threatening herding and cliff effects that could arise if the downgrade of a security under specific thresholds leads to a sudden disproportionate cascading effect. The FSB 2010 *Principles* contain a number of important recommendations<sup>3</sup>. Principles I and II provide the general framework requiring standard setters, authorities, and market participants to consider ways to reduce over-reliance on CRA ratings. Principle III explains that banks, market participants, and institutional investors should make their own credit assessments and not rely solely or mechanistically on CRA ratings.

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<sup>1</sup> Under the IOSCO CRA Revised Code of Conduct in 2015, a credit rating is defined as "assessment regarding the creditworthiness of an entity or obligation, expressed using an established and defined ranking system." For the purpose of this report only external credit ratings, which express a predominant and clear outlook on the creditworthiness (i.e., in particular the implied probability of default) of a particular instrument and/or entity, will be considered.

There also are external ratings of pooled investment vehicles that may emphasize other, non-credit and qualitative aspects of a selected issuer. For example, ratings of structured finance vehicles may include considerations of payment structure and cash flow mechanics, operational and administrative risks. Please refer to Standard & Poor's, *RatingsDirect* at 2 (Feb. 16, 2011, repub. Jan 17, 2012) [http://www.standardandpoors.com/spf/upload/Ratings\\_US/G\\_EX2-1.March2014.pdf](http://www.standardandpoors.com/spf/upload/Ratings_US/G_EX2-1.March2014.pdf) In addition, as discussed below in section 8, external ratings of funds include considerations of managerial talent, the effectiveness of a particular strategy in meeting the desired returns, the quality of internal operations and controls. For the purpose of this report, the term "*fund*" is understood broadly to include both registered (e.g., collective investment schemes - CIS) and non-registered collective investment vehicles (e.g., private funds) across different jurisdictions.

<sup>2</sup> Available at: [http://www.financialstabilityboard.org/publications/r\\_101027.pdf](http://www.financialstabilityboard.org/publications/r_101027.pdf).

<sup>3</sup> Relevant FSB principles for investment managers in detail are attached as Appendix B.

The 2010 FSB *Principles* further provide:

- That Principle III applies across the full range and applies to all sizes and levels of sophistication of asset managers and institutional investors;
- That senior management and boards of institutional investors have a responsibility to ensure that internal credit and risk assessments are made and that the asset managers they use have the skills to understand the instruments they are investing in and exposures they face;
- A list of measures that regulators could adopt to incentivize asset managers and institutional investors to avoid the mechanistic reliance on ratings<sup>4</sup>.

The FSB 2010 *Principles* concluded with an exhortation for standard setters – including IOSCO - and regulators to consider steps for translating the principles into more specific policy actions<sup>5</sup>.

In view of the need to provide guidance to its Member jurisdictions (and indirectly to market participants to develop alternative credit assessment procedures), IOSCO has launched a series of new mandates among its policy committees<sup>6</sup>. IOSCO's Policy Committee on Investment Management (Committee 5) has developed a set of good practices for consideration by market participants and regulators in relation to the use of CRA ratings in the asset management industry<sup>7</sup>.

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<sup>4</sup> As a follow-up to its 2010 *Principles*, in November 2012, the FSB published its so-called "Roadmap", highlighting the short- to medium-term milestones for progress towards lessening the continued over-reliance on CRAs and for strengthening financial firms' own risk assessments. The roadmap is available at: [http://www.financialstabilityboard.org/publications/r\\_121105b.pdf](http://www.financialstabilityboard.org/publications/r_121105b.pdf). Both the *Principles* and the Roadmap adopt a dual-track approach, in which the removal of the "hard-wiring" of references to CRA ratings in standards, laws and regulations is to be accompanied by promoting incentives for the private sector to develop its own internal credit risk assessment processes. In this respect, the FSB has conducted a thematic peer review of progress made in member jurisdictions in implementing the 2010 *Principles*. The final report on its main findings was published in May 2014 and is available at: [http://www.financialstabilityboard.org/publications/r\\_140512.pdf](http://www.financialstabilityboard.org/publications/r_140512.pdf). In particular, the Report states that approaches to reduce reliance on CRA ratings vary significantly across jurisdictions and financial sectors; while good progress has been made toward removing references to CRA ratings from laws and regulations, mechanistic reliance can also come from market practices and contracts.

<sup>5</sup> IOSCO has already addressed these issues with respect to asset managers and investments in structured finance instruments in a July 2009 report on *Good Practices in Relation to Investment Managers' Due Diligence When Investing in Structured Finance Instruments* (IOSCO 2009 *Good Practices*). Although the mandate focused on asset managers' due diligence when investing in structured finance products, the report recognized that many of the principles and themes discussed therein could be applied regardless of the type of product. This would concern, in particular, certain good practices related to the use of third parties, including CRAs, in the due diligence process.

<sup>6</sup> In line with the FSB approach, IOSCO's Policy Committee on Investment Management (Committee 5) launched a first mapping exercise in March 2011 to better understand the extent of its Member jurisdictions' reliance on regulations explicitly referencing CRA ratings for investment managers and identify gaps between existing domestic regulations and the FSB 2010 *Principles*. In this light, (Committee 5) carried out a second mapping exercise in October 2012. The results of this second exercise have revealed further progress in reducing the over-reliance on CRAs in national regulations applicable to investment management in line with the 2010 FSB *Principles*.

<sup>7</sup> For this purpose, a working group within Committee 5 was established co-Chaired by the French AMF and the U.S. SEC. It comprised the following additional regulators: the Australian ASIC, Brazilian CVM, the Japanese FSA, the Mexican CNBV, and the Québec AMF.

In drafting the present report IOSCO has drawn on the feedback received from various stakeholders (asset managers and their representative trade bodies, institutional investors and their associations, and CRAs). The set of Good Practices is addressed to national regulators, asset managers and investors, where applicable, and suggests specific practices that asset managers could undertake to reduce any potential over-reliance on external credit ratings in the asset management space.

Notwithstanding the concerns on over-reliance discussed above, it is widely accepted that credit ratings act as useful, and at times necessary, benchmarks for asset managers and investors. IOSCO further acknowledges that there is to date no fully satisfactory alternative to external credit ratings. They remain a key factor for market participants, which often refer to them as a “common language” to communicate about credit risk. Credit ratings rely on a blend of both quantitative (e.g., the systematic assessment of financial data, the calculation of ratios, running of models, etc.) and qualitative indicators (e.g., business risks, the impact of regulatory change, the quality of management, the implied future industry outlook, etc.) to objectively assess the probability of default (PD) or expected loss (EL)<sup>8</sup>.

This set of Good Practices (listed in Appendix A) aims at addressing any potential remaining over-reliance by asset managers on credit ratings and has received broad support from the various stakeholders. Importantly, changes have been implemented through sector specific regulation and asset managers have made efforts to limit their reliance on external credit ratings. Nevertheless, IOSCO’s work has shown that ratings continue to constitute a determining element in some investment decisions due to investor demands, which may result from regulation to which investors are subject or their own internal guidelines. In this respect, investor use of credit ratings could be an area for further work but goes beyond the scope of the present report.

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IOSCO’s Policy Committee for the Regulation of Market Intermediaries has launched a project to identify “*sound practices*” currently in place at intermediaries with regard to the use of alternatives to credit ratings to assess creditworthiness.

<sup>8</sup> By definition, CRA credit ratings are assessments on the general creditworthiness of an obligor (issuer) or of its creditworthiness in relation to a particular security or financial obligation and the relative likelihood that it may default, taking into account the foreseeable future events. Please refer to Moody’s Investor Service, Ratings Symbols and Definitions (August 2014) at 4, available at [https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC\\_79004](https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004); Standard & Poor’s, About Credit Ratings (2012), available at: [http://www.standardandpoors.com/aboutcreditratings/RatingsManual\\_PrintGuide.html](http://www.standardandpoors.com/aboutcreditratings/RatingsManual_PrintGuide.html); FitchRatings, Definitions of Ratings and other Forms of Opinion (Dec. 2014) at 4, available at: [https://www.fitchratings.com/web\\_content/ratings/fitch\\_ratings\\_definitions\\_and\\_scales.pdf](https://www.fitchratings.com/web_content/ratings/fitch_ratings_definitions_and_scales.pdf)

## Uses of external credit ratings by asset managers

Asset managers may refer to external credit ratings to different degrees in the construction and management of their portfolios. Given the diversity of asset classes and breadth of different investment vehicles, each following an investment strategy that is set to meet different investor needs, there is no single way that asset managers use external credit ratings.

Asset managers commonly use external credit ratings in three principle areas<sup>9</sup>:

- Investment management: external credit ratings may be used to guide asset selection in the construction and optimization of an investment portfolio, to guide the selection of eligible collateral received or posted from/to different counterparties or to assess a counterparty's overall financial health and ability to uphold its obligations *vis-à-vis* one or more funds, and in evaluating the credit quality of certain guarantors or of sponsors that may provide support to certain pooled investment vehicles (e.g., structured finance vehicles<sup>10</sup>).
- Risk management: external credit ratings may be taken into account in running liquidity tests, monitoring diversification rules, and more generally when estimating and managing portfolio risk;
- Communication: external ratings (both credit ratings of portfolio assets and ratings of managed funds) may be used for marketing purposes as well as for more general communication with investors (including in reports), brokers and other market participants.

### 1. Internal credit assessment

As set out in the FSB 2010 *Principles*, a key measure to reduce market reliance on external credit ratings is for asset managers to conduct their own credit assessments. The FSB 2010 *Principles* state that asset managers should be able to make their own determinations of the credit quality of the assets they intend to acquire or have acquired without mechanically relying on credit ratings, and should publicly disclose information about their credit assessment processes. Pursuant to the *Principles*, several jurisdictions have introduced a requirement for asset managers to conduct their own credit assessment or due diligence before investing in fixed-income products (e.g., Brazil, EU, South Africa).

IOSCO's 2009 *Good Practices* highlighted certain good practices in relation to asset managers' due diligence when investing in structured finance instruments.

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<sup>9</sup> These uses of ratings are based on the results of the mapping exercises conducted among Committee 5 Member jurisdictions over 2011-2012 and feedback on the consultation report.

<sup>10</sup> In general, a guarantor of a debt security has an unconditional obligation to pay the guarantee holder the principal amount of the underlying security plus accrued interest upon default. A sponsor of a structured finance vehicle on the other hand is not legally obligated to provide support to the entity, but some sponsors have done so. For example, please refer to Alistair Barr, *HSBC's Bailout Puts Pressure on Citi, "Superfund,"* MarketWatch, Nov. 26, 2007, available at <http://www.marketwatch.com/story/hsbcs-35-bln-siv-bailout-puts-pressure-on-citi-superfund>. In the context of structured finance vehicles, external credit ratings may be considered where an evaluation of securities issued by the vehicle may include consideration of the credit quality of a guarantor or explicit support provider. As an example, please refer to Moody's Approach to Rating Asset-Backed Commercial Paper (available at [https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBS\\_SF398273](https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBS_SF398273)).

Among these, the following still hold true for asset managers for the present report:

- Understanding the methodology, parameters and the basis on which the assessment of a CRA was produced, and having the adequate means and expertise to question that methodology, basis and the parameters, notably to identify their limits.
- Understanding how the assessment of the CRA was formed without relying excessively or solely on it to evaluate the assets invested in. External credit ratings do not substitute for a manager's due diligence: they may be the beginning of due diligence, but not the end<sup>11</sup>.

The overarching principle is that, while CRA ratings may be used as an input by asset managers, a manager should have appropriate controls and procedures in place internally to assess and manage on an on-going basis the credit risk associated with its investment decisions. A manager has fiduciary duties to its clients, which would encompass an understanding of the material credit risks of any investments that the asset manager makes or recommends and that they are appropriate for the client's risk profile and investment objectives.

Asset managers that invest in fixed-income products should have the appropriate expertise and processes in place to perform credit risk analysis in line with their investment policies<sup>12</sup>. To that end, managers should refrain from investing in instruments or issuers when they do not have sufficient information to conduct an appropriate internal assessment of the credit quality. In jurisdictions where applicable, regulators may check as part of the authorization process the adequacy, means and expertise that asset managers put forward to pursue the investment policy. However, these standard setters and regulators should be wary of imposing regulations relating to standards for in-house credit assessment, in particular to the extent that it might reintroduce other types of over-reliance and potential trigger effects stemming from an excessive homogeneity of practices that may result from overly prescriptive rules. In particular, standard-setters and regulators should take into account the nature, scale and complexity of the activities carried out by the manager when monitoring the adequacy of its credit assessment process.

For an asset manager, developing its own in-house credit assessment expertise is an essential added value provided to clients and represents one of the key factors managers use to differentiate themselves from one another. Although the approaches adopted by asset managers to assess credit risk may substantially differ from one another, asset managers generally should disclose in an understandable way to their investors the approach they follow<sup>13</sup>.

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<sup>11</sup> See *Good Practices in Relation to Investment Managers' Due Diligence When Investing in Structured Finance Instruments*, Final Report, Report of the Technical Committee of IOSCO, July 2009, available at: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD300.pdf>

<sup>12</sup> The same practice should apply to the evaluation of the financial strength of a guarantor or support provider to the extent it is a consideration in evaluating the creditworthiness of securities issued by a structured finance vehicle, and asset managers should not rely exclusively on external credit ratings in assessing the creditworthiness of those entities. Please see note 10 above.

<sup>13</sup> IOSCO understands that in general two internal models exist for assessing creditworthiness. In the first model the same team of professionals performs both portfolio management and credit assessment tasks; in the second model, credit research is carried out by a separate team of professionals. As a general rule, managers should disclose to their investors the internal model used. The risk of the first form of organization lies in the inherent conflict of interest between the desired "objectivity" of a manager's credit assessment and the manager's interest in pursuing higher returns through less creditworthy

While encouraging the development of internal credit assessment procedures, as noted above, IOSCO recognizes that external credit ratings can play an important role in providing asset managers with useful inputs to in-house credit research both before investing and while managing a portfolio. For example, external credit ratings can serve as a preliminary screen for asset managers while not replacing their own credit analysis. Asset managers may also use research from other entities, such as investment banks or brokers or from independent research providers, financial health assessors, structural models, market data, or portfolio management tools. In this regard, IOSCO acknowledges that its recommendations should allow for external credit ratings to continue to be used as benchmarks, among other purposes, complementing a manager's internal credit analysis and providing an independent assessment as to the quality of the portfolio constituents.

Asset managers could consider credit assessment procedures that include some or all of the following criteria, as appropriate:

- Performing the assessment on the basis of an internal assessment scale and through the application of a rigorous methodology validated by the management board;
- Basing such methodology on the relevant information available as appropriate to the type of instruments within the investment mandate;
- Ensuring that information used for the assessment is of sufficient quality, updated regularly and from trusted sources;
- Reviewing the assignment of internal credit assessments on an on-going basis and regularly assessing the impact of external events likely to alter the credit quality of an individual entity (e.g., events in the broader financial market, or specific to the entity such as a corporate event, a change in the relative external credit rating, etc.);
- Regularly reviewing the assessment procedure so that when there are material changes in investment objectives and financial market conditions, or in case of any other material change affecting its parameters the assessment procedure can be updated accordingly;
- Documenting, where relevant, the assessment procedure and the meaning of each internal assessment so as to provide the rationale underlying specific assessments, including a description of parameters, data sources, assessment models and their underlying assumptions, ratings' assignment processes, and events likely to trigger changes in the assessments;
- Specifying if, how, and the extent to which external ratings are taken into consideration and clarifying in the procedure the type of measures the asset manager would put in place in the event of a downgrade by a CRA where external ratings are used as inputs in the internal process, particularly if an investment grade rating is used as an investment threshold;
- Making available to investors, for instance, in prospectuses and/or relevant marketing materials, a brief summary description of these internal assessment procedures focusing on salient information.

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investments. Such conflicts are generally managed and mitigated through internal policies, procedures and controls.

It should be noted that external credit ratings also may be used as an indicator of liquidity. In periods of stress, some managers may be more prone to sell downgraded assets not only because of a change in the CRA's credit quality assessment, but also as managers fear the assets may become illiquid. Ratings may be taken into account in liquidity risk management when investors want to take less risk and generally hold high quality liquid securities. Internal credit assessment models may need to take into account other market indicators to evaluate the liquidity of a finance instrument. These may include, for instance, the issuer's amount of outstanding debt, the size and currency of the bond, the type of security, the depth and diversity of the issuer's investor base, the length of time since the issue date, and the estimated time to liquidate the bond.

### ***Good practices***

***Asset managers make their own determinations as to the credit quality of a financial instrument before investing and throughout the holding period.***

***Asset managers have the appropriate expertise and processes in place to perform credit risk assessment appropriate to the nature, scale and complexity of any investment strategy they implement and the type and proportion of debt instruments they invest in, and should refrain from investing in products / issuers when they do not have enough information to perform an appropriate credit risk assessment.***

***External credit ratings may form one element, among others, of the internal assessment process but do not constitute the sole factor supporting the credit analysis.***

***The manager's internal assessment process is regularly updated and applied consistently.***

## **2. Asset managers' access to underlying credit rating information**

When referring to external credit ratings to guide asset selection, managers should be able to assess the methodologies that the chosen CRAs have used to determine their credit ratings. The appraisal of an external credit rating may vary depending on the type of issuer or asset rated because of differences in available information<sup>14</sup>. An asset manager would benefit from an adequate level of disclosure, accompanied by inquiries, when appropriate, for the chosen CRAs about rating methodologies, credit outlooks, as well as broader market events or factors likely to affect the average credit quality of the invested portfolios. Such disclosures are also in line with IOSCO's revised *Code of Conduct Fundamentals for CRAs* concerning the important role that transparency can play by allowing asset managers to understand and compare the processes of various CRAs<sup>15</sup>, to identify, where necessary, the limitations of the CRAs' methodologies, models and key parameters, as well as to develop their own internal credit assessments, which may incorporate data disclosed by CRAs<sup>16</sup>.

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<sup>14</sup> In feedback received, one commenter noted that external credit ratings for corporate issuers tend to be much more reliable than for structured products where the information available is more limited.

<sup>15</sup> Please refer to the letter from IOSCO Board Chairman, Greg Medcraft, to the Finance Ministers and Central Bank Governors of the G20 of 15 April 2013; Available at: [http://www.iosco.org/library/briefing\\_notes/pdf/IOSCOBN01-13.pdf](http://www.iosco.org/library/briefing_notes/pdf/IOSCOBN01-13.pdf)

<sup>16</sup> In this regard, especially for certain types of structured products, asset managers could decide to exercise their own due diligence in conformity with the IOSCO 2009 *Good Practices*. Please refer to paragraph accompanying and preceding note 12 above.

### *Good practice*

*Where external credit ratings are used, asset managers understand the methodologies, parameters and the basis on which the assessment of a CRA was produced, and have adequate means and expertise to identify the limitations of the methodology and assumptions used to form that assessment.*

### **3. Asset managers' disclosures on uses of external credit ratings**

External credit ratings may be used by some asset managers to communicate the level of credit risk of a given portfolio and by investors when selecting the risk profile of a fund. It remains common practice to describe in a fund's disclosures the investment universe of a specific fixed income fund by referring to a minimum external credit rating that limits the securities in which the fund can invest.

IOSCO's mapping exercises have shown that requirements for asset managers to disclose their use of external credit ratings vary among jurisdictions, as well as across asset classes, or types of investment contract (e.g., discretionary investment contracts or not). In some jurisdictions, disclosures remain at the discretion of the manager or depend on the significance that external credit ratings may have in determining the risk profile of a fund portfolio<sup>17</sup>.

In light of the above and given the importance of fostering greater transparency for investors, asset managers should be encouraged to make available their policies with regard to the use of external credit ratings, for example, in prospectuses and/or in the relevant marketing documents. Information could contain some or all of the following elements, as appropriate:

- The sensitivity of the invested portfolio to changes in the assigned credit ratings, downgrades on the return/risk profile<sup>18</sup> and redemptions from the fund. Such description could include the likely effects resulting from changes in the external credit quality of collateral or of a counterparty, or where appropriate, of a guarantor or sponsor where this could have a material impact on the portfolio;
- A description (or reference to public availability) of the methodology underlying any CRA ratings on which the manager relies, with the main assumptions;
- Where the asset manager performs its own internal assessment, a general description of its methodology, including its underlying assumptions, including, if appropriate, the use of external credit ratings.

### *Good practice*

*Asset managers review their disclosures describing alternative sources of credit information in addition to external credit ratings and make available to investors, as appropriate, a brief summary description of their internal credit assessment process, including how external credit ratings may be used to complement or as part of the manager's own internal credit assessment methods.*

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<sup>17</sup> For instance, in one jurisdiction only if instruments subject to credit risk form a "significant" part of the portfolio, and where CRA ratings are given significant weighting by the manager in making credit assessments, would they be required to be disclosed. Furthermore, such disclosure is required only where investment is sought from investors who are neither professional nor sophisticated.

<sup>18</sup> In this regard, please also refer to the IOSCO 2009 *Good Practices*.

#### 4. Quality of counterparties and collateral

- *Counterparties*

While in the context of asset selection, there tends to be reduced reliance on external credit ratings both from the regulatory perspective and market practice; asset managers and investors still widely refer to them when it comes to determining the quality of collateral and counterparties, where references to external credit ratings remain both in private contracts and in prudential rules<sup>19</sup>.

In practice, this may translate into a situation where an asset manager could close out one of its managed funds' positions, for instance with a derivative counterparty, from the moment the latter is affected by a credit rating downgrade. For example, a downgrade or the cancellation of the credit rating of the counterparty is included in the Additional Termination Event clause of the ISDA Master Agreement which outlines the standard terms applied to a derivatives transaction between two parties<sup>20</sup>. Under the clause, if a given institution's credit rating falls below a predetermined threshold or is withdrawn by one or more credit rating agencies, the counterparty has the right to close out all derivative contracts with this institution<sup>21</sup>.

- *Collateral*

Moreover, external credit ratings may also be taken into consideration when it comes to determining the size of haircuts applicable to certain collateral. For instance, it is IOSCO's understanding that the size of the haircuts applied by the European Central Bank (ECB) depends on the credit quality of the collateral as determined by external ratings<sup>22</sup>.

With respect to regulatory requirements, the revision of asset eligibility rules in many jurisdictions has led to a reassessment of the use of ratings for collateral exchanged on the basis of margining agreements in the context of derivative and securities financing

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<sup>19</sup> Please refer to the discussion in section 6.1 below on references to credit ratings in investor mandates. For instance, in Appendix C, example (iv)), with regard to the credit quality of eligible counterparties to repo transactions, one relevant article of the relevant regulation provides that “[...] *Such (repo) transactions shall not be permitted with those entities, which in the quality of counterparties, do not possess a long-term (external) rating above or equal to A-*”. Another example can be found in the relative investment guidelines of a European UCITS fund whereby counterparties to swap derivative contracts must have a long-term rating above or equal to A-. The same applies for counterparties to repo or securities lending transactions.

<sup>20</sup> The ISDA Master Agreement is the most commonly used agreement for OTC derivatives transactions, and is published by the International Swaps and Derivatives Association (ISDA).

<sup>21</sup> Please refer to the article *Downgrade Termination Costs* of Fabio Mercurio, Roberto Caccia and Massimo Cutuli published in March 2012 in Risk.net magazine; available at [http://www.risk.net/digital\\_assets/4143/risk\\_0312\\_mercurio2.pdf](http://www.risk.net/digital_assets/4143/risk_0312_mercurio2.pdf). In this article, the authors demonstrate that Ratings-based (RB) additional termination event (ATE) clauses in International Swaps and Derivatives Association agreements can have a significant impact on the valuation of derivatives portfolios when rating events occur.

<sup>22</sup> See *The ECB Guidelines on Monetary Policy Instruments and Procedures of the Eurosystem*, September 2011, available at: [https://www.ecb.europa.eu/ecb/legal/pdf/1\\_33120111214en000100951.pdf](https://www.ecb.europa.eu/ecb/legal/pdf/1_33120111214en000100951.pdf)

transactions<sup>23</sup>. In addition, reforms are underway in some jurisdictions to introduce alternative criteria or methods<sup>24</sup> for managers to evaluate the quality of received/posted collateral away from external credit ratings. Such changes could mitigate the risk of pro-cyclical effects due to sudden credit downgrades of securities used to secure financial transactions<sup>25</sup>.

When evaluating the quality of collateral, asset managers could consider the type of collateral and the characteristics of the issuer and whether the collateral fulfils some or all of the following tentative parameters, as appropriate<sup>26</sup>:

- Sufficiently liquid<sup>27</sup> (at least as liquid as the eligible assets in case the counterparty does not honour its obligations and the rights to collateral are enforced);
- Valued on a regular basis (e.g., valued on a daily basis and exhibiting a low price volatility and low bid-ask spread);
- Issued by an entity unaffiliated with the counterparty and/or displaying a low correlation with it;

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<sup>23</sup> For instance, in Europe, Article 46 of EU Regulation No. 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) provides that a CCP shall accept highly liquid collateral with minimal credit and market risk to cover its initial and ongoing exposure to its clearing members. For financial instruments, the Delegated Regulation No 153/2013 expressly states in its Annexes I and II that when performing their internal assessments, CCPs shall employ a defined and objective methodology that shall not fully rely on external opinions (for further details, see Annex 1 of Regulation 153/2013). Available at: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0041:0074:EN:PDF>

<sup>24</sup> For instance, in the U.S., regulatory amendments eliminated the requirement that collateral (other than cash or government securities) for a repurchase agreement must be rated in the highest category by certain CRAs or be of comparable quality if the CIS is looking to the collateral issuer for certain purposes under the Investment Company Act of 1940. Instead the amended rule requires that collateral other than cash or government securities must consist of securities that the CIS's board of directors (or its delegate) determines are: (i) issued by an issuer that has an exceptionally strong capacity to meet its financial obligations; and (ii) sufficiently liquid that they can be sold at approximately their carrying value in the ordinary course of business within seven calendar days. See Removal of Certain References to Credit Ratings Under the Investment Company Act, Investment Company Act Release No. 30847 (December 27, 2013).

<sup>25</sup> According to a comparative study authored by the European Central Bank (ECB), minimum credit ratings may be an *additional* requirement in establishing the quality of collateral under the framework of central banks and of CCPs. As an example, under the Eurosystem, collateral quality is independently assessed on the basis of the minimum probability of default (PD) calculation (required under the Basel rules for measuring regulatory capital), which is then compared with the ratings of an external CRA. The Eurosystem also allows the use of alternative credit assessment systems, such as in-house central bank credit assessment systems, counterparties' internal rating-based systems or third-party providers' rating tools. Other central banks typically require more than one rating from the external CRAs. For further information, please refer to the ECB study *Collateral Eligibility Requirements: A Comparative Study Across Specific Frameworks* published in July 2013; available at: <http://www.ecb.europa.eu/pub/pdf/other/collateralframeworksen.pdf>.

<sup>26</sup> In this sense, as an example, please also refer to the ESMA *Guidelines on ETFs and other UCITS* issued in December 2012; available at: [http://www.esma.europa.eu/system/files/2012-832en\\_guidelines\\_on\\_etfs\\_and\\_other\\_ucits\\_issues.pdf](http://www.esma.europa.eu/system/files/2012-832en_guidelines_on_etfs_and_other_ucits_issues.pdf)

<sup>27</sup> Liquidity is a function of several factors that those managing collateral should consider. In general, factors that may typically affect the liquidity, and hence the valuation, of collateral are demand pressures, inventory, availability of transparent pricing, etc.

- Sufficiently diversified across issuers, markets, industries and/or regions and is exposed to low country risk;
- Governed by a clear legal regime allowing rights to collateral to be enforced immediately (i.e. without the prior approval of the counterparty) and within well-defined limits for its potential re-investment;
- Subject to stress-testing to assess the liquidity risk where received collateral represents more than a minimum portion of a fund's net asset value (NAV);
- Application of a clear haircut policy across varying asset classes;

***Good practice***

***When assessing the credit quality of their counterparties or collateral, asset managers do not rely solely on external credit ratings and consider alternative quality parameters (e.g., with respect to collateral, parameters such as liquidity, valuation, correlation etc.).***

## **5. Managing external credit rating changes**

Notwithstanding an asset manager's (or even investor's) recourse to its own internal analysis on the creditworthiness of an instrument and/or its issuer, it is acknowledged that external credit ratings represent an important and objective benchmark for many market participants, particularly for those with fewer resources to devote to the development of internal credit rating scales or models. In this regard, the potential cliff effects that can result from a credit ratings downgrade may be of particular concern to regulators.

IOSCO understands that there is no standard reaction to external credit rating downgrades, and managers often may have anticipated the external credit rating change. Nevertheless, if they rely more heavily on external credit ratings, asset managers should have appropriate internal procedures when a security is subject to an external credit rating downgrade taking due account of investors' best interests. These procedures may include specific "grace periods" that may range, for example, from ten days to three months to allow managers to delay divesting the related securities if it would be in the best interests of the investors. In other cases, asset managers may keep the security in the portfolio and/or decide not to acquire more of the asset, and/or acquire better rated instruments so as to increase the portfolio's overall credit quality. Procedures are likely to vary depending on the portfolio and on the investors' guidelines. While some managers may be constrained in their ability to invest in relatively low-rated assets on behalf of their clients, other managers may have more leeway and develop strategies to capitalize on opportunities to buy or sell the affected securities.

***Good practice***

***Where external credit ratings are used, a downgrade does not automatically trigger the immediate sale of the asset. Should the manager/board decide to divest, the transaction is conducted within a timeframe that is in the best interests of the investors.***

## **6. Investor reliance on external credit ratings**

The consultation process has shown that the use of external ratings by asset managers is mainly demand-driven. Investors generally consider external credit ratings before investing and throughout the life of their investments to define the range of assets in which they choose to invest or to communicate levels of risk tolerance. As such, external credit ratings represent a “common language” used by parties to an investment management agreement. In the absence of external credit ratings provided by CRAs, many investors would need to rely almost exclusively on the asset manager in determining whether a security is of investment grade or of high credit quality. As such, references to CRA ratings, even when embedded in investment contracts, may prove beneficial to investors by offering them alternative information points from a third party, while establishing that certain expectations as to how the assets should be managed are to be taken into account by the asset manager. Investors also may rely on credit ratings, among other factors, when choosing to invest (or remain invested) in a particular investment vehicle.

### **6.1. References to external ratings in individual investment mandates**

It is worth noting that investors control asset allocation strategies, and investor mandates include various investment guidelines and restrictions, which may include credit ratings. An investor may impose strict investment restrictions that are derived from regulatory requirements or the investor’s internal rules. For instance, an investor that is a bank or an insurance company subject to the Basel framework or in Europe the Solvency regime may determine its investment universe based on the capital cost incurred for specific instruments. Apart from these international standards, some investors may still be subject to national laws and regulations that incorporate CRA ratings in prescribing investments for those entities. For instance, in some jurisdictions retirement plans may be required by law to define their investment universe according to CRA ratings. In such circumstances, managers may establish privately managed accounts that are tailored to the specific profile and needs of the investor (e.g., a large pension or insurance fund). The asset manager would exercise its discretion within specific bounds by purchasing only those securities rated at or above a minimum external credit rating in conformity with the guidelines established by the investor<sup>28</sup>. In this regard, a privately managed account can offer the investor a greater degree of flexibility in negotiating a mandate, including the desired minimum credit quality of the individual assets to constitute the portfolio.

The degree of CRA rating reliance largely depends on the sort of investment vehicle, on the investment purpose this serves, and on the degree to which the asset manager must observe minimum external credit ratings under private agreement with the investor. References to external credit ratings may trigger mechanistic reliance if embedded in trigger clauses; conversely, if used for reaching a consensus between client and agent for defining the investment criteria or risk tolerance, these references may be less problematic.

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<sup>28</sup> For examples of the type of language that has been used in investment guidelines, please refer to Appendix C.

## 6.2. Investor use of fund ratings

Funds also may have external ratings. These generally differ from external credit ratings of individual financial instruments and of their issuers in that fund ratings emphasize different non-credit and qualitative aspects of a selected issuer, such as the effectiveness of a particular strategy in meeting desired returns, the process of investment decision-making, etc.<sup>29</sup> Fund ratings are generally not used in rules and regulations. Investors, however, may use fund ratings, among other factors, when choosing to invest (or remain invested) in a particular vehicle, or to compare two or more separate portfolios.

For certain types of investment portfolios (e.g., MMFs, bond funds, etc.), asset managers may be incentivized to request the rating of one or more of the funds they manage to meet investors' demands<sup>30</sup>.

In very specific cases, the external rating of the fund may be based on the credit assessment of the vehicle's assets. In this respect, European MMFs are an interesting example. Stakeholders have explained the development of MMF credit ratings in Europe by the added value provided to investors in the absence of a defined common regulatory framework<sup>31</sup>. Prior to the introduction of ESMA's guidelines on MMFs in 2010, there was no common definition of an MMF in Europe. Investors therefore used CRA credit ratings to ensure that a fund met

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<sup>29</sup> An example of this second category is provided by Morningstar's methodology for rating funds, split between the Star Ratings, which are backward-looking, strictly quantitative, assessing a fund's past performance in terms of returns adjusted for risk/volatility, of performance vis-à-vis competitors in the same category, and of value generated for investors over specified periods; and the more recent Analyst Rating system, where more qualitative and "subjective" factors are taken into account to express a forward-looking opinion on the people (a fund's managers), the process (i.e., how a fund's proclaimed strategy is translated into a portfolio), the parent (i.e., what are the managing company's priorities), the performance (i.e., why did a fund behave in a certain way in certain markets and probability of the same repeating in the future), and the price (i.e., is a fund a good value proposition for investors compared to peers). The Analyst Rating system methodology fact sheet is available at: <http://corporate.morningstar.com/US/documents/MethodologyDocuments/FactSheets/AnalystRatingforFundsFactSheet.pdf>. For further information, please refer to the Morningstar *Equity Research Methodology* of January 2012, available at: [http://news.morningstar.com/pdfs/Equity\\_Research\\_Methodology\\_010512.pdf](http://news.morningstar.com/pdfs/Equity_Research_Methodology_010512.pdf). See also Fitch Ratings with regard to the fund quality ratings criteria: Assessing Funds' Investment Processes and Operational Attributes, available at: [https://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=552845](https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=552845). The Fitch Quality Ratings have three pillars: (1) an assessment of the investment process, its resources and the management company; (2) an operational "pass/fail" analysis; and (3) a 'reality check' of the qualitative assessment against the manager's historical risk-adjusted performance.

<sup>30</sup> For example, some investors will only invest in MMFs that have received the highest rating (this is more common with respect to Constant Net Asset Value MMFs). In its position statement on the European Commission Proposal for Regulation of Money Market Funds, the European Association of Corporate Treasurers (EACT) underlines the importance of external credit ratings in MMF fund selection commenting that investors in MMFs appreciate the oversight provided by independent ratings and incorporate external ratings criteria in their internal policies and controls (available at: <http://www.eact.eu/docs/EACT-Position-Statement-on-MMF-Regulation-Oct13.pdf>).

<sup>31</sup> Please refer to the comment letters from HSBC and IMMFA sent to the European Commission in the context of a consultation on the UCITS directive; available at: [http://ec.europa.eu/internal\\_market/consultations/2012/ucits/registered-organisations/hsbc-global-asset-management\\_en.pdf](http://ec.europa.eu/internal_market/consultations/2012/ucits/registered-organisations/hsbc-global-asset-management_en.pdf), and: [http://ec.europa.eu/internal\\_market/consultations/2012/ucits/registered-organisations/institutional-money-market-fund-association\\_en.pdf](http://ec.europa.eu/internal_market/consultations/2012/ucits/registered-organisations/institutional-money-market-fund-association_en.pdf).

minimum standards in terms of credit quality and liquidity and was subject to appropriate oversight. The guidelines, by setting a common framework, appear to have contributed to reducing the rationale for investor reliance on external ratings. These stakeholders have also pointed to a number of risks that could stem from the use of MMF ratings, particularly in an environment where the number of financial institutions with a sufficiently high credit rating has become smaller.

In this context, the likelihood of an MMF's rating downgrade and the pressure to maintain the rating have increased. The general approach of CRAs in rating MMFs is to focus primarily on the basis of preservation of capital and providing liquidity to shareholders<sup>32</sup>. The high credit quality of the underlying assets – with the resulting highest awarded fund rating by a CRA – are therefore essential requirements for these funds to be marketed in view of the above objectives. Thus, if individual securities are downgraded, or even placed under negative review, an MMF could have an incentive to sell those securities in order to keep its portfolio in line with the criteria set by the CRA notwithstanding the manager's own credit assessment of the underlying asset's credit quality<sup>33</sup>.

Further, in some cases, investors may use the external rating as a proxy for the resilience of the fund rather than conducting their own due diligence. These investors may therefore have a strong incentive to redeem an MMF's shares if the MMF is downgraded or put on negative watch<sup>34</sup>. As boards of institutional investors and corporate treasurers often require an MMF to have the highest possible rating for them to invest, MMFs are often either rated "AAA" or not rated, which may create a risk of sudden redemptions in a rated MMF if it no longer meets the requirements for the CRA rating. However, investor appetite for ratings of MMFs may be reduced with the strengthening of regulatory frameworks applicable to MMFs<sup>35</sup>.

A CRA rating a global bond fund attaches significant weight to the average credit quality of

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<sup>32</sup> As an example, please refer to Moody's Revised Money Market Fund Rating Methodology and Symbols of March 10, 2011, [https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC\\_131303](https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_131303).

<sup>33</sup> In the U.S., the incentive to sell securities as a result of a credit ratings downgrade may not be a consequence of the impact on the fund's rating. Rule 2a-7 under the Investment Company Act of 1940 governs the operations of U.S. MMFs. The rule requires an MMF's board of directors promptly to reassess whether a security that has been downgraded by a CRA continues to present minimal credit risks and take such action as the board determines is in the best interests of the fund and its shareholders. Proposed amendments to rule 2a-7 issued in July 2014 would eliminate the required board reassessment in the event of a downgrade and instead require written policies and procedures requiring an MMF's manager to provide ongoing review of the credit quality of each security to determine that it continues to present minimal credit risks. See Removal of Certain References to Credit Ratings and Amendment to the Issuer Diversification Requirement in the Money Market Fund Rule, Investment Company Act Release No. 31184 (July 23, 2014), <http://www.sec.gov/rules/proposed/2014/ic-31184.pdf> (noting that as a practical matter the amendment would require monitoring for downgrades because of the potential effect on a portfolio security's market value).

<sup>34</sup> See Fitch puts *Matrix-owned funds on review due to firm's financial resources*, published in *MoneyMarketing* on 12 December 2011; available at: <http://www.moneymarketing.co.uk/fitch-puts-matrix-owned-funds-on-review-due-to-firms-financial-resources/1043059.article>.

<sup>35</sup> The European Commission published in September 2013 a draft Regulation on Money Market Funds where it proposes to prevent an MMF from soliciting or financing an external credit rating "to ensure that fund managers and investors stop relying on external credit ratings that could be detrimental to the functioning of the money market when downgrades occur". For further details, please see: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52013PC0615&from=EN>

the underlying portfolio, its sensitivity to market risk factors, such as duration, spread risk, currency fluctuations, etc., as well as to its past performance relative to a benchmark<sup>36</sup>. At this stage, it is IOSCO's understanding that investors do not rely on credit ratings of the assets in different types of fund portfolios to the same extent. Specifically, between two types of fixed income portfolios, where one is labeled "*high yield*" (or "*speculative grade*") and the other "*investment grade*", end-investors would rely more heavily on the credit quality of underlying assets of the investment grade fund as assessed by CRAs. The reliance would be less true for a high yield portfolio where investors willingly take on greater risks and rely more heavily on a manager's individual skill.

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<sup>36</sup> As an example, please refer to Fitch's *Global Bond Fund Rating Criteria* of August 2013, available at [https://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=715678](https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=715678). Unlike bond funds, equity funds – defined as those that invest either wholly or predominantly in common stock – that are rated are generally assessed on the basis of their relative performance over a specific period and on the quality of the manager, reflected in its financial profile, its client servicing ability, its investment infrastructure, etc. As an example, please refer to Moody's *Methodology for Assessing the Investment Quality of Equity Funds* of February 2012, available upon request. However, the present report only looks at a fund rating to the extent that it reflects the creditworthiness of the underlying portfolio and could potentially create an undue reliance on CRA ratings.

IOSCO acknowledges that considerable efforts have been made in the aftermath of the financial crisis to reduce reliance on external credit ratings. In a number of jurisdictions, progress has been made toward removing references to credit ratings hard wired into laws and regulations. For their part, asset managers do not appear to have a mechanistic approach towards external credit ratings, but generally tend to have a robust internal credit assessment process in which external credit ratings usually form only one element among others to be taken into consideration before making an investment decision. Asset managers also indicate that they engage with CRAs on a more frequent basis to understand the parameters and assumptions behind CRA methodologies.

By contrast, various forms of reliance on external credit ratings remain on the investor side. Some investors use ratings in investment mandates to set strict restrictions on the range of permitted investments. These references to external credit ratings may derive from regulatory requirements or an investor's own internal rules, and they may result in mechanistic reliance, which could trigger forced asset sales in the event of downgrades. To address continuing concerns, IOSCO recommends considering potential ways to reduce possible investor overreliance on external ratings as a result of references in regulatory requirements.

## Appendix A – List of Good Practices

Asset managers make their own determinations as to the credit quality of a financial instrument before investing and throughout the holding period.

Asset managers have the appropriate expertise and processes in place to perform credit risk assessment appropriate to the nature, scale and complexity of any investment strategy they implement and the type and proportion of debt instruments they invest in, and should refrain from investing in products / issuers when they do not have enough information to perform an appropriate credit risk assessment.

External credit ratings may form one element, among others, of the internal assessment process but do not constitute the sole factor supporting the credit analysis.

The manager's internal assessment process is regularly updated and applied consistently.

Where external credit ratings are used, asset managers understand the methodologies, parameters and the basis on which the assessment of a CRA was produced, and have adequate means and expertise to identify the limitations of the methodology and assumptions used to form that assessment.

Asset managers review their disclosures describing alternative sources of credit information in addition to external credit ratings and make available to investors, as appropriate, a brief summary description of their internal credit assessment process, including how external credit ratings may be used to complement or as part of the manager's own internal credit assessment methods.

When assessing the credit quality of their counterparties or collateral, asset managers do not rely solely on external credit ratings and consider alternative quality parameters (e.g., liquidity, valuation, correlation, etc.).

Where external credit ratings are used, a downgrade does not automatically trigger the immediate sale of the asset. Should the manager/board decide to divest, the transaction is conducted within a timeframe that is in the best interests of the investors.

## **Appendix B – Relevant FSB Principles for investment managers in detail**

Principles I and II provide the general framework requiring that standard setters, authorities and market participants consider ways to reduce overreliance to CRA ratings.

### **Principle I. Reducing reliance on CRA ratings in standards, laws and regulations**

Standard setters and authorities should assess references to credit rating agency (CRA) ratings in standards, laws and regulations and, wherever possible, remove them or replace them by suitable alternative standards of creditworthiness.

### **Principle II. Reducing market reliance on CRA ratings**

Banks, market participants and institutional investors should be expected to make their own credit assessments, and not rely solely or mechanistically on CRA ratings.

### **Principle III.3. Internal limits and investment policies of investment managers and institutional investors**

Investment managers and institutional investors must not mechanistically rely on CRA ratings for assessing the creditworthiness of assets. This principle applies across the full range of investment managers and of institutional investors, including money market funds, pension funds, collective investment schemes (such as mutual funds and investment companies), insurance companies and securities firms. It applies to all sizes and levels of sophistication of investment managers and institutional investors.

Principle III.3.b. Senior management and boards of institutional investors have a responsibility to ensure that internal assessments of credit and other risks associated with their investment are being made, and that the investment managers they use have the skills to understand the instruments that they are investing in and exposures they face, and do not mechanistically rely on CRA ratings<sup>37</sup>. Senior management, boards and trustees should ensure adequate public disclosure of how CRA ratings are used in risk assessment processes.

Principle III.3.c. Regulatory regimes should incentivise investment managers and institutional investors to avoid mechanistic use of CRA ratings. The principle provides a list of incentives to avoid the mechanistic reliance on ratings. These are *inter alia*:

- Restricting the proportion of a portfolio that is solely CRA ratings-reliant;
- Supervisory monitoring of credit and other risk assessment processes (in the case of supervised investment managers and institutional investors);
- Requiring the boards, trustees or other governing bodies of investment managers and institutional investors to regularly review any use of CRA ratings in their investment guidelines and mandates and for risk management and valuation;

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In the text accompanying the Principle III.3.b, the FSB report adds that the case of smaller, less sophisticated investors (who do not have the resources to conduct internal credit assessments for all their investments or who may outsource all or part of their investment management), this could be carried out through the trustees or others responsible for directing the investment strategy, ensuring that they understand the risks implied by the strategy they are following, as well as the appropriate uses and limitations of CRA ratings.

- Requiring public disclosures of internal due diligence and credit risk assessment processes, including how CRA ratings are or are not used, with the aim of encouraging investment managers to develop more rigorous and individual processes included in investment mandates, rather than relying on common triggers;
- Requiring public disclosures of risk assessment policies related not solely to specific rating thresholds, but also accounting for the types of instruments (thus reflecting the different nature of the risks applying to, for instance, structured finance products compared with corporate bonds). Such disclosures should be made in a manner consistent with the goal of streamlining disclosures for customers.

**Appendix C. Examples of references to external credit ratings in fund investment mandates or in national SRO standards**

The following box illustrates the use of references to external credit ratings in fund investment mandates or in national SRO standards. Below are examples of language that has been used by (i) a large pension fund, client to a large global manager, in an excerpt taken from the relevant investment guidelines; by (ii) and (iii) with excerpts taken from the investment guidelines relative to a managed account run by another large global manager in the interest of institutional clients; and by (iv) in a national self-regulatory organization (SRO) regulation concerning certain complementary pension schemes with regard to asset eligibility rules.

According to (i), *“Fixed income securities shall not be rated less than Baa3 or its equivalent.”* [...] *“All securities must be rated by either Moody’s or Standard & Poors.”*

According to (ii), *“Securities must be rated either by S&P or Moody’s. [...] Securities rated equal to or lower than BBB+/Baa1 must have no more than 50% of the Fund’s total NAV. In case of a downgrade, the Investment Manager can hold securities rated equal to or lower than BB+/Ba1 but must be no more than 10% of the Fund’s total NAV.”*

According to (iii), the following table illustrates the relative weight of government and corporate bonds as a percentage of the account’s portfolio relative to their long-term rating issued by S&P<sup>38</sup>:

<b>Long-term grade at time of purchase</b>	<b>Bonds issued (or guaranteed) by a sovereign with a minimum rating of A-</b>	<b>Other bonds (corporates) with a rating between AAA and AA-</b>	<b>Other bonds (corporates) with a rating between A+ and A-</b>	<b>Other bonds (corporates) with a rating of BBB+ or lower</b>
<b>Max. portfolio weight per issuer</b>	35%	5%	3%	1%

According to (iv) *“Bonds and other types of debt instruments comprising the minimum 60% quota of a portfolio must obtain an (external) rating above or equal to A- or equivalent (where no rating is available, the rating of the issuer may be referred to). Nevertheless, in the case of a managed account or of a dedicated investment fund mandate, securities rated below A- or above or equal BBB- are allowed to be invested in up to a limit of 5% of a portfolio on condition that those rated at least A- represent at least 60% of the portfolio.”*

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<sup>38</sup> The mandate further admits that the comparable ratings of Moody’s and Fitch are also taken into account and where “split ratings” occur, the lowest of among three CRAs shall be considered.