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July 7, 2015

Mohamed Ben Salem
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Calle Oquendo 12
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Re: Comment on Alternatives to the Use of Credit Ratings to Assess Creditworthiness

Dear Mr. Ben Salem:

The IIF broadly supports the work of IOSCO aimed at examining the reliance on credit ratings by large market intermediaries, and identifying sound practices with regard to the use of alternatives to credit ratings to assess creditworthiness. Therefore, the IIF welcomes the opportunity to comment on the proposals contained therein.

General Comments

- The IIF is generally supportive of the "sound practices for assessing credit risk by large market intermediaries" listed in the paper and believes them to cover the main areas while leaving sufficient leeway for market intermediaries to apply and adapt them to their specific business models and commensurate risk management needs.

  In the same spirit, our view is that the final version of this paper ought to focus solely on these sound practices and main principles given that (i) some of the comments provided by surveyed intermediaries seem to be rather idiosyncratic in cases where there might be a range of sound practices; and (ii) some of the comments are difficult to interpret. It is likely that the idiosyncratic comments are valid for the responding firm given the varying global regulatory regimes in which they operate; however, other practices would likely be equally good but just not described in the commentary.

- Rather than including in the final paper survey results which may be misconstrued as recommended practices for all, may prove confusing, and/or are not entirely representative of all groups of large intermediaries, we recommend to simply expand in the final IOSCO paper on the sound practices. A key requisite is to avoid ambiguity in the wording of the 13 sound practices so that interpretations are aligned with what are truly the best practices. Clear and unambiguous principles will unequivocally lead to harmonized local regulations and supervision.

- To emphasize this point a bit more: by citing some of the specific examples of survey results it can inadvertently give the impression that these are the best practices. For many issues there is no single best practice, but there is a range of reasonable and good practices that may depend on the business model of the firm, the size of the investment/exposure relative to the size of the intermediary, the jurisdiction in which they are operating, and so forth.

- For this purpose, we suggest that IOSCO convenes an IOSCO-industry roundtable to discuss sound practices based on which the high-level principles can be further fine-tuned. Given the large variety in types of market intermediaries and their commensurate risk management needs, and how well established regulatory guidelines are within a country, being prescriptive about the practices underlying the sound principles should be avoided at all cost.

- While we understand why IOSCO decided to cast the net wide – there is a wide variety of large intermediaries active in the derivative and securities markets – a clear repercussion is that some conclusions cannot be drawn for the entire group. Between intermediaries that have a buy-and-hold strategy and those that trade, as well as between intermediaries active in derivatives markets and those that invest in securities, risk and due diligence practices logically can differ substantially, even though the same core principles apply to all. Attention should also be placed to differentiate practices from financial intermediaries active in sophisticated financial instruments vis-à-vis market intermediaries whose risk management practices are geared towards more conventional financial instruments.

  Similarly, the use of external ratings will differ between different types of market intermediaries. For instance, asset managers and their clients, the asset *owners*, may need external ratings as common language and benchmark in their agreed investment guidelines.

  On a similar note, the type of investments or derivatives determine to a large extent where the focus of the credit assessment will be. For structured or secured products, intermediaries will not just assess the creditworthiness of the counterparty/issuer, but put equal emphasis on the underlying collateral, collateral counterparty or structure.

- The IIF is concerned that the practices described may not be truly representative of what is happening in different financial sector institutions: insurers, pension funds, asset managers, banks, and broker/dealers all may have different business models and corresponding risk management practices. Within institutions, Chinese walls may also play a role. Further, there seems to be some geographic bias in the survey results. Therefore it is important that the described practices not be misconstrued as applied by all or, conversely, applied by one or only a few market intermediaries. In the same vein, rather than the practices described in the paper, only the Sound Practices should be taken as guiding principles for local regulators and supervisors.

- We further note that there is a mismatch between the title of the Consultation report and the report itself: while the title seems to suggest a sole focus on the alternatives to the use of credit ratings to assess creditworthiness, the report de facto describes

(counterparty) credit risk management practices more broadly. While we do not disagree with the amplified focus, the overarching message should indeed be that market intermediaries deploy a wide variety of risk management tools and practices in their (counterparty) credit risk assessments. The title used in the May 7 press release "Sound practices at large intermediaries for assessing credit risk" seems to cover this better.

- Also, while we support the objective of eliminating overreliance and mechanistic reliance on external ratings, external ratings can serve effectively as benchmarks or provide relevant complementary information to internal due diligence processes. The current title seems to suggest that external ratings should be substituted altogether by alternative credit risk assessment tools. The suggested title above would address this issue as well.

  In conclusion, and as outlined further in our Detailed Comments section, while we agree that credit ratings are not a substitute for independent credit analysis, they are an important reference point in the credit analysis and investment process. Global, publicly available ratings are also a key element in warding off financial fragmentation.

- In this context, we stress the multiple reforms that have been enacted, proposed and implemented for Credit Rating Agencies (CRA) over the past few years. These, coupled with a clear message that credit ratings should never be the sole focus of creditworthiness assessments, should suffice to create an ambience in which all market intermediaries and their customers conduct proper, targeted and comprehensive credit analysis.

- Lastly, we do not understand why this guidance is confined to *large* intermediaries. It seems fair to conclude that large financial intermediaries may well benefit from economies of scale in establishing internal credit risk assessment. Assessing the probability of default relies heavily on data sources; the compilation of data for internal risk assessment may impose onerous cost for some market intermediaries. However, pre-crisis overreliance on external ratings in actual fact was observed in many smaller financial institutions that were drawn by the combination of AAA ratings and attractive yields. Herd behaviour by groups of small market intermediaries has the potential to create systemic risk.

Draft Sound Practices

We conceptually agree with the draft sound practice recommendations, however as previously mentioned we would like to avoid diverging interpretations and/or misinterpretations by regulators. The recommendations below could benefit from further refinement in that they may otherwise turn out to be overly prescriptive vis-à-vis current credit assessment practices. Therefore, we include below our commentary.

Sound Practice 5

- To avoid conveying the impression that credit ratings should not be part of the risk assessment process, this point should be clarified, perhaps with the addition of a clause

at the end, e.g. "... and stay abreast of market indicators, with external ratings used to complement the process as needed."

Sound Practice 6

- Although we understand that this recommendation is intended to be high level, we also believe that additional detail needs to be included regarding how the adequacy of "internal capabilities to independently and adequately assess the exposure" is to be measured. Further, some exemptions should be allowed. For further clarification, we refer to our General Comments section.

Sound Practice 7

- There needs to be further clarification on the wording of this recommendation, especially what is meant by "take on additional leverage." It is unclear how "growing" would put more pressure on the risk assessment for a firm that is already in a particular business, unless this wording is meant to encapsulate expanding the asset classes or products and/or creating undue concentration effects. Furthermore, the language of the recommendation could suggest that there should be a differential treatment for larger institutions compared to smaller institutions. While we embrace "materiality" and "proportionality" as a general concept, we believe that all intermediaries – large or small – should fully understand and assess the risks they take. It would make more sense to differentiate between short-term trading and long-term investment.

Sound Practice 8

- The language of this recommendation appears to mix up two collective issues i.e. (1) concentration risk management with (2) the holistic assessment of (counterparty) credit risk, by incorporating both quantitative and qualitative factors. We agree that it is important to rely on both qualitative and quantitative measures, and not solely rely on quantitative measures; however we believe that the concentration issue needs to be disaggregated and discussed in a separate recommendation.
- Furthermore, we note that credit ratings (both internal and external) should not be seen as purely quantitative measures. They generally include qualitative assessments: many credit rating models contain a statistical model component and an expert judgment layer where the quality of management and other qualitative factors are assessed and weighted.

Sound Practice 9

- We would suggest clarification on the words "fundamental value of the instrument" to comprehend what will be the exact expectation of regulators when assessing an intermediary's compliance with the recommended practices.
- We note that the risk level and investment appetites are closely related to the purpose of the business activities (e.g. an insurance company's risk appetite will be different from the risk appetite of a broker/dealer). In addition, on the asset manager side, generally sector limits and mandates are not controlled by the asset managers but set by their customers. In any case, the concept of prescribing investment appetite is a bit jarring – investment appetite is dependent on a wide range of variables, of which the ability to assess credit risk is only one. Clarification is warranted more generally because it seems counter intuitive for some types of financial intermediaries to prescribe

"investment appetite", since this may well be determined by market forces, i.e. supply and demand, beyond financial intermediaries' control.

Sound Practice 10

- The IIF believes that if the intermediary has a robust credit risk oversight framework, including, but not limited to, an internal risk rating framework, there is no need for a different process for non-investment grade securities. Generally, intermediaries have processes in place to actively and closely monitor counterparties subject to a series of consecutive downgrades, downgrades below a certain level and counterparties with very low creditworthiness, but we deem imposing a distinction between investment grade and non-investment grade too prescriptive. We further note that investment grade and non-investment grade are distinctions based on external ratings and would therefore de facto encourage the use of same.
- In addition, we note that it is not true in all cases that a non-investment grade product requires more scrutiny than an investment grade product. For certain products, e.g., leveraged lending, asset-backed lending, investment grade names require the same level of review than non-investment grade names, and in fact, there are other criteria that are more important to consider. We suggest this recommendation say that firms should "Consider if non-investment grade products require more scrutiny". It should not automatically be assumed they do.

Sound Practice 11

- The IIF conceptually agrees with the objective to reduce overreliance on external ratings. Without prejudice to the above, we however point out that in certain circumstances external ratings may still play a significant role (e.g. in assessing how investors with constrained mandates may behave, or contractual triggering of a credit event). We will elaborate on this issue in our Detailed Comments section. We refer to the summary statement "For example, CRA ratings *could* be…" we believe the language should be slightly amended to "… *may* be a lagging indicator".

Detailed Comments

While the Consultation Document summarizes survey answers and findings from Roundtables, the IIF members believe that in some areas clarification (or even in a few occasions, corrections) are warranted. The below comments therefore should be seen in the light of further explanation of practices.

Comments on p. 3 and 9

- The IIF concurs with the objective of proper due diligence and the elimination of mechanistic reliance on external ratings. Without prejudice to the aforementioned however, we note that in the absence of robust alternatives, external ratings still should be allowed. We list below various examples to illustrate this point.

  We refer for instance:
  - To the necessity in certain contracts to use a measure to trigger a credit event that is deemed acceptable, well understood and neutral by both contractual parties. Until a viable alternative to external ratings is developed for such a

purpose, the contractual parties may not have sufficient trust in the other party's internal credit assessment or rating.

- To the market-making nature of the trading floor and trade obligations (e.g. bonds, etc.) which do not have internal ratings, where it becomes impractical to require internal ratings for all such transactions. In this case, a crossover rule that derives inventory limits may be more appropriate to assess credit capacity using an internal rating.
- To the use of a ratings-derived limit for an investment portfolio which includes single name limits by external rating, and portfolio limits by external rating. Similarly, for fixed income market making it may not make sense to complete a comprehensive credit review to the extent contemplated in the paper.
- To define, in investment management agreements, the universe of securities that asset managers are allowed to choose from, also allowing the asset owners to compare risk and performance across portfolios.
- To consider credit ratings as one input in the selection of high quality securities as eligible collateral.
- To the practicality of a requirement to fully subject every security to a full internal assessment, for example in the case of a repo book which is large overnight or inventory.
- Similarly, for some SPVs and structured transactions, it will prove challenging to avoid reference to external ratings as there are may be no robust alternatives.
- Another example is the elimination of any "expert opinions" to the requirement for inclusion of at least 1 investment grade rating for trading positions receiving "specific capital" relief or, in Canada under NI81-102, which requires counterparts for regulated funds to be conducted with counterparts with a minimum rating of A.
- In case external ratings are replaced in prudential or other regulation by simple factors[1] that do not capture the full risk and internal credit assessments are also not allowed, the end result may actually prove to be less robust prudential measures. In such cases, we recommend that external ratings are re-introduced.

In most if not all of the above illustrative examples, credit ratings provide unique, well understood benchmarks, but would not preclude intermediaries from performing adequate due diligence. Internal credit assessments in actual fact give intermediaries the opportunity to create alpha over the benchmark formed by the credit rating.

Comments on p. 7

- Credit ratings can indeed prove to be a lagging indicator. However, the IIF does not support this as a generalized view. Where intermediaries have ample information at their disposal and have an elaborate relationship with the issuer/counterparty, this may well be the case. However, the reverse case may be true as well, i.e. a downgrade by one of the CRA's can prove to be a relevant trigger preceding further internal review, especially for better rated counterparties. There can be a time lag between on-site visits to counterparties as a result of which either the CRA or the intermediary can be better informed at a particular stage. CRA provide a gatekeeping service for the market and

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[1] We refer for example to the dual factor approach in the newly proposed Basel Standardized Approach for Credit Risk and the use of OECD ratings for sovereign counterparties in the US Standardized Approach

their "negative watch" signals provide intermediaries a second opinion and a reference point to hold their own views against.

Comments on p. 13

- In most firms, the role of audit is to monitor the adherence to policies and procedures by the business units and by the risk management function. Independent reviews of credit decisions are often conducted by dedicated Risk review or Risk oversight groups, but as a matter of principle many firms do not include this in the mandate of group audit.
- Since the group of market intermediaries is very diverse, the focus that they will put on the issuer or counterparty's creditworthiness is "the heart of the assessment" in a more or lesser degree. For instance, in the case of repo style transactions, it is not just the creditworthiness of the counterpart, but equally important is the underlying risk of the collateral (the counterpart of the collateral). Also, depending on the business model, the client relationship will be more extensive.
- A missing component in the list of topics is the loss given default grade or the facility/product rating. While this is not a factor of counterparty creditworthiness, sometimes the probability of default and the loss given default are positively correlated.

Comments on p. 14

Commercial paper and structured products

- As a general comment, we believe that the listed credit factors that surveyed intermediaries cited in this section represent a non-exhaustive list, and that in reality large market intermediaries have a broader scope of factors that are included in their credit assessments.
- We observe that asset-backed securities are oftentimes included in the notion of structured products; the text on p. 14 is therefore somewhat confusing.
- We note that not all credit intermediaries are banks, and therefore not all market intermediaries can make use of the internal ratings based approach. Furthermore, this ratings based approach is currently being revisited by the BCBS.
- Most structured products and CP (at least the ones mentioned in the Consultation paper) are not distributed to retail clients and footnote 28 should therefore be more focused on products that are available to retail clients.

Asset-Backed Securities

- We believe that the comments made by surveyed parties on asset-backed securities are not fully representative of current practices:
    - The role of issuer/originator of an ABS is normally limited to servicing the underlying assets and/or providing support facilities. The main focus of the due diligence is therefore by definition on both the underlying assets and on structural features.
    - In Europe securitization-related due diligence requirements for investors are cast in stone by way of regulations for funds, insurance companies and banks. They include requirements to fully assess all relevant factors, including the structural transaction features, waterfall etc. "Certain firms" should therefore be replaced by "all firms".

Comments on p. 15

Credit risk weights of Counterparties

- We assume that what is meant by "credit risk weights" and "risk-weighted assets" in footnote 30 is regulatory capital requirements. It is unclear what is meant exactly in this section. Intermediaries often use internal credit assessments or ratings, and intermediaries that are part of a banking group use these as well for regulatory capital. The example given of risk sensitivity in the footnote does not seem entirely accurate as self-liquidating, short-term trade finance transactions often present low risk, and might even prove to be lower risk than a mortgage loan.
- We further note that most intermediaries do not see concentration risk, industry sector risk and country risk as stand-alone risk categories: concentration risk includes concentrations in industry sectors, geographies and single names, all of which are incorporated in risk appetite frameworks and monitored by way of limits.

Comments on p. 17-18

Reliance on Credit Ratings

- We note that that the statements made in the section seem to be contradictory to earlier statements on p. 7 in Section A. Overview, claiming that at least the largest market intermediaries never relied on external ratings.
- We also do not fully understand and dispute the representativeness of the sentence "while most firms do not generally conduct any extra specific due diligence when using CRA ratings, a number of market intermediary firms perform some level of due diligence *before relying on them.*" In our view, intermediaries do not rely on them, they take them into account and generally are aware of the underlying rating agency methodologies.
- We also do not understand the point made on "data points". We assume that this relates to historic default and loss data, and note that since Basel II has existed for a long time, the market intermediaries that are part of banks as well as many other intermediaries will by now likely have sufficient historic data to make a proper creditworthiness assessment unless they start to invest in a new asset class.

We welcome a close dialogue with IOSCO on this important matter. As in the past, the IIF stands ready to provide further input and any necessary expansions or clarifications on all of our comments.

Yours sincerely,

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