ASSET MANAGEMENT INDUSTRY GUIDELINES TO ADDRESS OVER-RELIANCE UPON RATINGS

Starting in the summer of 2007, accumulating losses on US subprime mortgages triggered an unexpectedly widespread disruption to the global financial system. This turmoil followed an exceptional boom in credit growth and leverage in the financial system; a boom that was characterised by an unprecedented expansion of the market for securitisation of credit risk and the aggressive development of the originate-to-distribute model of financial intermediation. This model depended critically upon confidence in originators' underwriting standards and the performance of credit rating agencies. Large losses were, and continue to be, sustained on the resultant complex structured securities. Many credit markets became illiquid, hindering credit extension.

There has been a wide-range of responses, initiatives and interventions directed at stabilising the current situation and increasing the resilience of markets and financial institutions going forward. Not least amongst these is the work of the Financial Stability Forum (FSF). In its April 2008, Report on Enhancing Market and Institutional Resilience[i], the FSF states:

"Investors should address their over-reliance on ratings. Investor associations should consider developing standards of due diligence and credit analysis for investing in structured products."

EFAMA, ESF and IMA[1] have produced these guidelines (the "Guidelines") as a response to the call of the FSF. Importantly, these guidelines have been prepared from the standpoint of

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[1] **European Fund and Asset Management Association (EFAMA)**: EFAMA is the representative association for the European investment management industry. EFAMA represents through its 24 member associations and 42 corporate members about €14 trillion in assets under management of which €6.8 trillion managed by around 53,000 investment funds at end September 2008. For more information, please visit www.efama.org.
European Securitisation Forum (ESF): The ESF, an affiliate of the Securities Industry and Financial Markets Association is the voice of the securitisation and CDO market place in Europe, with the purpose of promoting efficient growth and continued development of securitisation throughout Europe. Its membership is comprised of over 160 institutions involved with all aspects of the securitisation and CDO business, including issuers, investors, arrangers, rating agencies, legal and accounting advisors, stock exchanges, trustees, IT service providers and others. The ESF has two sister organisations: the American Securitization Forum and ASIFMA. The credit rating agency members of the ESF have not been party to ESF discussions in relation to these guidelines nor have they been involved in the formal ESF process to endorse the guidelines. For more information on ESF please visit www.europeansecuritisation.com.
Investment Management Association (IMA): IMA is the trade body for the UK's £3.4 trillion asset management industry. The money its members manage is in a wide variety of investment vehicles including

Europe’s asset management industry and address the role in the investment process of asset managers that are agents, or fiduciaries, for their clients, the owners of capital. Those clients for whom the asset managers act will include pension funds, UCITS, insurers, corporates, sovereign wealth funds, hedge funds and bank portfolios (“the asset management clients”). In addition, many of these institutions may manage their own funds, which are not intended to be covered by these Guidelines, but may be covered by similar but separate guidelines.

The Guidelines are written so as to be applicable across a wide range of securitisation, structured finance and structured credit products, including but not limited to RMBS, CMBS, ABS, CDOs, whole business securitisations, insurance linked securities and credit linked notes. Together for ease of reading these are all referred to in these guidelines as “structured credit products” or “SCPs”. The term “originator” refers to the seller, or servicer, of an asset pool, while the arranger is the broker/dealer that structures the deal, obtains ratings, and distributes the product

SCPs have generally not been a major investment area for traditional asset managers. Accordingly, the quantum of losses suffered by such asset managers in the last year and a half has not been of the same magnitude as those suffered by other market participants. This is the result, in part, of legislative constraints on the types of allowable investments and in part of the investment aims of asset managers. Even prior to the FSF report, many asset managers had been reviewing their due diligence protocols and their credit processes. Nevertheless, it is acknowledged that not all asset managers always fully understood the nature of some SCPs and that excessive reliance on credit ratings did, in some cases, occur.

Over-reliance rather than any reliance is addressed in these guidelines, indeed some regulations (rightly or wrongly) demand that some reliance is placed. There are clearly benefits to having credit rating services. They provide valuable information which may play a proper role in any investment process. At their best, credit ratings help the market to effectively and efficiently evaluate and assess credit risk, price debt securities, benchmark issues and create a robust secondary market for those issues. But even at best, ratings do not provide all the information needed and in addition events have shown that conflicts, or potential conflicts, and other factors affect the quality of the ratings. Accordingly, the Guidelines encourage asset managers to address any weaknesses in the investment processes which come from over-reliance upon credit ratings. The capability of asset managers to so act depends, however, upon the quality and extent of the information disclosed by the issuer and

authorised investment funds, pension funds and stocks and shares ISAs. Its role is to represent the industry and promote high standards.

the rating agencies since these form a necessary prerequisite to any investor's own risk analysis.

The Guidelines

1. **When investing in SCPs asset managers must have regard to their obligation to act professionally and in the best interests of their clients**.

    a. Those persons at asset managers with responsibility for assessing SCPs for investment should be competent and diligent. Clients can be expected to rely upon their asset managers to exercise due skill, care and diligence in the areas in which they hold themselves out as able to make decisions on behalf of their clients. Where asset managers do not have the necessary competences in relation to any type of SCP they should refrain from buying and managing such investments (subject to any specific instructions).

    b. Asset managers should have well-articulated investment processes in relation to SCPs that are applied consistently. The analysis of the underlying assets, structures, obligor risk and any correlation risk in SCPs can be challenging, and some asset managers may be tempted to avoid the costs of doing their own analysis. There is a risk that this tendency to save costs can become aligned with an incentive to treat credit ratings as complete proxies for the analyses that ought to be made. It is important therefore that the investment processes include risk analysis commensurate with the complexity of the structured product and the materiality of their holding.

    c. Asset managers, acting in the best interests of clients, should require SCP issuers, originators and distributors to provide them with all necessary information and assistance on the SCP in question to meet their obligations to their clients throughout the lifecycle of any holding. Where the information is insufficient or unclear, or the assistance inadequate, the asset manager should challenge the other parties, to an extent commensurate with the complexity of the structured product and the materiality of their holding. If dissatisfied, asset managers should consider whether their client's interests would be better served by declining to buy or hold the SCP in question. An example of inadequate assistance would be where disclosure is made in such form or in such amount, that it does not facilitate easy identification of the information that is critical from the point of view of the asset manager; it does not follow that a document which is legally comprehensive is in fact comprehensible.

d. Asset managers should monitor whether any determinations, opinions or assumptions about an SCP that underpinned a decision to invest or continue to hold, remain valid during the lifetime of any holding, and to take action accordingly.

2. Asset managers should understand the limitations to any credit ratings and to address the risks arising.

Credit ratings, and so the risk of over-reliance upon such ratings, play a role in:

(i) investment guidelines and mandates;
(ii) the selection and retention of particular structured products; and
(iii) risk management and valuation.

Ratings should not replace appropriate risk analysis and management on the part of investors. It is necessary therefore to be aware of the limitations of any credit ratings, some of which are set out below. Enhancements suggested by supervisors and governmental bodies also identify areas not currently covered by credit ratings. The guiding statements below draw upon these.

a. Credit ratings are incomplete descriptions of riskiness. Credit ratings may be assessments of creditworthiness, but they are not assessments of the level of liquidity, market or rating volatility risk nor should ratings be exclusively relied on for valuation purposes. Critical assumptions about risk, diversification and value should not be founded upon a credit rating.

"[in relation to structured finance], due to tranching and the effects of default correlation, the one-dimensional nature of credit ratings based on expected loss or probability of default is not an adequate metric to fully gauge the riskiness of these instruments. As the unexpected loss properties of structured finance products tend to differ significantly from those of traditional credit portfolios or individual credit exposures, structured finance tranches can be significantly riskier than portfolios with identical weighted average ratings."[ii]

Adding tranched products to an existing portfolio raises issues regarding the management of correlations on the portfolio level - particularly for "correlation-intensive" products such as CDOs referenced to corporate credit default swaps, and certain other products. Investors need to be aware of the possibility of hidden concentrations leading to higher than expected losses when portfolio correlation has been underestimated.[iii]

"Some end-investors and fund managers may have mistakenly assumed that the credit ratings of these products provided information on other risks. Many of these instruments are 'buy and hold' securities for which there is not always a readily available secondary market. A single rating does not capture adequately all of the risks inherent in these products — for example, liquidity risk — as reflected in the differential pricing of products within a similar ratings band"[iv]

b. *Asset managers need to understand the methodology and competences of a rating agency whose opinion is to be taken into consideration.*

Structured finance tranches are usually tailored by arrangers with certain rating levels and corresponding rating agency requirements in mind. Deal origination thus involves obtaining structuring feedback from the rating agencies through the arranger, and subsequent engagement in an iterative dialogue with the agencies through the arranger in order to finalise the structures. Whilst these are characteristics of the rating process for SCPs, reliance upon credit ratings should recognise that engagement in deal structuring can give rise to a risk that arrangers become over-focused on designing structural aspects of a SCP to meet the minimum requirements of a CRA model. Such "box-checking" could expose weaknesses in the CRA's methodology.[v] There is also a risk that arrangers will approach a second rating agency if it does not appear that the first will rate the SCP as the arranger might have hoped; this adds to the importance of understanding the methodology and competences of any rating agency (and implicitly envisages that rating agencies will assist this process through increased transparency).

c. *Significant areas of information are not available to those who rely upon credit ratings. Note the list below of comments upon credit rating process and data – these are informative as they identify what is not available generally.*[vi]

(i) Agencies do not generally publish the expected loss distributions of structured products, these could provide a visual reminder of the fatter tails embedded in the loss distribution in structured products.

(ii) Agencies do not provide a summary of the information provided by originators of structured products. Information on the extent of originators' and arrangers' retained economic interest in a product's performance could be included in such a summary, which may then satisfy investors that incentives are well aligned or encourage asset managers to perform more thorough risk assessments.

(iii) Agencies do not produce explicit probability ranges for their scores on probability of default so as to provide a measure of the uncertainty surrounding their ratings.

(iv) Agencies do not use the same credit assessment criteria. Currently, some use probability of default, some expected loss given default and others a combination of these. This leads to a risk of misinterpretation.

(v) As rating agencies do not score instruments in relation to market liquidity, rating stability or volatility over time or even the certainty with which a rating is made, a credit rating is not suitable for monitoring the non-credit risks in a portfolio.

3. In the best interests of their clients, where appropriate, asset managers should challenge mandates which appear ill-designed.

Ratings can be an effective first filter within an investment process, when comparing a universe of available SCPs, but ratings should not be the decisive factor in an investment decision. Asset managers may have more or less say in the mandates they are given; at times ill-designed regulation, asset allocation specialists or the client may constrain any input available from the asset manager. However where appropriate, asset managers should challenge mandates that over-rely upon ratings as clients, or those advising them, may not always understand, for example, that when structured finance is an allowable asset class in investment mandates, ratings-based investment constraints may not be effective as a tool for defining broad maximum levels of portfolio credit risk.[vii]

4. Asset managers should periodically assess the adequacy and effectiveness of their arrangements for addressing the above Guidelines.

Regulatory requirements frequently address both the need for adequate and effective internal controls and the critical role played in such a process by the responsible senior management of any firm. It is essential in addressing due diligence that the arrangements put in place to address the other Guidelines are periodically assessed, in addition to the assessments required by Guideline 1.d for example.

Whilst the nature and detail of arrangements will differ across the wide-range of asset manager firms, some questions will be common to many reviews:

- Do our policies say what we do, and do we consistently do what they say?
- Where policies provide for exceptions and escalations, have these worked and do they remain relevant and are they over-used?
- Are control functions sufficiently independent of or segregated from line functions?
- Are we measuring the effectiveness of our arrangements and does the management information provided to senior management identify the right signals in a timely manner? Has senior management reacted as expected?
- How has the market evolved since the last review and so do existing arrangements remain adequate and effective despite any changes?
- Have there been key personnel changes or key changes to the investment strategy which have lead to significant changes to necessary competences at our firm?

At times reviews will be event-driven. Severe market events as experienced since July 2007 are obvious examples of what may trigger a review, but the introduction of a new type of SCP or alteration to the common characteristics of an existing type may also require a firm to review relevant arrangements.

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[i] http://www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf, see page 37
ii Committee on the Global Financial System, The role of ratings in structured finance: issues and implications, January 2005, page 34
iii CGFS Report, page 32
iv Bank of England, Financial Stability Report, October 2007, Issue No. 22, page 43 (http://www.bankofengland.co.uk/publications/fsr/2007/fsrfull0710.pdf)
v CGFS Report, page 15
vi BoE FSR No. 22, page 57
vii CGFS Report, page 32