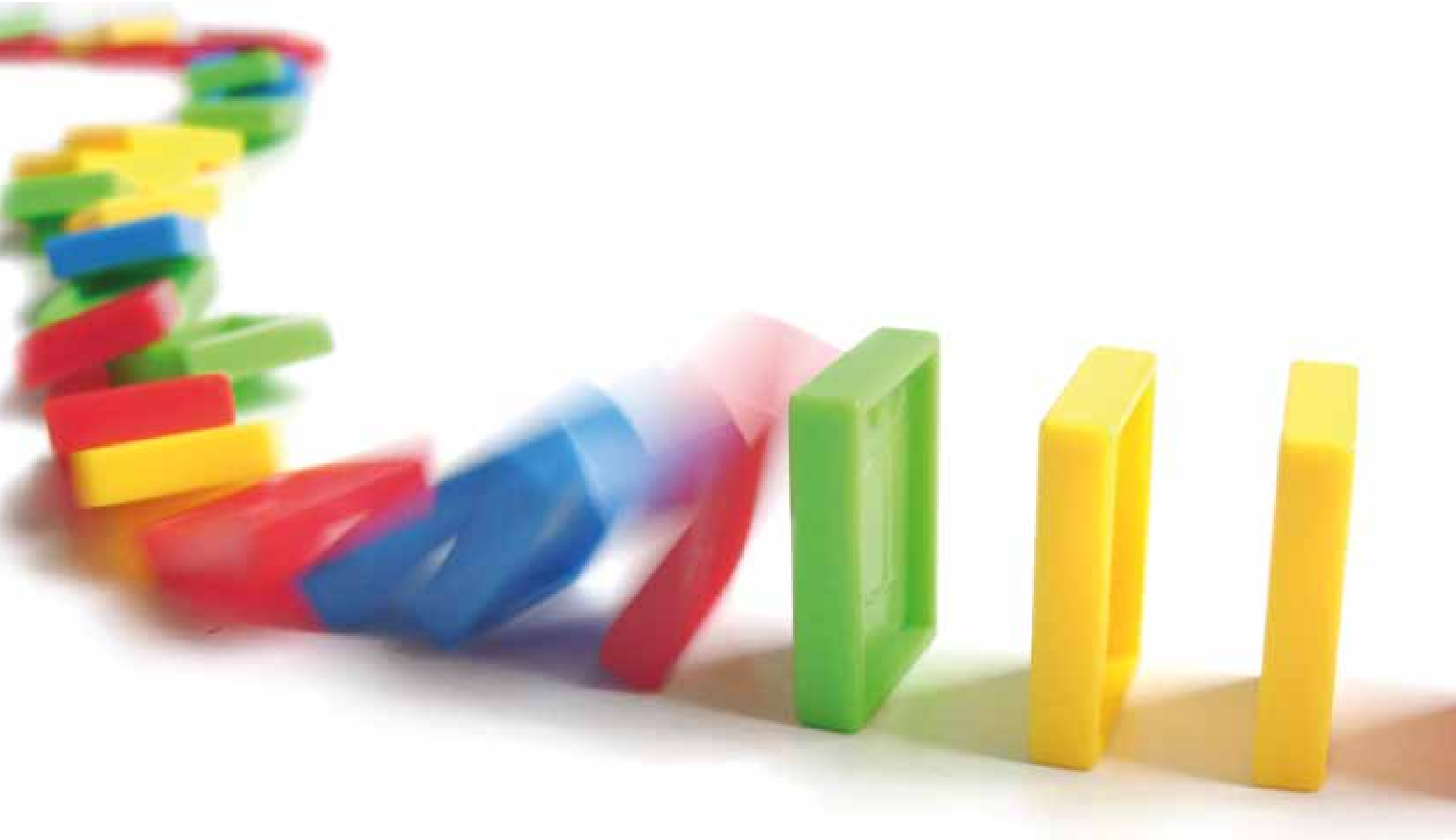

# How the CRA Regulation will impact the asset management industry

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- What is the credit rating agencies (CRA) Regulation?
- Why has it been introduced?
- Implications for the asset management industry
- Challenges for the customer, custodian and audit firm
- Risk or opportunity for asset managers?

The new regulation applicable to the credit rating agencies (CRA Regulation) states that the EBA, EIOPA and ESMA "shall not refer to credit ratings in their guidelines, recommendations and draft technical standards where such references have the potential to trigger sole or mechanistic reliance on credit ratings by the competent authorities" (Art. 5b(1) Regulation (EU) No. 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No. 1060/2009 on credit rating agencies).

In plain language, it will no longer be possible for credit ratings to be the only factor used to define an investment universe, a level of risk, a dispersion ratio, a level of capital charge per rating, etc. The impact will not be insignificant. For many years, credit ratings published by rating agencies have represented a 'common language' for assessing credit risk in a portfolio or a balance sheet. Asset owners and asset managers use credit ratings to define an asset allocation, set limits and authorise counterparties for the purpose of calibrating credit risk. The same applies to controls made by the custodian. Furthermore, under Solvency II, insurance companies can no longer base their portfolio selections solely on credit ratings.

Asset managers, insurers and banks will have to broaden credit risk assessments of their assets with a non-exclusive and non-systematic reliance on credit ratings. Firms will have to define a credit risk scale and methodology based on an internal approach to credit risk. Credit ratings may be an input of this methodology, but others must be included.

The CRA Regulation was a result of the shock wave triggered by the subprime crisis. The credit rating agencies were singled out for a number of reasons. First and foremost, many credit ratings given to structured products were clearly too high compared to the same rating for a corporate issuer. An AAA-rated collaterised debt obligation (CDO) was not as secure as an AAA-rated corporate bond, misleading investors.

Furthermore, some issuers defaulted despite being rated as investment grade at the time of default or a few days before. Some issuer ratings may have been too 'friendly'. Moreover, it has been suspected that the 'issuer pays' model (i.e. the issuer pays to obtain a rating from an agency) may, in certain cases, lead to a conflict of interest. The leading position of credit agencies in evaluating credit risk in the market was a matter of concern.

The rating agencies came under fire again a few months later during the euro crisis for downgrading some government ratings, possibly at the worst moment for the market. Many investors had credit rating limits within their own risk frameworks, which forced them to sell government bonds that had been downgraded. It could be argued that this triggered the massive 'disorderly sell off' on the Eurozone government bond market. In some cases, these downgrades started a vicious circle generating further downgrades. Strict reliance on credit ratings to define an investment universe was thus generating a systemic risk.

While some of the criticism aimed at the credit agencies concerning their rating of structured products was valid, it could also be said that this very new sector did not have the benefit of a historical approach.

Now that the CRA Regulation is here, asset managers will have to implement it in their organisation: first, by modifying all the fund prospectuses that used to include a reference to credit ratings to define their investment universe, allocation process, selection methodology and risk limits. In each case, credit ratings have to be removed and replaced by an internal methodology to assess credit risk, which will increase the cost of credit coverage and IT support. The new regulation will raise the barriers to entry for new players in the credit market and may cause problems for small asset managers.

Furthermore, as asset managers are moving towards their own assessment of credit risk, the junction point between the customer and its custodian will have to be redefined. A large number of institutional investors are still following rules based solely on credit ratings from agencies. Under the typical business model involving the asset manager (AM), customer and custodian, the main credit risk limits were defined in the fund prospectus, and the custodian checked that the AM was following the rules.

The CRA regulation will require a new system to be put in place. For dedicated funds, limits based on credit ratings can no longer appear in the prospectus. If a customer wants to keep the old credit rating-based risk framework, this will have to be stated in the delegation agreement, and the custodian will have to carry out controls on both the prospectus and the delegation agreement (leading to new costs and controls). Otherwise, the customer will have to endorse the AM's credit risk methodology (as is the case for open funds) meaning, at the very least, new controls of the asset manager and new due diligence. This may ultimately mean that an asset owner will have as many methodologies to control as delegated AMs. Meanwhile, audit firms will have to carry out controls on AMs, using the prospectus based on the internal approach of each AM, thereby creating new controls and requiring a new approach for each AM—with further cost implications.

To the **point**:

- The CRA Regulation will lead to structural changes in the way credit risk is managed in the asset management industry
- The relationship between the customer and custodian will have to change, generating more flexibility yet also more risk of misunderstandings
- From a purely investment standpoint, the CRA regulation will create attractive opportunities. For instance, an AM (investment grade only) may invest in a BB+ issuer before an upgrade (if it considers it to be an investment grade issuer) and receive excess returns, instead of losing money when being systematically forced to sell it in the opposite case
- AMs that invest in establishing a robust internal credit risk methodology should succeed in generating new returns for their customers, despite the constraints and costs of the new regulation

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