BlueBay Asset Management LLP: Response to the ESMA Consultation Paper on Guidelines on Disclosure Requirements Applicable to Credit Ratings

March 2019

Introduction

BlueBay Asset Management LLP is one of Europe's largest specialist active fixed income managers, entrusted by clients with over US$60.1 billion in assets under management (as of 31st December 2018) in corporate and sovereign debt, rates and FX. Our investment philosophy and approach is focused on delivering absolute-style returns, with an emphasis on capital preservation. We have an established track record of innovation and performance, providing a broad range of relative return, total return and alternative investment portfolios in both public and private debt markets.

We welcome the opportunity to respond to this ESMA public consultation.

As a specialist fixed income manager, BlueBay is a consumer of credit ratings, and we are a client of the credit ratings related analysis produced by credit rating agencies (CRAs). Given the unique and important role that credit ratings play in financial markets, in terms of providing an indication of the creditworthiness of the issuer, it is critical there is sufficient level of transparency provided by CRAs around the characteristics of the rating level itself, as well as the basis for any changes or actions to these. Users of credit ratings – which includes investors – will be better placed to understand the reasoning behind the credit ratings, any risks, uncertainties and limitations underpinning the credit rating, as well as where further information can be found to facilitate our own credit analysis. As such, we are supportive of initiatives that promote transparency as a core principle.

Our investment analysis considers both financial and non-financial factors – where the latter is commonly referred to as sustainability or Environmental Social Governance (ESG) factors. BlueBay believes that some ESG factors – just as some financial factors - can potentially have a material impact on an issuer's long-term financial performance. Poorly-managed ESG risks can lead to inefficiencies, operational disruption, litigation and reputational damage, which may ultimately impact an issuer's ability to meet its financial responsibilities. Supplementing traditional financial analysis by reviewing ESG-related management practices and performance is, therefore, not only prudent but also in line with BlueBay's fiduciary duty to optimise investor returns. There is also increasing recognition that as some ESG factors can potentially represent systematic financial risks, ensuring a sustainable financial market is critical to avoid potential future financial crises.

Responses to questions

<u>CRA regulations' requirements for press releases</u>

Q1: Do you agree with the proposed Guidelines for press releases that accompany credit ratings or rating outlooks? If not, please explain.

[The proposals being:

- *An indicator of whether the credit rating has been endorsed for use in the EU*
- *In the case of an unsolicited credit rating a prominent statement using a clearly distinguishable colour code explaining the involvement of the rated entity*
- *Name, job title, contact of persons responsible (lead analyst and/or chair of rating committee, legal entity responsible for issuing the credit rating*
- *Indication of all substantially material sources used to prepare the credit ratings*
- *Principal methodology(s) used in the credit ratings*
- *Sensitivity of the rating to future developments*

- *The meaning of each rating category, including definitions of default, risk warnings, sensitivity analyses, key rating assumptions etc.*
- *An indication whether the rating was disclosed to the rated entity and amended following that disclosure]*

Specific

The outlined requirements appear reasonable to propose and could provide users with greater clarity, consistency and ultimately confidence in the credit ratings. However, we believe some are more useful to have than others, such that ESMA should consider focusing on a few key requirements and suggest the others as additional areas to cover at the discretion of CRAs.

The ones we believe should be prioritized are those relating to the basis of the rating level where this was unsolicited, the principle methodology(s) used in the credit ratings, sensitivity of the rating to future developments, the meaning of each credit rating, sensitivity analysis and key ratings assumptions, and an indication of whether the rating was disclosed to the rated entity and subsequently amended.

However, some of the above would benefit from being repositioned and clarified. Specifically, on the requirement on an indication as to whether the rating was disclosed to the rated entity and amended following that disclosure, we believe this would benefit from additional wording as the requirement should go beyond what is currently stated to include (shown as underlined text):
"An indication whether the rating was disclosed to the rated entity and amended following that disclosure. In the instance where the rating was amended, the former rating needs to be disclosed, as well as the basis for the rating change."

In the case above, we believe it would be important to know what the un-amended rating was **before** it was amended, and **what** the specific reason(s) for this change is (e.g. what the nature of the factual error and/or new information that led to the revision from the rating prior to the appeal). This would provide more complete information.

Regarding unsolicited credit ratings, we believe an alternative and simplified requirement to the existing one could be as follows (shown as underlined text), which would provide users with the information around the extent to which the credit rating is based on publicly available information, or if there were direct interactions with the issuer:
"*In the case of an unsolicited credit rating, disclose if the issuer participated and provided financial accounts information."*

As a general principle, ESMA should allow some flexibility in the level of information available on these areas within the press release itself (e.g. considering it sufficient to include a link to information outside of the press release rather than requiring full details within it) to ensure the documentation remains concise and effective, and is not taken up with regulatory disclosures (for example the meaning of the rating such as 'BBB' via a link to a publicly available document rather than set out in the press release itself).

General

As press releases accompanying issuance of credit ratings have become the vehicle through which CRAs meet the majority of their disclosure obligations with respect to credit rating issuance, we agree with the focus on this specific documentation. There should be consistency and harmonisation in the information disclosed by CRAs in press releases in accordance with the necessary requirements as this builds trust and confidence in CRAs and the quality of their outputs.

Given this does not appear to be the case, we welcome efforts by ESMA to close this gap, and support the idea proposed of collating a set of good practices within a single guidance document. The emphasis on minimum standards makes sense, although we recognise that there may be circumstances where this may not be relevant or appropriate. In such instances, where a CRA deviates from the guidance, there should be an explicit 'comply or explain' approach taken.

In terms of the 'what' aspect of the disclosure guidance, we believe it is important to have concise and effective disclosure as well as avoid, as much as possible, a long list of prescriptive regulatory disclosures (for example, as investors it is not evident that the legal entity of the office that issued the rating and press release is relevant to be included in the press release). A balance needs to be struck between these two aspects for the guidance to deliver meaningful and effective disclosure. The focus of disclosure in the press release documentation should enable readers to understand the underlying key elements in terms of 1) why a rating is where it is (e.g. the level), and 2) why the level has changed (e.g. the rating action).

With regards to the 'how', whilst it is helpful to offer some illustrative examples of this, we would advise against being too prescriptive and allow for some degree of discretion for the CRAs.

Q2: Do you agree that a standardised scheme indicating the rated entities level of participation would be beneficial? Do you have any comments on the proposed standardised scheme?

We agree that disclosure on basis of the unsolicited credit rating would be helpful, but would suggest an alternative and simplified requirement to the existing one could be shown in as follows (shown in underlined text), which would provide users with the information around the extent to which the CRA rating is based on publicly available information, or if there were direct interactions with the issuer:
"*In the case of an unsolicited credit rating, <u>disclose if the issuer participated and provided financial accounts information."</u>*

Q3: Do you have any comments on specific items under this section? If yes please explain with reference to the proposed item's number

We have outlined those items we have specific suggestions for in terms of revisions. More generally we would encourage ESMA to have greater clarity in terms of the scope / focus of disclosures in the press release documentation. We would recommend that such disclosures need to cover two aspects in terms of the underlying key elements (defined as material and relevant to the credit opinion): 1) why the rating is where it is (e.g. the level), and 2) why the rating level has changed (e.g. the rating action).

<u>ESG factors under the CRA regulation</u>

Q4: Do you have any comments on the proposed Guidelines under this section?

The provisions considered relevant being:

- *The key elements underlying the rating issuance [Annex I, Section D, I, 5]*
- *A credit rating agency shall accompany the disclosure of rating methodologies, models and key rating assumptions with guidance which explains assumptions, parameters, limits and uncertainties surrounding the models and rating methodologies used in credit ratings… [Annex I, Section D, 2a]*

As incorporation of ESG factors into investment activities increases, fixed income investors need to better understand how data sources they are subscribed to, including credit ratings, consider such factors as part of their proprietary ratings. Given ESG factors are not an explicit part of the CRA Regulation, we welcome ESMA's acknowledgement of the need to address this, in light of the European Commission's Action plan for sustainable finance and provide some steer for the industry in order to ensure that the quality of CRAs disclosures supports investors increasing focus in this area.

We agree that in doing so, it is not to infer that the consideration of ESG factors are more relevant or material than the consideration of non-ESG factors to the creditworthiness assessment of an entity or issuer – rather it is about identifying *all* credit material factors that are relevant to the credit rating/opinion. However, categorizing such factors under 'ESG' would be a useful signpost to provide in the current context, given the relative infancy of the ESG investing field and increasing regulatory focus on promoting sustainable financial markets.

In providing guidance, ESMA should avoid interfering with the content of credit ratings or methodologies and should not mandate or recommend specific factors be considered by CRAs in their approach. We believe this is avoided by focusing on disclosure guidance.

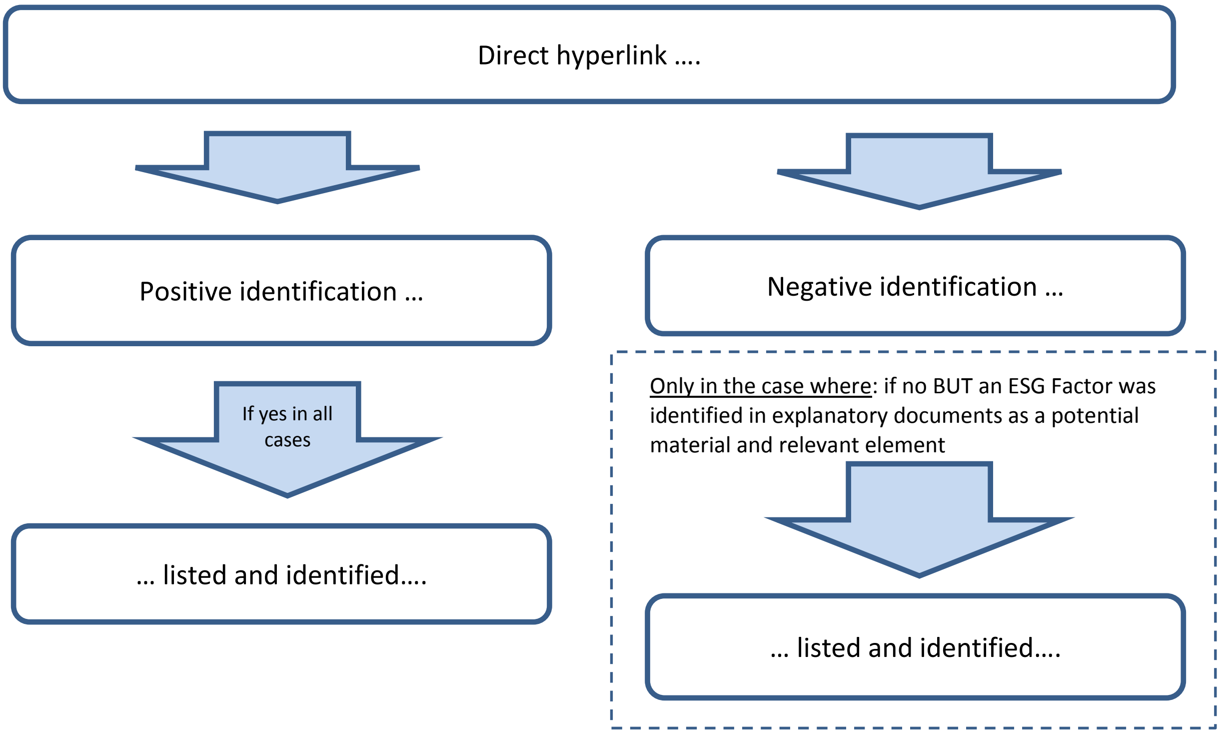
We believe ESMA should not be prescriptive about what is categorised as ESG factors but rather leave CRAs to set out how they define this themselves. A point of clarification: the taxonomy being referred to in the consultation paper should be seen as a policy tool which seeks to identify investment activities that make a substantive contribution to environmental/sustainability objectives rather than to be used as a conceptual framework for categorising ESG matters.

It may be helpful for ESMA to consider replacing the words 'key underlying' with 'material' as this is a term that is more widely used and understood by the market and is more consistent with its use when referring to other relevant credit factors that can contribute to a rating level or a change/action.

We would recommend the scope of the ESG disclosure should be the same as outlined for ratings per se i.e. they need to cover two aspects in terms of the underlying key elements: 1) why the rating/opinion is where it is (e.g. the level), and 2) why the rating/opinion level has changed (e.g. the rating action).

Whilst we support efforts to improve disclosure in terms of **how** CRAs disclose the consideration of ESG factors (which would be the press releases given this is the main tool being used by CRAs currently) **when** they are a key underlying element behind the issuance (rating level or rating action) of a credit rating as a minimum, it may be helpful in the future to consider the possibility of providing guidance in other areas of CRA regulation as it relates to ESG factors, to improve quality of CRAs' credit rating related disclosures per se outside of the press release documentation (see our response to Q5).

We understand ESMA's reasoning behind the proposed approach in terms of recommending incremental measures to allow for some degree of appropriateness for all CRAs, however, we believe this could potentially be achieved through an alternative solution. Instead of the approach illustrated in the graphic on page 20 of the consultation paper, where measures are set up as sequential 'in addition' measures depending on the situation, it may that these are required as standard, but there is an explicit 'comply or explain' requirement to enable the user to state the reasoning for not doing so, in this way proportionality can be taken into account. We also note the current approach only requires additional commentary where there is a positive ESG identification case, and whilst we agree this is key, it would also be helpful to seek commentary as to the reasons why it was not considered a key element for this specific issuer, but only **when** in the broader rating methodology, it was identified as a potential material and relevant ESG factor. In other words, it is just as helpful for users to know why an ESG factor is not considered key at the specific issuer level, when it may be in the context of the issuer type or industry etc. Note, we are not advocating additional commentary where there is a negative identification for the specific issuer and the ESG factor was not considered a key element in the relevant/applicable methodology document. We appreciate a balance needs to be reached in ensuring the requirements do not add disproportionate length to the press release documentation, but we believe this could be a pragmatic solution. An alternative approach would be as follows:



Q5: Are there any additional actions that CRAs could take to improve the disclosure of the consideration of ESG factors?

Ratings related offerings
As stated in the response to Q4, it would also be helpful if there was guidance which goes beyond the press release documentation on the '**what'** and '**where'** CRAs disclose in relation to ESG factors as it relates to inputs into their credit ratings.

One possible area relates to the explanatory documents such as ratings methodologies. Disclosing ratings methodologies as they relate to specific issuer types and/or sectors or themes, forms the basis of the issuance of credit ratings for specific issuers. Within these documents, it would be desirable if CRAs disclose all factors – financial or ESG related – which are viewed as likely to be a key element in the credit rating. In other words, factors that have a material impact on an issuer's creditworthiness in terms of determining the rating itself, as well as the likelihood that those factors may result in a rating action / change in the rating assigned. Some signposting on which factors are categorised as financial or ESG would be helpful given the increasing interest by investors and others on integrating ESG factors into credit analysis. CRAs should explain the criteria for arriving at what is considered material and what is not (e.g. issuer type, sector etc.), the level of confidence they have on the assessment (e.g. indication of the level of uncertainty) and the scope (e.g. particularly in terms of the time horizons being taken into consideration). Taking into account that some ESG factors are more latent in nature and play out over a longer time frame than generally covered by credit ratings (e.g. climate change), which adds to the level of uncertainty in the outcomes, and considering the trend in investors wanting to invest with a long-term mindset, CRAs could consider providing an indication as to the timeframe they would consider such factors to be credit material. Disclosure on the tools and techniques used to arrive at these views would be helpful (e.g. scenario and stress testing analysis).

Non-ratings related ESG orientated offerings

Outside of any ratings related products, CRAs may consider developing products and/or services which explicitly address investors' ESG requirements which are not limited to their impacts on creditworthiness, and indeed some have already done so e.g. launch of green bonds or ESG assessment products. Where this is the case, CRAs should be clear about the nature and scope of these offerings to avoid potential confusion with ratings related products.

Organisational governance & capacity

Outside the context of specific offerings, investors are interested in understanding how CRAs approach and manage ESG considerations in their processes to ensure the quality and independence of these processes, as well as demonstrate they have appropriately trained and qualified individuals to make those ESG related assessments. Just as investors are increasingly being asked to demonstrate their due diligence process to incorporate ESG factors into their investment process, disclosure on such matters by CRAs would also be helpful in relation to their work.

NOTE: much of our view on incorporating ESG in credit risk analysis and in relation to credit ratings which has inform on our responses to this consultation has been informed by our involvement in the collaborative investor-CRA initiative convened by the UN-supported Principles for Responsible Investment (PRI). The Advisory Committee on Credit Ratings, which was first established in 2016, has published three reports on how to advance ESG incorporation in credit risk and ratings analysis. ESMA may find it beneficial to refer to the reports as they provide insight into how CRAs can advance their efforts, in particularly the third report from January 2019, outlines specific recommendations for CRAs across a range of areas, including disclosure. As a result of this involvement, we have observed and welcome that many CRAs have recognised the need for improved transparency on their practices in relation to ESG factors, and some have already initiated efforts to respond to this, although there is more which can be done to ensure consistency.