

Credit Rating Services Bill, 2012

Parliamentary briefing

Presenter: Ismail Momoniat and Roy Havemann | National Treasury | 22 May 2012



national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

Structure

1. **Background**
2. Key issues
 - Jurisdiction and application
 - Liability
3. Other issues
 - Investor Protection
 - Integrity and Independence
 - Transparency and Accountability

Credit Rating Services Bill provides a legal framework for regulating credit rating agencies

Purpose of the Bill

- The Credit Rating Services Bill introduces new legislation that provides for
 - (i) the registration of credit rating agencies (CRAs);
 - (ii) for the control of certain activities of CRAs;
 - (iii) conditions for the issuance of credit ratings and
 - (iv) rules on the organisation and conduct of CRAs, and for matters connected therewith.
- Reference points:
 - Financial Crisis and G20 outcomes
 - International Organisation of Securities Commissions (IOSCO) “Statement of principles regarding the activities of credit rating agencies”
 - Other jurisdictions- EU, USA, Australia
 - EU equivalency requirements

Role of credit ratings agencies

- Credit ratings agencies assign ratings to securities (usually debt instruments)
- Credit ratings are a measure of the ability of a issuer to repay
- For example, AAA rating means that there is almost no chance of an issuer defaulting; whereas a C rating suggests an issuer is almost completely unable to pay

Need to regulate credit ratings agencies

- Credit rating agencies are considered to have failed, first, to reflect early enough in their credit ratings the worsening market conditions, and second, to adjust their credit ratings in time following the deepening market crisis. The most appropriate manner in which to correct those failures is by measures relating to conflicts of interest, the quality of the credit ratings, the transparency and internal governance of the credit rating agencies, and the surveillance of the activities of the credit rating agencies.
- The users of credit ratings should not rely blindly on credit ratings but should take utmost care to perform own analysis and conduct appropriate due diligence at all times regarding their reliance on such credit ratings.

Para. 10, European Parliament Regulation (EC) No 1060/2009

The activities of credit rating agencies are currently unregulated

Concerns with current role of rating agencies

- Credit rating agencies played a central role in the global financial crisis
 - Until close to its collapse Lehman Brothers was AAA-rated
 - Role of credit rating agencies in exacerbating current Eurozone debt crisis
- Pro-cyclicality of credit ratings
- Potential conflicts of interest
 - Evidence that some credit rating agencies provide consultancy services as well as rating services
 - CRAs play an important role, and should be held to the highest standards of rigour and independence
 - Ratings are a cornerstone of other regulation (e.g. banks)
- G-20 commitments are two-fold:
 - Create a globally-consistent regulatory framework for agencies
 - Reduce the reliance on ratings in legislation

Regulation is a rapidly developing area

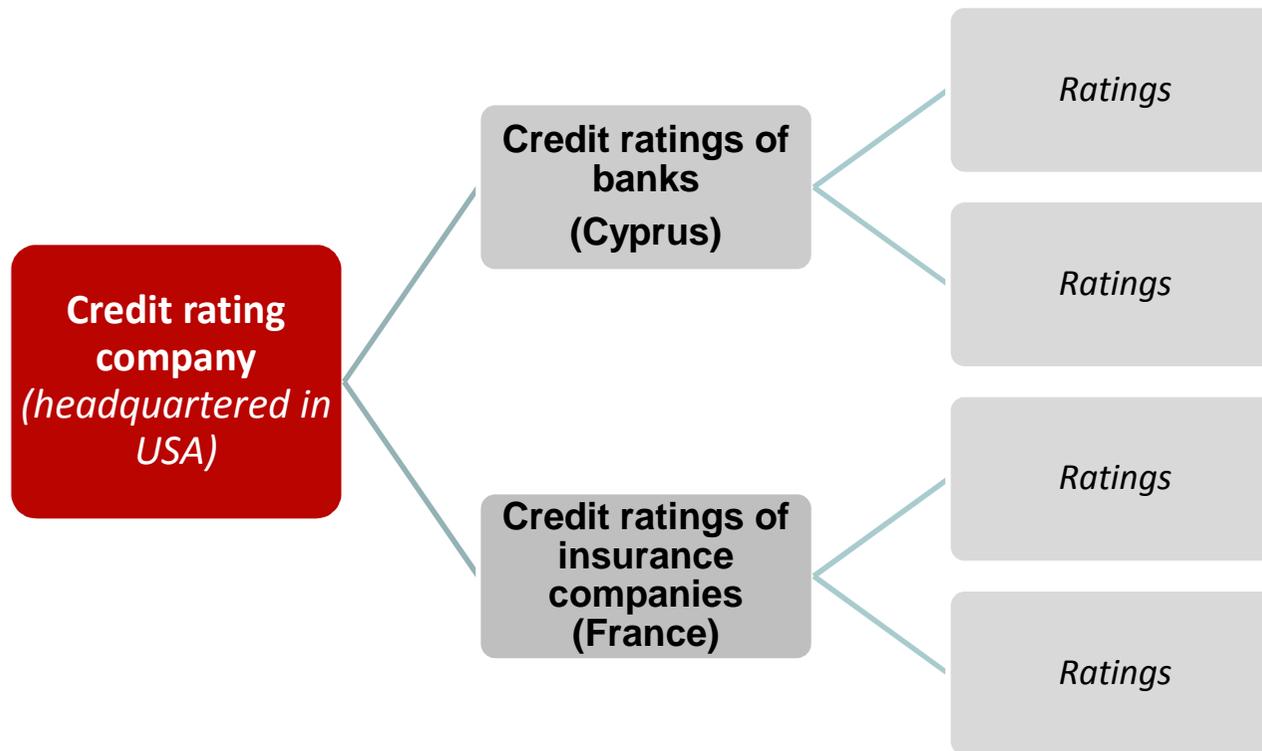
- Must have regime in place as soon as possible
- National Treasury / Financial Services Board published draft Bill in August 2011
- European Union released CRA3 in November 2011
 - New requirements in terms of mandatory rotation, disclosure and liability
 - ESMA noted possible difficulties in implementation
- Canada published regulations in January 2012
- United Kingdom Treasury Select Committee enquiry published in March 2012
 - Highlighted potential problems with strict interpretation of CRA3
- Argentina published regulations in April 2012
- Need to balance legal certainty with flexibility, particularly as unintended consequences

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Credit rating agencies operate globally...

- The three main agencies in South Africa operate as true multinationals, with different services provided in different jurisdictions



... but legislation needs to have teeth domestically

Ensuring legislation is effective

- Key challenge is to create a framework where the regulation will have “teeth”, without extra-territorial powers
 - Section 4: “A regulated person must for regulatory purposes only use credit ratings that are issued or endorsed by credit rating agencies which are registered in accordance with this Act.”
 - For example, this applies to:
 - Banks Act – regulatory capital for banks
 - Pension Funds Act – how pension funds may invest
 - Collective Investment Schemes Control Act – how CIS’s (unit trusts) and money market funds may invest
- Implication: regulated persons have to use registered rating agencies
- However, no such requirement on private investors, and investors are encouraged to do their own research when making investment decisions.

Our legislation follows EU approach and allows for endorsement

Concept of endorsement

- It would be counterproductive to require a CRA to perform all its activities in South Africa
 - Key strength of an agency is its ability to specialise and compare companies with similar companies in other parts of the world
- Rather, agencies can “endorse” ratings undertaken in another jurisdiction (Chapter 4, section 18)
- Since submission of Bill to Parliament early in 2012, other jurisdictions have finalised their regulatory approach, and consideration may be given to simpler regime that allows registrar flexibility to interpret endorsement regime, and allows for approved external credit ratings agencies

Approach to liability entrenches common law

- Drafting committee spent substantial time crafting appropriate liability provision
 - *Agencies*: meeting the requirements of the Act should be sufficient, and this should absolve agencies from further liability
 - *Other commentators*: agencies should be held liable for all investor losses if agencies make incorrect rating on which investors act to their detriment.
- Unbiased legal opinion was that common law liability provisions are most appropriate
 - Well-established case law on grounds for liability (negligence, maliciousness i.e. normal rules for delictual culpability) and principles for restitution
 - Act entrenches common law and does not allow agencies to contract out of liability

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The Bill aims to promote *investor protection* by:

Investor protection requirements

- requiring that ratings are defined, reviewed and updated in a timely and non-selective manner;
- refrain from publishing a rating if a credible rating is not possible;
- communicate with investors and the public with respect to questions, concerns and complaints;
- improve disclosure of information to regulators and the market;
- differentiate ratings for structured products;
- provide full disclosure of their ratings track-record and assumptions;
- prepare audited annual financial statements;
- empowering the FSB as regulator, including working with foreign regulatory authorities; and
- provide for common law delictual liability, and not allow contracting out

The Bill aims to promote *integrity and independence* by:

Integrity and independence requirements

- requiring that CRAs be organised in a way that ensures that their business interests do not impair the independence and accuracy of their credit ratings;
- requiring that approval be granted in order for a CRA to provide services other than credit ratings (and ancillary services);
- stipulating strict criteria that must be met for the endorsement by a CRA of a foreign issued/published credit rating;
- requiring that CRAs publish and adhere to a code of conduct;
- requiring that CRAs disclose the general nature of their compensation arrangements; and
- requiring that CRAs must disclose historical default rates of their rating categories;

Integrity and Independence *contd.*

- requiring effective risk management systems and internal controls
- ensuring that at all times the organisation has the necessary knowledge and experience to conduct credit rating services;
- requiring that confidential information be protected;
- requiring that ratings be based on thorough analysis of available information;
- requiring that rigorous and systematic methodologies, subject to validation based on historical information, be used as well as that methodologies, methods and key ratings assumptions be subjected to regular review;
- requiring that the impact of macroeconomic or financial market change on credit ratings be monitored;
- requiring that directors must meet fit and proper requirements
- requiring a permanent, independent and effective compliance function

The Bill also aims at promoting the transparency and accountability of the credit rating industry by:

- requiring that records be kept for 5 years
- requiring that each credit rating agency must provide the registrar with required information
- requiring that each credit rating agency must disclose policies and procedures regarding unsolicited ratings;
- requiring that each credit rating agency must publish and adhere to a code of conduct;
- requiring that each credit rating agency must disclose the general nature of its compensation arrangements;
- each credit rating agency must disclose, every twelve months, historical default rates of its rating categories; and
- each credit rating agency must publish an annual report to the public, which must include, *inter alia*, information on its legal structure and ownership, a description of its internal control mechanism that ensures quality of its credit rating services and financial information on its revenue sources.

Thank you