

# Credit Rating Services Bill, 2012

*NCOP briefing*

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**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

# The activities of credit rating agencies are currently unregulated

## Concerns with current role of rating agencies

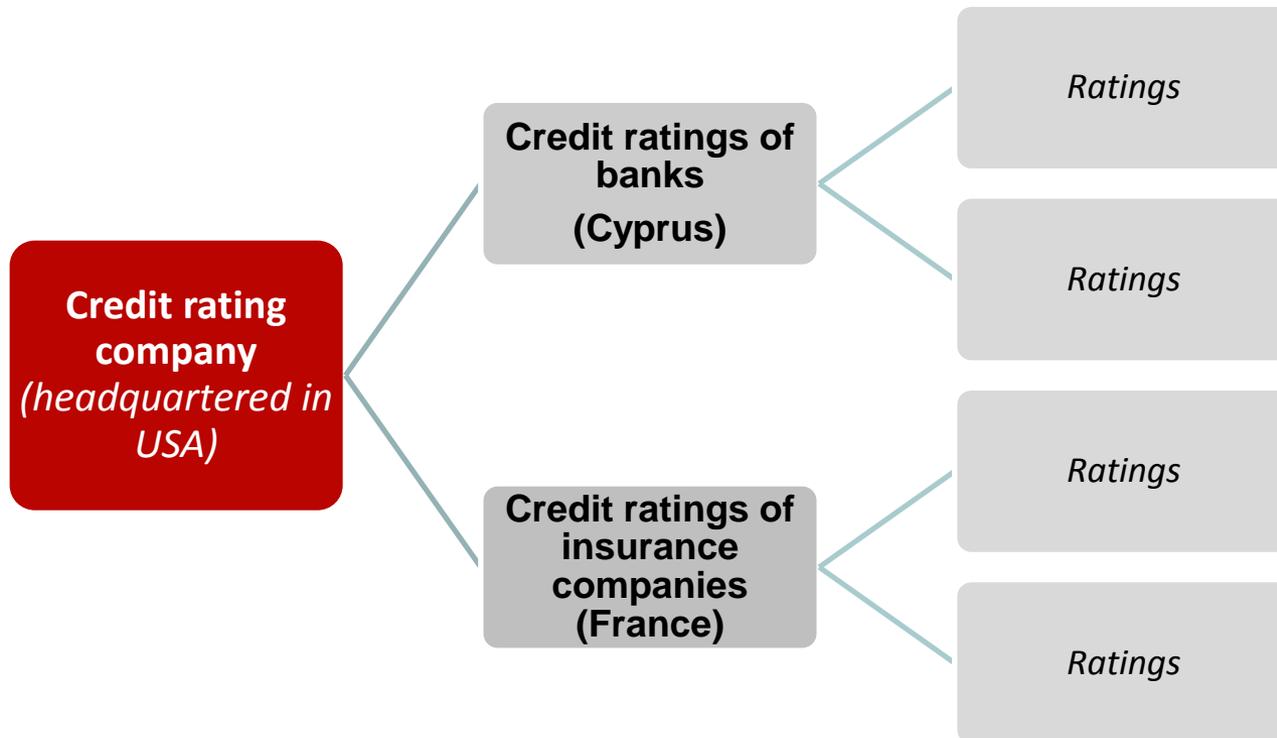
- Credit rating agencies played a central role in the global financial crisis
  - Until close to its collapse Lehman Brothers was AAA-rated
  - Role of credit rating agencies in exacerbating current Eurozone debt crisis
- Pro-cyclicality of credit ratings
- Potential conflicts of interest
  - Evidence 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

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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 (1): “Where a regulated person uses published credit ratings for regulatory purposes, such a regulated person must only use credit ratings that are—
  - (a) issued or endorsed by credit rating agencies which are registered in accordance with this Act; or
  - (b) issued or endorsed by an external credit rating agency approved by the registrar.”
    - 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 will have to meet the following requirements:
  - Registered legal entity in South Africa can “endorse” ratings done by the **same** agency in another jurisdiction (Chapter 4, section 18)
  - If the legal entity “endorses” ratings, then:
    - Ratings may be used for regulatory purposes
    - But agency liable for claims
  - Compliance function and back-office support can be outside SA

# 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

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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 delictual liability

# 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 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.

# Structure of the Bill

<b>Chapter I</b>	contains the relevant definitions and sets out the objects of the Bill. It also indicates how and to whom the Bill and rules made thereunder apply.
<b>Chapter II</b>	provides for the registration, deregistration and suspension of CRAs.
<b>Chapter III</b>	deals with the duties of credit rating agencies, including the appointment of directors, methodologies, models and key ratings assumptions, publication of credit ratings, code of conduct, outsourcing and other services, disclosure requirements, keeping of records, annual reports, the compliance function and accounting and auditing requirements.
<b>Chapter IV</b>	deals with the requirements for the endorsement of external credit ratings.

# Structure of the Bill *contd.*

<b>Chapter V</b>	specifies the extent of liability for CRAs and ensures the independence of CRAs.
<b>Chapter VI</b>	deals with the administration of the Bill, particularly the powers and functions of the Registrar and Deputy Registrar of Credit Rating Agencies, including delegation and assignment, power to make rules, on-site visits and inspections, power to issue directives, exemptions, fees and penalties, and relationship with other regulatory authorities.
<b>Chapter VII</b>	provides for enforcement actions and remedies, including referral to the Financial Services Board enforcement committee, civil action, offences and penalties and the right of appeal.
<b>Chapter VIII</b>	provides for regulations, the saving of rights, the amendment of other Acts of Parliament and the short title and commencement of the Bill.

*Thank you*