



**STANDARD & POOR'S
RATINGS SERVICES**

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Financial System Inquiry
GPO Box 89
Sydney NSW 2001
fsi@fsi.gov.au

Dear Sir or Madam,

Financial System Inquiry Submission

Standard & Poor's Ratings Services ("Standard & Poor's") is pleased to make the following submission to the Financial System Inquiry. We wholeheartedly support initiatives by the Australian Government to foster an efficient, competitive and flexible financial system, consistent with financial stability, prudence, integrity and fairness. We hope our submission contributes to the dialogue, and we welcome recommendations and improvements to the financial system regulatory framework that result in lower costs and fees and greater efficiency in the allocation of capital.

Executive Summary

Credit ratings play many important roles in the international financial system, including assisting governments and other global issuers to gain access to capital to support prosperity and growth. Comparable, transparent and forward-looking credit ratings also serve global capital markets by contributing to their efficiency and stability. The current regulatory framework for credit rating agencies (CRAs) in Australia has, however, resulted in certain unintended consequences, with some investors not able to access the same level of research and analysis from CRAs as other investors. We believe there is a need for international consistency in regulatory oversight of CRAs, given credit ratings are issued and used globally. In particular, a requirement in Australia for CRAs to be a member of an external dispute resolution ("EDR") scheme if their credit ratings are available to retail clients is inconsistent with regulatory regimes for CRAs in other jurisdictions.

In our view, the EDR scheme requirement is inappropriate for CRAs, and the Australian market will be best served if all investors, including retail investors, can have access to the credit ratings of global CRAs, as is the case in other countries. We request the Australian Government take this opportunity to provide an exemption from the requirement for CRAs to be a member of an EDR scheme if they hold a retail licence.

Background information about Standard & Poor's

With offices in 25 countries, including Australia, and a history that dates back more than 150 years, Standard & Poor's provides high-quality market intelligence in the form of credit ratings, research, and thought leadership. Today, Standard & Poor's has more than 1,400 analysts around the world. We assign credit ratings to 127 countries. In total, we have credit ratings on over a million securities with a face value of more

than US\$60 trillion. In Australia, Standard & Poor's operates through Standard & Poor's (Australia) Pty Ltd ("S&P Australia"). Our team of Australian-based analysts covers more than 2,200 outstanding debt securities and other programs issued by Australian and New Zealand companies, financial institutions, and national and local government entities, as well as more than 300 structured finance transactions.

Standard & Poor's credit ratings express our opinion about the ability and willingness of an issuer to meet its financial obligations in full and on time. Beyond that, credit ratings can also speak to the credit quality of an individual debt issue, such as a corporate note, a municipal bond or a mortgage-backed security, and the relative likelihood that the issue may default. Credit ratings are intended to provide a long-term view of creditworthiness based on fundamental analysis. Unlike market-based indicators such as bond spreads or credit default swap prices, ratings do not reflect market sentiment or the dynamics of supply and demand. In other words, they are not a trader's view of credit risk. Ratings do not address asset value nor do they speak to the liquidity of a security. They are not a buy or sell recommendation. Credit ratings address only one aspect of a debt instrument – credit quality.

At Standard & Poor's, we strive to make our credit ratings comparable, transparent and forward looking – three attributes that are important to investors. Because credit markets are global, we aim for comparability in our credit ratings around the world as well as across asset classes and sectors. We address this by establishing global criteria frameworks and methodologies, which we apply consistently. It is critically important to provide a consistent view of credit risk across countries for those issuers who seek a global market for their debt and investors who seek global diversification. Transparency is important because we believe that making clear the methodologies we use to establish credit ratings and publishing them on our web site help market participants understand how we analyse credit risk.

Comparable, transparent and forward-looking credit ratings serve the capital markets by contributing to their efficiency and stability. Although credit ratings are important, they are certainly not the only source of information available to the credit markets. Investors draw on many different sources, including their own analysis, other research houses and local rating agencies. They are very clear in telling us that they make their own risk commitment decisions and do not rely mechanistically on ratings from the major agencies. That's an approach we welcome. A diversity of views better informs the assessment of credit risk and can only be good for the market and the financial system.

Role of credit ratings in the financial system

Credit ratings help foster the development and smooth functioning of the global capital markets. Investors often use credit ratings to help assess credit risk and to compare different issuers and debt issues. They also help reduce the information asymmetry between investors and issuers and encourage a more liquid flow of capital around the world.

As a 2010 IMF report pointed out, ratings “. . . allow borrowers to access global and domestic markets and attract investment funds, thereby adding liquidity to markets that would otherwise be illiquid.” Ratings also meet the need for less well-known issuers to gain market access by having information and analysis of their credit profile widely available on a comparable basis. Furthermore, the capital markets are playing a greater role in financing governments, companies and consumers – a trend that is likely to continue for years to come as banks become subject to higher capital

requirements and other restrictions. That means that there will be a strong need for credit research and ratings. Our research suggests that global bank loan and debt capital markets will need to finance up to US\$53 trillion of corporate borrowings over the next five years. This amount includes existing debt of approximately US\$35 trillion that requires refinancing. Global corporate bond issuance topped nearly US\$4 trillion dollars for the whole of 2012. In addition, governments around the world must find sufficient funds to pay for ongoing growth and development, particularly in the area of infrastructure. Ultimately, the most important role ratings play is to foster the development and smooth functioning of capital markets to help companies and countries grow.

The regulatory landscape and credit rating agency regulation in Australia

Today there is greater transparency and more accountability and oversight at CRAs than at any time in our history. The regulatory landscape for CRAs has been irrevocably changed. Governments across the world have put in place many new rules and regulations to address the issues that led to the crisis, and CRAs are subject to regulatory controls that did not exist before the crisis. For our part, we have reinforced the integrity and independence of our ratings process. We have increased our transparency, providing more information to the market about how we develop our criteria, arrive at our ratings, what they mean, and what could cause them to change. And we have made important analytical changes that we believe will make ratings more stable, more comparable, more forward looking and thus more valuable to the global financial community. Standard & Poor's has welcomed regulatory reforms that are internationally consistent and strengthen transparency and oversight and improve market confidence in CRAs. There is, however, a need for international consistency in regulatory oversight because, as described above, ratings are issued and used globally.

S&P Australia holds an Australian Financial Services Licence to provide credit ratings to wholesale clients. When licensing requirements became effective in Australia for CRAs in January 2010, S&P Australia applied for a wholesale-only license due to concerns about credit ratings being subject to an EDR scheme, such as the Financial Ombudsman Service for retail licence holders. We believe the Australian market has been disadvantaged and market participants have been frustrated by the inability to make credit ratings issued by global CRAs available to retail investors. For the reasons outlined below, S&P Australia encourages the Australian Government to reconsider the regulatory framework for CRAs as part of its broader review of the financial system through this inquiry.

There is no international precedent for having credit ratings subject to review by an EDR scheme. The United States¹ and European Union² regimes expressly prohibit regulating the substance of a credit rating or the methodology by which credit ratings are determined. We continue to remain concerned that membership of an EDR scheme would undermine the global consistency and comparability of ratings and would impinge our analytical independence and objectivity. Importantly, in Asia Pacific the trend is for other jurisdictions to exempt CRAs from their equivalent requirements relating to external dispute resolution. The Financial Services Branch, Financial Services and Treasury Bureau, Hong Kong has provided an exemption from the EDR requirements for Type 10 licensees (Providing Credit Rating Services) in its conclusions regarding the proposed establishment of an Investor Education Council and a Financial Dispute Resolution

¹ Section 15E(c)(2) of the United States Securities Exchange Act of 1934

² Article 23(1) of the Regulation (EC) No 1060/2009 of the European CRA Regulation

Centre³. The Monetary Authority of Singapore also announced an exemption from dispute resolution scheme requirements for CRAs.⁴ Finally, in Taiwan, the Financial Supervisory Commission (“FSC”) announced in March 2013 that EDR would not apply in relation to credit ratings⁵. Notably, the FSC in its rationale for the decision confirmed that that after studying practices in other jurisdictions relating to credit ratings and the independence of credit rating agencies, it would be inappropriate to subject financial consumer disputes relating to credit ratings to review by the ombudsman body.

S&P Australia would be extremely concerned if the substance of credit rating opinions – forward-looking statements made at a point in time about the likelihood that a particular obligor will pay back principal and interest in the future – could be subjected to review by an EDR scheme. Furthermore, S&P Australia is concerned that this would interfere with the analytical independence of CRAs. The analytical independence of rating analysts and their opinions must be preserved, and the “second-guessing” of credit rating opinions could adversely impact the exercise of independent judgment and be detrimental to the markets. An EDR scheme that allowed for second-guessing of forward-looking opinions, based on the consistent application of CRAs’ rating methodologies, could expose many of these opinions to groundless challenges based on hindsight and speculation. Any EDR scheme directive to change the substance of a credit rating could result in the extraordinary creation of dual credit ratings – an Australia “EDR” credit rating and a “rest of the world” credit rating. Ratings are issued and used globally, so we assess that this scenario would create investor confusion and harm to the markets. Finally, an EDR scheme could require the provision of information that is commercially confidential, highly sensitive and proprietary to third parties.

The case for reform

External credit ratings are extensively used across markets and support good quality credit analysis and market disciplines, particularly when used with other forms of analysis and risk-management processes. Investors tell us that they value our credit research and ratings as inputs - alongside many others - in their financial analysis. Standard & Poor’s distributes essential information to the global financial system including through more than 4.5 million annual visitors to our websites and blogs, 2.25 million views a year on e-newsletters and email alerts and over 65,000 social media followers. Given the current regulatory situation in Australia, we believe the Australian retail client is blocked from the opportunity to access this important analysis. In the absence of legislative change aligning the regulatory requirements for CRAs to the international norm, we believe that the current asymmetry of information will continue and retail investors will not be able to readily access credit ratings. We continue to believe the EDR scheme requirement is not appropriate for CRAs and that the Australian market will be best served if all investors can have access to the credit ratings of global CRAs, as is the case in other jurisdictions.

³ ‘Proposed Establishment of an Investor Education Council and a Financial Dispute Resolution Centre - Consultation Conclusions’, Financial Services Branch, Financial Services and Treasury Bureau, page 23, available from: http://www.fstb.gov.hk/fstb/ppr/consult/consult_iec_fdrc.htm

⁴ Paragraph 1.5, ‘Response To Feedback Received – Consultation On Proposed Regulation Of Credit Rating Agencies’, Monetary Authority of Singapore, 17 January 2012, http://www.mas.gov.sg/resource/publications/consult_papers/CRA%20Response%20to%20Feedback_FINAL.pdf

⁵ Advance notice for the formulation of a draft on “not to entertain an application as per the Article 24, Paragraph 2, Sub-paragraph 9 of the Financial Consumer Protection Act” http://gazette.nat.gov.tw/EG_FileManager/eguploadpub/eg019044/ch04/type3/gov36/num11/Eg.htm.

Conclusion

For these reasons outlined in our submission, we strongly encourage the Australian Government to use this opportunity to amend the Corporations Act 2001 to provide an exemption from the requirement for CRAs to be a member of an EDR scheme if they hold a retail licence. Such an exemption would further enhance Australia's integration with the global financial regulatory framework and be consistent with objectives of the financial system inquiry, namely to ensure a more efficient and flexible financial system. As outlined above, with capital markets playing a larger role in debt capital allocation, achieving an outcome that ensures the availability of credit ratings to all users of the capital markets – and thereby providing symmetry of information for all investors -- should be an encouraged.

We would be happy to discuss our submission further with you at a convenient time. Please do not hesitate to contact me if you have any queries about this letter.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'John Bailey', written over a light grey rectangular background.

John Bailey
Managing Director
Australia and New Zealand