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Panel on Financial Affairs
Special Meeting on 19 July 2010

Background brief on regulation of credit rating agencies

Purpose

This paper provides background information on the subject of regulation of credit rating agencies (CRAs) in Hong Kong, and summarizes the main concerns and views expressed by Members when the subject was discussed at Council meetings in recent years.

Background

2. The ratings assigned by CRAs represent their opinion on the ability of the borrower or issuer to meet its financial obligations. Credit rating is thus a key reference for investors to assess the safety of an investment. Since the onset of the global financial crisis in 2007, concerns have been expressed by the market about the failure of CRAs to sufficiently consider the risks inherent in more complicated financial instruments and, as market conditions were worsening, to reflect this promptly in their ratings. Specifically, users of ratings are concerned about the business practices and business models adopted by CRAs that may affect their impartiality and independence.

3. There have been active discussions on how to improve the corporate governance of CRAs at various international and regional forums including Group of Twenty, Financial Stability Forum, International Organization of Securities Commissions (IOSCO), Asia-Pacific Economic Cooperation, Asian Development Bank and Association of Southeast Asian Nations Plus Three. These discussions have focused on how to encourage CRAs to meet the highest standards of IOSCO to avoid conflicts of interest, provide greater disclosure to investors and to issuers, and differentiate ratings for complex products.

4. According to the Administration¹, investors and users in Hong Kong have mainly relied on three international CRAs for their provision of rating services. They are Moody's, Standard & Poor's and Fitch. As their services are global in nature, Hong Kong's financial regulators, namely the Securities and Futures Commission and the Hong Kong Monetary Authority, have been following closely international and regional initiatives that promote appropriate oversight of CRAs.

Major concerns and views expressed by Members during relevant discussions at Council meetings

5. A motion on "Reforming financial regulators" was passed at the Council meeting on 26 November 2008, urging the Government to expeditiously conduct a comprehensive review and study of the existing financial regulators to ascertain if there was any need to rationalize and improve their regulatory roles, functions and resources in the regulation of the financial sector, or introduce other improvement measures, so as to plug the existing loopholes in the regulation of the financial sector and better protect the interests of investors and the insuring public.

6. During the motion debate, individual Members expressed the following views in respect of CRAs -

- (a) While Hong Kong is an international financial centre, it has neither any locally based CRAs nor any proper mechanism to regulate CRAs effectively, rendering little protection to investors and fund raisers in Hong Kong. The Government should actively study ways of regulating agencies, draw on the experience of Europe and the United States and the latest development, and introduce and apply proper approaches. The Government should also adopt every reasonable measure to encourage and nurture the development of local rating agencies.
- (b) Following the Lehman Brothers Minibonds Incident, the existing international finance rating institutions have lost much of their credibility. Hong Kong would be susceptible to a similar incidents if it continues to rely on the ratings given by these institutions. Hong Kong should strengthen collaboration with international financial regulators and introduce reforms to consolidate its position as a financial centre and protect the assets of the people.

7. At the Council meeting on 4 March 2009, Dr Hon David LI raised an oral question on the role and function of CRAs. The major views and concerns expressed by Members and the Administration's responses are as follows –

- (a) On the question of whether there is scope for the establishment of an Asia-based international CRA in Hong Kong, the Administration

¹ The Administration's reply to the oral question raised by Hon David LI on "The role and function of credit rating agencies" at the Council meeting on 4 March 2009.

responded that it welcomed any business initiatives to increase competition in the existing credit rating market. While acknowledging the benefits, the Administration was mindful that the sustainability of any new credit rating agency hinged on its ability to build up its track record fast enough to win a critical mass of rating users, and to comply with the highest IOSCO standards on independence, professionalism and impartiality.

- (b) As one criticism of the current system is that CRAs depended on the issuers for their revenue, a Member asked whether the Administration would evaluate the validity of a publicly-funded CRA in Hong Kong, which might be supported in part by a levy on new issues. The Administration responded that the biggest asset of CRAs was their independence and impartiality. A publicly-funded agency would also bring in questions about independence. However, the Administration would continue to listen to market views on whether there was a case for a publicly-funded CRA in Hong Kong.
- (c) A Member asked, in the light of the Lehman Brothers Minibonds Incident, whether the Administration would take the initiative to conduct independent assessment of and investigation into the performance and monitoring of the CRAs concerned. The Administration responded that as in the case of other countries including the United States and countries in Europe, there was no direct monitoring of CRAs in Hong Kong. The approach mostly taken was to rely on international bodies, such as the IOSCO, to examine the CRAs' compliance with the code of business conduct.

Latest development

8. As advised by the Administration, the European Union (EU) introduced in December 2009 the Regulations on CRAs. Accordingly, with effect from 7 June 2011, only credit ratings that are issued under "equivalent" regulatory regimes of other countries may be used in EU. If credit ratings prepared by the Hong Kong-based CRAs are to continue to be serviceable in the EU, Hong Kong would need to develop a compatible regulatory regime and to have it operational by 7 June 2011. As such, the Securities and Futures Commission would like to consult the Panel on Financial Affairs on the issue at the meeting on 19 July 2010.

References

9. The relevant information is available at the following links:

Motion debate on "Reforming financial regulators"

<http://www.legco.gov.hk/yr08-09/english/counmtg/hansard/cm1126-translate-e.pdf>

(page 183)

Oral question raised by Dr Hon David LI on "The role and function of credit rating agencies" at Council meeting on 4 March 2009

<http://www.legco.gov.hk/yr08-09/english/counmtg/hansard/cm0304-translate-e.pdf>
(page 53)

"Regulations on Credit Rating Agencies" issued by European Union

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0001:0031:EN:PDF>

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