Comments on the Consultation Papers Concerning the Regulatory Oversight of Credit Rating Agencies

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Q1 Is it appropriate for Hong Kong to subject CRAs to a regulatory oversight regime consistent with international developments?

My Comments:

Credit ratings have been dominated by US and European rating agencies. One simple reason is that governments and corporations in the US and Europe actively issue debts. After the financial crisis in 2008, we have seen the robust economic environment in Asia, especially the Greater China region. The market expects the presence of ratings agencies which are more familiar with the Asia markets and are able to provide impartial information about the Asia risk to global investors.

Hong Kong keeping a high standard on licensing CRAs will be a very important move to strengthen Hong Kong as a leading financial centre. The debt securities and related products issued in Hong Kong, including Renminbi bonds and certificates of deposits, will easily get recognized by global investors. This will help attract more international capitals to the Hong Kong financial markets and the banking sectors.

Q2 Should regulatory oversight of CRAs be achieved by extending the existing licensing regime under the SFO to CRAs and those of their staff who perform regulated functions?

Q3 Do our draft amendments to the SFO effectively distinguish "providing credit rating services" from "advising on securities"?

Q4 Should the proposed new licensing requirement apply to the rating of sukuk?

My Comments:

"Credit ratings" may have been narrowly defined in this consultation paper. I agree that "providing credit ratings" is different from "advising on securities". "Advising on securities" is to advise clients to make rational decisions to buy or dispose of an asset by considering both return and risk information. "Providing credit ratings" focus mainly on default risk (or downside risk). This does not contain any information on the upside potential or on whether a debt instruments is priced fairly.

After the Lehman incidence, some financial institutions have advanced their product risk rating system on all investment products distributed to their clients. These new ratings systems consider a number of risk dimensions, such as liquidity risk, market risk, credit risk and etc. Take 5-year Euro-denominated Spanish Government Bond as a example. The risk of this product is not simply default risk. Interest rate risk, credit migration risk and currency risk are all present.

"Credit ratings license" should not be limited to credit ratings. This may better be refined to cover "risk ratings". SFC raises the issue of Islamic Bonds, which have lots of legal risk. The risk of Islamic products and structured finance products is not simply default risk. If some ratings agencies offer investment fund risk ratings, will it be regulated in the same way? These funds may be bond funds or credit-liked funds. If the ratings agencies offer integrated risk ratings on investment products, rather than credit ratings, will it be regulated in the same way?

The purpose of CRA licensing is to ensure that the rating agencies will perform their due diligence on risk assessment and provide this information to relevant information users. It seems that the consultation paper does not address the issue on risk rating process of other risk dimensions relating to financial assets.

Q11 Is the draft list of Recognized Industry Qualifications and Local Regulatory Framework Papers for Type 10 regulated activity appropriate?

My comments:

For credit ratings, the best reference is the Basel II document. The proposed industry qualifications in Appendix C may not adequately cover the depth of the knowledge on modern credit ratings. (I myself was a member of HKSI examination committee and examination panel member of SEHK.)

For structured finance products, the most appropriate training is a MSc degree in financial mathematics or financial engineering or computational finance or a even PhD in quantitative finance. To analyze those complex products, simulation and VBA programming are common expectations. A simple CFA/HKSI qualification is not adequate.

It is better that SFC considers the professional backgrounds of the applicants rather than list out some qualifications which may be below standard.