



FINANCIAL  
SERVICES  
BOARD

# CREDIT RATING SERVICES ANNUAL REPORT 2015

Annual update on the Supervision of  
Credit Rating Agencies registered in South Africa



# TABLE OF CONTENTS

1.	<u>INTRODUCTION</u> .....	1
2.	<u>INDUSTRY OVERVIEW</u> .....	2
3.	<u>OUTCOMES OF THE ONSITE REVIEWS</u> .....	6
4.	<u>WORK PLAN FOR THE 2015/16 FINANCIAL YEAR</u> .....	7

## KEY OF TERMS AND ACRONYMS USED IN THIS REPORT

Term/Acronyms	Meaning in this Report
<b>Act</b>	The Credit Rating Services Act, No. 24 of 2012
<b>CRA</b>	Credit Rating Agency
<b>CRSD</b>	Credit Rating Services Department
<b>ESMA</b>	European Securities Market Authority
<b>FSB</b>	Financial Services Board
<b>King Code</b>	The King Code Report on Corporate Governance for South Africa 2002 / 2009
<b>Registrar</b>	The Registrar of Credit Rating Agencies, who is the executive officer of the FSB in terms of the FSB Act
<b>Rules</b>	Credit Rating Agency Rules (Board Notice 228 of 2013)

### 1. INTRODUCTION

- 1.1. The regulation of credit rating agencies is an important step taken post the financial crisis and is the focus of on-going policy proposals. The approach emphasizes conformance with the internationally accepted “register and be supervised” regulatory model, with a focus on increasing transparency, maintaining independence and managing conflicts of interest. Increasing competition in the ratings industry is one of the desired outcomes.
- 1.2. The credit rating services department applies both on and off-site supervisory measures and follows an interactive approach in the supervision of CRAs. The department seeks to influence and encourage compliance with the objects of the Act, and the mandate of the FSB. The objectives of the FSB are particularly to;
  - (i) register credit rating agencies in South Africa
  - (ii) establish CRA compliance with registration requirements
  - (iii) determine the extent to which legislation has improved credit ratings issued in South Africa, and
  - (iv) establish where improvements in the process are required.
- 1.3. The Act was assented to by the Presidency on 9 January 2013 and became operative on 15 April 2013 following a notice by the Minister of Finance. The Rules were promulgated and published in the Government Gazette on 15 November 2013. The Act together with the Rules, provide for both the regulatory and supervisory requirements which are legally binding on credit rating agencies and external credit rating agencies operating in South Africa.

- 1.4. The CRSD was established on 1 April 2013 and is mandated to oversee the implementation of the Act and to supervise and regulate the credit rating services industry going forward.
- 1.5. A registration system for credit rating agencies was introduced following the determination by the Minister of Finance that “17 December 2013 was the date with effect from which a person may not perform credit ratings or issue a credit rating in South Africa unless such a person is a registered credit rating agency”.
- 1.6. Two credit rating agencies were approved and registered on 13 December 2013, while applications for two additional CRA's were received on the same date. Their applications for registration were approved on 6 May 2014. These two CRAs were granted exemptions up to 20 June 2014 from complying with section 3(2) of the Act thereby permitting these entities to carry on business relating to the performance of credit rating services and the issuing of credit ratings until the Registrar had finally granted or refused their applications.
- 1.7. A principled approach to regulation has been adopted by the FSB and it is a stated goal that this approach should move beyond credit rating agencies to include the role of ratings in financial and securities markets and more broadly, in maintaining market integrity and financial stability.
- 1.8. The department investigated the activities of three entities to ascertain if their activities fall within the ambit of the Act. Two investigations have been completed with no material findings and the FSB will continue to monitor the operations of these. Investigations into the third entity are ongoing.
- 1.9. Work is underway to have a multilateral memorandum of understanding concluded with the European Securities and Markets Authority (“ESMA”) in place. This will facilitate cross-border cooperation and enforcement and the exchange of information among the international community of credit rating agencies and regulatory authorities.

## 2. INDUSTRY OVERVIEW

- 2.1. The new legislative platform in South Africa was created to support the G20 principles and IOSCO code of conduct fundamentals for credit rating agencies. The G-20 commitments are two-fold:
  - (i) create a globally-consistent regulatory framework for agencies, and
  - (ii) reduce the reliance on ratings in legislation.
- 2.2. The IOSCO principles include the Quality and Integrity of the Rating Process, CRA Independence and the Avoidance of Conflicts of Interest and CRA Responsibilities to the Investing Public and Issuers.
- 2.3. During the authorisation phase, all CRA's, except one, requested exemptions from sections of the legislation in their applications for registration. The registrar was able to accede to some of these requests, for instance the request for exemption from the rotation of analysts.

In other instances the requests were declined for example, requests for exemption from the requirement for the appointment of independent non-executive directors. Where a request for an exemption was refused, the FSB noted that CRAs failed to consider that an exemption would only be granted upon adequate demonstration that they had implemented measures and procedures which guaranteed compliance with the same objectives as the requirements they wished to be exempted from. Notably all the exemptions granted were temporary which gives the FSB the opportunity to review the supporting mechanism proposed and to make appropriate recommendations were deemed necessary.

2.4. The first regulatory compliance reviews commenced in June 2014 focussing on four main areas, these being,

- (i) to evaluate the risk management and internal control systems in place,
- (ii) to determine CRA management of independence and avoidance of conflicts of interest,
- (iii) an evaluation of the corporate governance of the entity, and
- (iv) how CRA's administer their responsibilities to comply with the Act.

2.5. By year-end 2014, the CRSD had managed to review and assess all the registered CRAs by way of an onsite visit. This fulfilled one of the main conditions of registration which required the CRSD to review information/documents submitted in respect of the applications for registration made as well as to assess remedial actions taken by the CRAs to fully comply with all the exemptions declined.

### 3. OUTCOMES OF THE ONSITE REVIEWS

3.1. The FSB reports in its summation of the reviews is that there was a noted "selective" compliance by some CRA's with non-compliance often being at the CRA's own determination or by its delays in implementation of legislative requirements. It was noted that CRA's could not produce a report evidencing that an analysis had been undertaken and completed indicating "Gaps" in compliance with the legislation and in some instances it was apparent that CRA's tended to rely on the onsite review to highlight shortcomings. Below are some of the major shortcomings and deficiencies for which the FSB has requested action plans for rectification.

3.1.1. There were two instances where exemption from compliance with Rule 2(2), requiring independent non-executive directors, had been requested. The FSB was and remains concerned with the lack of representation at board level in South African subsidiaries as observed from the onsite assessment. This is of particular concern for the FSB when it comes down to having access to senior officials of the rated entity to discuss matters which arise in credit ratings assigned to South African rated entities. This became more relevant as the on-site visits progressed toward completion where, on reviewing the reporting of credit ratings published in South Africa, the FSB was repeatedly reminded by some of the

CRA that it has “no jurisdiction” over issues arising from credit ratings issued outside of South Africa.

- 3.1.2. It is for this reason some CRAs did not deem it necessary to comply with South African reporting requirements, for example in complying with reporting requirements of South African legislation for Structured Finance transactions. The FSB therefore directed that two CRAs appoint two independent non-executive directors, at least one of which must be a resident in South Africa in order to comply with the requirements of Rule 2(2)(d). This decision was further based on the fact that,
- (i) the FSB will not have regulatory authority over directors of the European Union registered parent company, and
  - (ii) allowing the current structure to be in operation may negatively affect the FSB’s pursued equivalence and endorsement requirements with ESMA, as ESMA does not recognise independent non-executive directors outside of its jurisdiction.
- 3.1.3. The FSB reviewed steps taken by CRAs to meet the requirements of Rule 2(1). This rule requires the board to adopt corporate governance policies which are consistent with the principles and practices of effective corporate governance as contemplated in the King Code on Corporate Governance Principles. One CRA declined to complete the King Code interactive template citing the small size of its local operations as to render completion insignificant. The FSB stressed that corporate governance is a fundamental requirement of credit rating agencies irrespective of the size of their operations. Engagement with the CRA on this matter is on-going. The testing of whether a CRA has effectively implemented King Code governing provisions will be done in the follow up onsite examinations.
- 3.1.4. The FSB noted instances of a lack of documentation of the workings of board committees and other internal meetings, i.e. relating to control functions, business line management meetings and in some cases a lack of adequate terms of reference for the committees in place. In these circumstances the FSB recommended that CRAs improve the documentation of board meetings to evidence sufficient board oversight and demonstrate sufficient engagement, especially by independent non-executive directors in executing their duties. One CRA was requested to institute measures to ensure that rating criteria updates and model validation were subjected to a formal independent review function within the CRA with verifiable documentation as evidence of this having been carried out having to be kept in place.
- 3.1.5. The regulations mandate the segregation and independence between the internal review and analytical functions and CRA’s have been reminded to aim not only for formal structural separation but also for an effective separation in practice.
- 3.1.6. The FSB has recommended to one CRA that procedures and controls governing the review of criteria, methodologies, proprietary models and the rateability of new products, etc., be strengthened through validation by a person/committee independent from the team responsible for rating activities as required by Rule 3(5). One CRA was requested to have



a written policy on detailing the step-by-step process and documents to be reviewed when deciding on whether to rate a new type of transaction or not.

- 3.1.7. The FSB noted cases where compliance supervisory controls needed to be strengthened through,
- (i) International rating agencies designing an annual compliance audit and monitoring plan taking into consideration smaller operations, such as South Africa, and
  - (ii) undertaking a formalised review of the operations of local units with regards to adherence to internal procedures and the regulatory framework. In some instances there was insufficient information for the FSB to draw insights and conclusions as to the effective supervision of compliance activities. CRAs were requested to develop terms of reference, an annual audit plan and compliance manual to provide a step-by-step guide and to demonstrate compliance with Rule 3(5). The FSB requested that one CRA develop roles and responsibilities for its employees and that these are clearly defined and communicated throughout the organization and that it emphasises to senior management and staff that they need to understand and are accountable for their own compliance obligations. The CRA was required to invest in compliance tracking software for detecting potential compliance breaches in advance and for checking compliance with the relevant regulatory requirements. It was also requested to immediately institute compliance monitoring reviews with reports being prepared for the board of directors. Some CRAs were requested to put structured training programs in place, as well as experience and competence requirements for the individuals they employ and who participate in the determination of credit ratings.
- 3.1.8. The FSB found that recording of details of rating committee meetings was incomplete and in some cases, non-existent. Discussions, deliberations and contributions made during the rating committee were not adequately recorded and minuted other than a noting of the final rating decision. The FSB has recommended that CRAs improve the recording of rating committee meetings to enhance the transparency and integrity of the rating process with regard to the participation of individuals and decisions made within committees pursuant to Rule 13(3)(e). Rule 13(3)(e) requires that, for each credit rating decision, CRA's are required to retain internal records and files, including non-public information and work papers, used to form the basis of any credit rating decision taken. In one CRA the FSB noted the participation of senior management with commercial responsibilities in rating committees which gives the appearance of a conflict of interest. In this case it was recommended that the CRA implement stronger barriers between its lines of business.
- 3.1.9. The FSB noted instances where there was a lack of adequate internal controls and functions in place in order to secure access to rating information. The CRA's were requested to ensure that adequate internal controls and functions are in place in order to secure access to rating information, i.e., confidential documents and information on upcoming rating actions which are generated, stored and processed in the CRAs' systems, before public disclosure of the outcome of the rating process. The FSB recommended that substantial control over

relevant interdepartmental communications, preferably through a clearance area within the CRA, should be implemented.

- 3.1.10. There were instances where proof by way of records and documented evidence of surveillance on existing ratings could not be produced. The FSB requested that CRA's conduct reviews to determine if adequate resources are devoted to the surveillance of outstanding credit ratings emanating from local operations and that all appropriate surveillance records with sufficient detail are maintained to permit an after-the-fact review.
- 3.1.11. There was one instance where it was recommended that a CRA review and strengthens its current practices for finalising complaints received. It was noted that there was room for improvement in handling complaints as poor communication in its current practise had the ability to leave cases hanging, potentially prejudicing clients because the compliance function, which may still be in the process of considering the facts or may even have closed the file, had not communicated this to the relevant operational office of the CRA.
- 3.1.12. The FSB found that the requirement of a log of all telephone calls made and received that relate to credit rating activities as required in Rules 13(3)(i) and 13(3)(h) was not being done. CRAs were requested to take remedial action to ensure that these logs are maintained as required by the legislation.
- 3.1.13. In a review of press releases the FSB noted that CRAs had not included the glossary of terms and acronyms used as required in Rule 10(10), which states that a credit rating agency must ensure that published credit ratings and reports contain details of definitions and a glossary of all terms and acronyms used in the publication. CRA's have been requested to incorporate the provisions of Rules 10(2)(e), 10(10) and 18(9) in their publications and press releases. The FSB concluded that having these disclosures contained within and by reference to a website was considered inadequate to address the full and complete disclosure as anticipated and required in the legislation.
- 3.2. Despite the shortcomings discussed above the FSB observed some positive outcomes which included;
  - (i) the implementation of regulation was accepted and CRAs had made significant progress in implementing the requirements into their local operations and having inclusions in their internal policies and processes;
  - (ii) compliance officers showed commitment to their responsibilities as required in South Africa although compliance reporting was not always complete; and
  - (iii) a communication channel was opened between the CRAs and the FSB and areas of concern and/or interpretation could be discussed.



## 4. WORK PLAN FOR THE 2015/16 FINANCIAL YEAR

- 4.1. The department will continue to proactively supervise credit rating agencies and work with them to address their shortcomings identified in prior onsite examinations. In order to achieve this, the FSB's supervision will engage with CRAs and assess their implementation of the relevant requirements of the Act and subordinate legislation. Recent work has highlighted that there are still issues around internal governance as well as independence, objectivity and quality of the rating process that need to be remedied.
- 4.2. Cognisance is taken of the fact that the operations of three CRAs are global in nature and scale. Their personnel participate in rating activities which includes the determination of ratings related to South Africa based entities. Based on this, the 2015/16 onsite examinations will include additional focus on:
- (i) rating policies and procedures, methodologies, criteria, and models used to determine credit ratings;
  - (ii) whether the credit rating agencies exercise sufficient compliance oversight over activities within the agency;
  - (iii) ensuring the full independence of the compliance function;
  - (iv) reducing and managing the risk of potential conflicts of interest;
  - (v) integrity of the rating process, and
  - (vi) validity of credit ratings for regulatory purposes.
- 4.3. This will be in addition to assessing each credit rating agencies' progress in implementing planned remedial measures from prior onsite examinations and testing the effectiveness of such remedial measures. Further on-site visits will be driven by the CRA evaluation and review (ad-hoc onsite investigations) and also on matters arising from any comments or complaints received from financial market participants, investors, the public and consumers.

### Note

International CRAs do not perform their structured finance analysis in South Africa and ratings are assigned out of their international offices. The FSB refers investors and users of structured finance credit ratings to the report titled "ESMA's Investigation into Structured Finance Ratings" which is available on the ESMA website and which can be accessed via [http://www.esma.europa.eu/system/files/esma-2014-1524\\_cra\\_public\\_report\\_on\\_sf\\_investigation.pdf](http://www.esma.europa.eu/system/files/esma-2014-1524_cra_public_report_on_sf_investigation.pdf).





