



18 August 2011

Roy Havemann
National Treasury
Republic of South Africa

Submitted via electronic mail to: financial.policy@treasury.gov.za

To Whom It May Concern:

Re: Comments on the Credit Rating Services Bill (the “Bill”)

Dear Sir/Madam,

We are pleased to submit for your consideration our response to your invitation for comments on the Credit Rating Services Bill, as announced in the Statement on the Cabinet meeting of 26 July 2011.

We share your interest in heightening the level of objectivity that is brought to the ratings process, and as former rating agency analysts ourselves we are keenly aware of the importance of creating a well-functioning ratings system. A healthy system affords our markets numerous benefits, including a host of efficiencies, which lead to market liquidity; the pitfalls of relying on a conflicted system can be, as we know, numerous and devastating.

For ratings reform to be successful, we believe it ought to provide an incentive, reputational or otherwise, for rating agencies to provide accurate ratings; ratings performance ought to be independently measurable and externally monitored, and in such a way as to encourage raters to say “no” to ratings in which they do not believe, despite the revenues they would otherwise have generated had they acceded.

Many of the tools necessary to ensure high quality ratings, including several noteworthy and progressive initiatives, are already provided for by the Bill. Thus, we will selectively concentrate our comments on certain high-level conflicts that may hinder the provision of unbiased credit ratings, and we will recommend ways in which they can be circumvented or minimised. For additional commentary please visit our ratings research described in the addendum to this submission, or our earlier submissions to international regulatory bodies, hosted on our website.

We recognise the serious nature of your task and hope that you will not hesitate to contact us should you value further communication.

Sincerely,

Guillaume Fillebeen and Gene Phillips
Directors, PF2 Securities Evaluations, Inc.



Conflicts of Interest, Part A

Chapter III part 7.1(d) of the Bill requires that:

“A credit rating agency must be organised in a way that ensures that its business interest does not impair the independence and accuracy of its credit ratings or credit rating services;”

We note that the impairment of an opinion may be a highly subjective matter: a credit rating agency (“CRA”) whose opinion is reasoned to have been impaired by a conflict may argue that it was able to reach its opinion, fairly, despite the apparent conflict.

For example, CRAs may be conflicted when rating their shareholders: ratings analysts may specifically suffer undue pressure, or may be biased, in determining whether to downgrade debt issued by key shareholders. Such a scenario would likely impair the level of objectivity brought to the ratings decision.

Additionally, it is in our opinion necessary to foster steady criticism of ratings by market participants and the media. Public criticism, delivered by way of various forms of media and research, provides a useful, positive feedback mechanism for rating agencies. If ratings errors or inaccuracies are brought to the public’s attention, the CRAs will be more likely to subsequently mend their procedures to avoid repeated errors. However, for fear of a backlash (i.e., a downgrade), we remain sceptical that any newspaper would criticise a rating agency that rates the newspaper company. Similarly, a journal whose advertising clients include rating agencies might be less likely to publish commentary that is adverse to the rating agencies.

We therefore submit for your consideration the express inclusion in the Bill of certain key conflicts, to be avoided by ratings agencies, which impair the independence and accuracy of ratings opinions:

- *CRAs are prohibited from rating debt issued by their shareholders (or affiliates thereof);*
- *CRAs are prohibited from rating media companies who business includes the dissemination of financial markets commentary; and*
- *CRAs are prohibited from advertising their services in newspapers, periodicals, journals or other forms of media that focus on the dissemination of financial markets commentary, research, news or criticism.*



Conflicts of Interest, Part B

Chapter III part 12.2(b) of the Bill allows that:

“A credit rating agency may provide services ancillary to its credit rating services, which services comprise of market forecasts, estimates of economic trends, pricing analysis, other general data analysis and related distribution services and any other services as prescribed.”

A downgrade of a client who purchases significant volumes of associated analytical services may encourage that client to terminate those services. Hence, a CRA may be pressured to hold off downgrading a revenue-generating client.

Material conflicts may also appear when a CRA prices a security that it has rated. Given the substantial overlap, it is arguable whether the two processes can be approached independently. (Does a high price undermine the legitimacy of a low rating?) Furthermore, it is uncertain whether rating agencies would be able to gain access to the market-related information necessary to price securities: banks, brokers and dealers often have an economic interest in withholding market information from the CRAs, especially if they're rated by the CRAs and they own these securities.

To the extent possible, we strongly recommend placing a fire wall” around ratings analysis. Investors would gain comfort from knowing that rating analysis generates a pure opinion about credit quality, not one even potentially influenced by business goals (like building market share). Investors should see that rating analysis is virtually barricaded into an “ivory tower,” and kept safe from interference by any agenda other than getting the answer right.²

Thus, to minimise the potential for unnecessary conflicts, we urge you to consider eliminating this passage in part or in its entirety. Clients external to the ratings process create material distractions and conflicts. We would encourage the focus of rating agencies to be unwavering, and limited to the important business of providing accurate credit ratings.

² For further reference on this topic, please visit Mark Froeba's testimony before the U.S. Senate Committee on Banking, Housing, & Urban Affairs' hearing on *Proposals to Enhance the Regulation of Credit Rating Agencies (August 5, 2009)*.



Addendum — Resources

Related Publications (available at <http://pf2se.com/Resources.asp?id=1>)

April 8, 2011: [*Special Report: Why It's a Problem That Only Rating Agencies Evaluate Their Performance*](#)

February 1, 2010: [*Economies of \(Ratings\) Scales Part 1*](#)

January 22, 2010: [*A Centralized Solution*](#)

January 8, 2010: [*"Gaming" the Ratings System, or the Observer Effect*](#)

September 14, 2009: [*Special Report: First Steps Toward Real Rating Agency Reform*](#)

Ratings Measurement

AccuRating™: <http://pf2accurating.com/>