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Manager
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By email: RetailCorporateBonds@treasury.gov.au

Dear Sir or Madam,

Discussion paper: Development of the retail corporate bond market: streamlining disclosure and liability requirements

Standard & Poor's (Australia) Pty Ltd ("**S&P Australia**") is pleased to make the following submission in relation to the Treasury discussion paper 'Development of the retail corporate bond market: streamlining disclosure and liability requirements' ("**Discussion Paper**").

Background

Standard & Poor's Ratings Services ("**S&P Ratings Services**"), a leading international credit rating agency ("**CRA**"), has been assigning credit ratings since 1916. The credit rating activities of S&P Ratings Services are conducted globally through various affiliated entities[1] that operate in accordance with policies and procedures and criteria that are generally globally applicable. S&P Ratings Services shares a globally integrated operating structure. In Australia, S&P Ratings Services operates through S&P Australia, which holds an Australian Financial Services Licence to provide credit ratings to wholesale clients only.

S&P Australia supports the decision of the Australian Government to review the use and availability of credit ratings as part of the Discussion Paper. When licensing requirements became effective in Australia for CRAs in January 2010, S&P Australia applied for a wholesale-only license due to concerns, which we believe other global CRAs who also applied for wholesale-only licenses share, about credit ratings being subject to an External Dispute Resolution ("**EDR**") 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 Treasury to reconsider the regulatory framework for CRAs as part of its consultation on developing a retail corporate bond market.

Specific Feedback

In response to the specific questions regarding the use and availability of credit ratings, please find below our response.

[1] The affiliated entities are all direct or indirect subsidiaries, branches or divisions of The McGraw-Hill Companies, Inc, a company incorporated in the State of New York, USA and publicly listed on the New York Stock Exchange.

Should the entity or the bond issue be required to have an investment grade rating (if available)? If so, how would an investment grade rating be defined and mandated?

S&P Australia supports the steps now underway internationally, under the direction of the Financial Stability Board ("**FSB**")[2], to reduce over-reliance on ratings in the financial system by taking the following two actions: (i) removing requirements to use ratings in regulations where such requirements have the potential to trigger mechanistic reliance on ratings; and (ii) encouraging, if not requiring, investors to conduct their own analysis of credit risk rather than relying solely on ratings. Ending the "hardwiring" of ratings in regulations will also create a level playing field for all providers of credit research and opinions. The Australian Government also supports the initiatives of the FSB. In its recent response to a survey on progress against implementing global policy reforms since the G20 Seoul Summit in November 2010 which was conducted by the FSB Implementation Monitoring Network, it stated 'we also endorse the FSB's principles on reducing reliance on external credit ratings. Standard setters, market participants, supervisors and central banks should not rely mechanistically on external credit ratings.'[3]

S&P Australia's philosophy is that we should compete, like any other business, on the inherent quality of our analysis. We should also do so in free and fair competition with other providers of credit research and benchmarks. In its efforts to avoid undue reliance on external ratings, we believe that the Treasury should not include credit ratings as the only benchmark to be disclosed for retail corporate bond issues. S&P Australia credit ratings are not absolute measures of default probability. Ratings express relative opinions about the creditworthiness of an issuer or credit quality of an individual debt issue, from strongest to weakest, within a universe of credit risk. They are not investment advice, or buy, hold or sell recommendations. They are just one factor investors may consider in making investment decisions and they are not indications of market liquidity of a debt security or its price in the secondary market.

We believe that external credit ratings serve a useful purpose, particularly when used with other forms of analysis and a risk management process. The majority of investors tell us that they value our credit research and ratings as inputs - alongside many others - in their financial analysis. We believe their continued interest in ratings is justified, because our ratings for nearly all asset classes performed broadly as expected during the financial crisis.[4] We encourage moves internationally to reduce over-reliance on credit ratings and suggest that if the Treasury wishes to proceed with requiring retail corporate bond issuers to disclose credit ratings that such disclosure is complemented with other benchmarks and that investors are encouraged to conduct their own analysis of credit risk.

In addition to our comments above, we also wish to highlight that ASIC's decision to withdraw class order relief that allows issuers of investment products to cite credit ratings without the consent of credit rating agencies[5] may lead to unintended market consequences if there is a requirement for a credit rating for retail corporate bond issues. For example, certain CRAs may choose not to provide consent in some or all instances. This result was seen in the United States, when the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), among other things, repealed the expert's consent exemption for Nationally Recognized Statistical Rating Organizations ("**NRSROs**") in the U.S. and exposed NRSROs to potential civil liability for consenting to disclosure of their credit ratings in U.S. public securities offerings. However, on July 22, 2010 the SEC granted issuers of asset-backed securities

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[2] 'Principles for Reducing Reliance on CRA Ratings', Financial Stability Board, 27 October 2010, http://www.financialstabilityboard.org/press/pr_101027.pdf

[3] 'FSB – G20 – Monitoring Progress – Australia' September 2011, http://www.financialstabilityboard.org/publications/r_111104.htm

[4] S&P published a study of its ratings in "A Global Cross-Asset Report Card of Ratings Performance in Times of Stress" dated 8 June 2010. This reflected a comprehensive review of credit ratings, spanning the spectrum of corporate, government and structured finance debt, issued in the US, Europe, Japan and Australia. It demonstrated that ratings for nearly all asset classes performed broadly as expected, with the exception of ratings on US residential mortgage-backed securities and on collateralised debt obligations backed by structured finance collateral.

[5] '09-225AD ASIC gives credit ratings agencies improved control over ratings use', Thursday 12 November 2009 http://www.asic.gov.au/asic/asic.nsf/byheadline/09225AD+ASIC+gives+credit+ratings+agencies+improved+control+over+ratings+use?openDocument

temporary relief from a regulatory requirement that the prospectuses for such securities include disclosure of their credit ratings, noting that the NRSROs have indicated that they are not willing to provide their consent at this time. The SEC indefinitely extended this exemption on November 23, 2010[6]. For the market, this result may lead to less information being readily available to investors in disclosure documents. We believe this runs counter to the fundamental goals of the proposals to develop the retail corporate bond market. In addition, CRAs that do provide their consent may adopt a more homogeneous approach to credit ratings, resulting in less diversity of opinion and strong disincentives for analytical innovation and increased competition in the industry. It may also create incentives for consenting CRAs to narrow the scope of their rating analysis (such as by restricting it to those rating processes that courts have deemed "reasonable") in order, again, to minimize the areas for potential second-guessing and litigation.

S&P Australia strongly encourages the government to clarify by way of legislative amendment that CRAs do not have to provide consent if credit ratings are disclosed in disclosure documents and product disclosure statements. Alternatively, we suggest that ASIC reinstate the previous class order exemption and expand it to also cover any citation of a credit rating in disclosure document and product disclosure statements. With that background in mind, we wish to highlight that any decision to mandate increased disclosure of credit ratings in disclosure documents and product disclosure statements may adversely impact capital flows, market growth and efficiency if such consent requirements are retained.
As noted above, S&P Australia supports investors' ongoing use of credit ratings as one tool among others in the investment decision-making process (ex., in managed fund investment guidelines). S&P Australia believes that rather than government mandates to mechanistically use ratings without considering other benchmarks, markets are best placed to decide the value of ratings. For the reasons outlined above, S&P Australia, does not support the proposal to require certain credit ratings alone without also encouraging investors to conduct their own assessment of credit risk. S&P Australia also urges the government to reconsider the consent requirement for use of credit ratings in disclosure documents and product disclosure statements.

What other measures could the Government or ASIC take to enable the provision of credit ratings to retail investors?

As mentioned above, S&P Australia holds a wholesale-only Australian Financial Services Licence. Among other requirements, the regulations for CRAs announced by ASIC on Nov 12, 2009[7] require credit rating agencies that wish to assign credit ratings for investment products offered to retail investors, to be members of an approved EDR scheme, such as the Financial Ombudsman Service. We would prefer to hold a broader license so that credit ratings can be provided to retail and wholesale clients in Australia, but we reluctantly obtained a wholesale-only licence due to our concerns regarding the requirement for CRAs to be a member of an EDR scheme.

S&P Australia would be extremely concerned if the substance of credit rating opinions – forward-looking statements made at one 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 chill the exercise of independent judgment and be detrimental to the markets. An EDR scheme that allowed for second-guessing of forward-looking opinions made based on the consistent application of their rating methodologiescould expose many of them to groundless challenges based on hindsight and speculation.

The need for credit ratings to be free from substantive review by regulators is explicitly recognised by legislation in the United States[8] and regulation in Europe[9]. Importantly, the Regulation (EC) No

[6] http://www.sec.gov/divisions/corpfin/cf-noaction/2010/ford072210-1120.htm
[7] 09-224MR ASIC outlines improvements to regulation of credit rating agencies in Australia, Thursday 12 November 2009 http://www.asic.gov.au/asic/asic.nsf/byheadline/09-224MR-ASIC-outlines+-improvements-to-regulation-of-credit-rating-agencies-in-Australia?openDocument
[8] Section 15E(c)(2) of the United States Securities Exchange Act of 1934

1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies ("**European CRA Regulation**") sets out several requirements that must be met by a third party regulatory system in order for it to be considered equivalent, including the requirement that 'the regulatory regime in that third country prevents interference by the supervisory authorities and other public authorities of that third country with the content of credit ratings and methodologies'[10] Any EDR scheme directive to change the substance of a credit rating could result in the extraordinary creation of dual credit ratings – a Australia "EDR" credit rating and a "rest of the world" credit rating, which would create investor confusion and harm to the markets. Ratings are issued and used globally. Finally, an EDR scheme could require the provision of information that is commercially confidential, highly sensitive and proprietary to third parties.

There is no international precedent for having credit ratings subject to review by an EDR scheme. As mentioned above, the US and EU regimes expressly prohibit regulating the substance of a credit rating or the methodology by which credit ratings are determined. There is, however, a need for international consistency in regulatory oversight because ratings are issued and used globally. We are concerned that membership of an EDR scheme would undermine the global consistency and comparability of ratings. Importantly, in Asia Pacific the trend is for other jurisdictions to exempt CRAs from the requirements relating to external dispute resolution. The Financial Services Branch, Financial Services and Treasury Bureau, Hong Kong has announced an exemption from the 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 Centre[11]. This was further acknowledged by the Hong Kong Securities and Futures Commission in its recent consultation paper on this topic.[12] The Monetary Authority of Singapore has also announced an exemption from dispute resolution scheme requirements for CRAs.[13]

For the reasons discussed above, we 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. For these reasons, 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. In the absence of legislative change, we believe that the current asymmetry of information will continue and retail investors will not be able to readily access credit ratings.

Standard & Poor's appreciates the opportunity to comment on the Discussion Paper. Please feel free to contact Jodie Henson, Associate General Counsel on (03) 9631 2234 or by email jodie_henson@standardandpoors.com if you require any further information or would like to discuss our submission further.

Yours sincerely

John Bailey

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[9] Article 23(1) of the Regulation (EC) No 1060/2009 of the European CRA Regulation

[10] Article 5(6)(c) of the European CRA Regulation

[11] '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/fsb/ppr/consult/consult_iec_fdrc.htm

[12] 'Consultation paper on proposals to amend the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission in relation to the establishment of the Financial Dispute Resolution Centre Ltd and the enhancement of the regulatory framework', Securities and Futures Commission, Hong Kong, November 2011, https://www.sfc.hk/sfcConsultation/EN/sfcConsultMainServlet?name=FDRCCoC

[13] 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