Press release

LCQ19: Regulation of credit rating agencies in Hong Kong

Wednesday, December 7, 2011

Following is a question by the Hon Frederick Fung and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (December 7):

Question:

Some time ago, the European Commission (EC) proposed the introduction of legislation to tighten the supervision and restriction on credit rating agencies (CRAs) (including increasing the transparency of their credit rating process and bolstering competition in the credit rating industry; making it mandatory for enterprises to change the CRAs they hire on a regular basis; as well as restricting the timing for CRAs to publish sovereign ratings). The proposed legislation also provides that any member state of the European Union (EU) or investor may bring civil liability legal actions against losses arising from the ratings; and encourages local banks and financial institutions to make their own assessments, with a view to reducing reliance on CRAs. Furthermore, the European Parliament passed a bill to confer greater power on the European Securities and Markets Authority to vigorously curb sovereign debt speculation, including imposing a ban on naked short selling in shares and sovereign debts, as well as in relevant credit default swaps (CDS). In this connection, will the Government inform this Council:

(a) whether the authorities have assessed if, compared with the existing regulatory regimes of other economies and the aforesaid legislative proposal of EC, the current regulation of CRAs in Hong Kong is too lenient, and if there is sufficient competition in the rating industry and adequate transparency in the rating process; if an assessment has been made, of the results; if not, the reasons for that;

(b) given that the European Parliament has endorsed a ban on naked short selling in shares and sovereign debts, as well as in relevant CDS, whether it knows how the relevant trading practices are regulated in Hong Kong at present; whether the authorities have a full picture of the participation of local financial institutions in the trading of financial derivative products (including taking part in the issuance of these products) relating to European sovereign debt (European debt) crisis; whether the authorities have conducted any risk assessment in this aspect, and in the event of sovereign defaults in EU countries, of the potential loss suffered by local financial institutions and the systemic risks likely to emerge in the financial market; if such an assessment has been made, of the results; if not, the reasons for that; and

(c) whether the authorities will make reference to the practices of EU to step up the regulation of CRAs and speculative practices, and require local financial institutions to enhance the transparency of trading and assets relating to European debts, etc.; if they will, of the details; if not, the reasons for that?

Reply:

President:

My reply to the questions raised by the Hon Frederick Fung is as follows:

Regulation of Credit Rating Agencies

In line with the international development of the regulation of credit rating agencies (CRAs), the Securities and Futures Commission (SFC) formulated a regulatory regime governing CRAs last year. The regime became effective on June 1, 2011. Under the new regime, CRAs and their rating analysts who provide credit rating services in Hong Kong are required to be licensed for Type 10 regulated activity under the Securities and Futures Ordinance (SFO) and are subject to supervision by the SFC. All licensed CRAs and rating analysts are required to comply with the applicable rules, codes and guidelines of the SFC, including the Code of Conduct for Persons Providing Credit Rating Services (the Code of Conduct). When considering whether the CRAs and the rating analysts are fit and proper to become licensees, the SFC would in general take the requirements set out in the Code of Conduct as one of the factors for consideration. If a licensed CRA or rating analyst is found to be guilty of misconduct, SFC may take a range of disciplinary actions, including revocation or suspension of licence, fines, public reprimand, etc.

The requirements set out in the Code of Conduct are primarily based on the "Code of Conduct Fundamentals for Credit Rating Agencies" issued by the International Organisation of Securities Commissions (IOSCO) in 2008 (the IOSCO Fundamentals). The Code of Conduct has also incorporated additional requirements and some supplementary provisions that have been introduced in other jurisdictions, particularly in the European Union, including the additional requirement of reviewing, at least annually, the rating target's creditworthiness, and restrictions on CRAs in entering into any contingent fee arrangement for providing credit rating services. The IOSCO Fundamentals, the local Code of Conduct, and measures regarding CRAs put in place in other comparable jurisdictions all revolve around the principles of integrity, independence, transparency and confidentiality. The SFC would closely monitor the international development and trends in CRA regulation to ensure that the CRAs regulatory regime in Hong Kong is in line with international regulatory direction and local needs.

Short selling

In respect of the European Commission's new requirements on naked short selling, Hong Kong has banned naked short selling since the 70's. In 2000, the maximum penalties for naked short selling had been increased from a fine of $10,000 and imprisonment for six months to a fine of $100,000 and imprisonment for two years. At the same time, new criminal offences were introduced for unreported short selling. Moreover, Hong Kong also imposes the uptick rule, i.e. short selling below the best current ask price is prohibited in Hong Kong. Separately, SFC understands that currently only EU countries have imposed ban on the purchase of credit default swaps without owning the related bonds. There is no similar measure in other major overseas markets. The Government and regulators will continue to closely monitor the development in this regard.

The European Debt Crisis

Due to the European debt crisis, some investment products are facing counterparty risk exposure to the European markets and/ or financial institutions. In view of this situation, SFC has put in place a number of measures, including monitoring these products' risk exposure to major international financial institutions; requiring the collateral level for each of the domestic synthetic ETFs be topped-up to achieve at least 100% collateralisation; closely communicating with major product issuers/ arrangers, fund management companies and overseas and local financial institutions and requiring them to inform SFC of any unusual situations. SFC has also put in place detailed contingency plans for various kinds of emergency situations, such as high level of market volatility, major financial problems or bankruptcy of any brokers or financial institutions, exchanges or clearing houses unable to operate in a fair and orderly manner, etc.

As of the end of June 2011, Hong Kong's banking system's total risk exposure to Greece, Ireland, Italy, Portugal and Spain constituted less than 1% of their total assets. In the event of default of these countries, the direct impact on the Hong Kong banking system is expected to be very limited. Although banks in Hong Kong do not have significant exposure to debts issued by European countries facing sovereign debt problems, the banking sector may suffer from the negative spillover in the event that fiscal problems of some European countries would lead to heightened risk aversion and trigger capital outflows from emerging markets or liquidity squeeze in the interbank market.

The Hong Kong Monetary Authority will continue to monitor banks' risk exposure through its day-to-day supervision, and has requested banks to strengthen their risk management and maintain adequate capital and liquidity to address the potential systemic risk arising from the global financial turmoil.

For the insurance sector, according to the Office of the Commissioner of Insurance (OCI), exposure of authorised insurers in Hong Kong to the European market is about 5% of their total investment. The impact of the European debt crisis on the overall stability of the Hong Kong insurance industry is therefore insignificant. The OCI will continue to monitor the international market situation and review the investment portfolios of insurers and conduct stress tests from time to time to ensure that the insurers are solvent.

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