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BEFORE THE U.S.-CHINA ECONOMIC & SECURITY REVIEW COMMISSION

HALL OF THE STATES

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Mr. Chairman, Members of the Commission, good morning, I am Vickie A. Tillman, Executive Vice President of Standard & Poor's Credit Market Services, which includes Standard & Poor's Ratings Services ("S&P"), the unit responsible for assigning and publishing credit ratings of issuers and securities. I welcome the opportunity to appear before this Commission to discuss China's financial regulatory system, particularly as it applies to capital markets and foreign credit rating agencies. Per the Commission's request, in this testimony, I will address four related topics:

- A comparison of China's regulatory environment with those of other Asian countries
- Chinese regulators' perception of the role of credit ratings and credit rating agencies in today's global financial system
- Regulatory and other barriers that limit foreign ratings agencies from entering and competing in China's capital market
- Regulatory barriers that affect the banking/insurance industries

We have conferred with USTR, the International Trade Commission, the American Embassy in Beijing as well as senior Chinese government officials on these issues and I look forward to sharing our thoughts on them with you today as well. Our overall view is that while significant structural reform of China's capital market environment continues to take place, further progress is needed, especially with respect to allowing foreign credit ratings agencies to compete on par with local agencies and operate independently. Before turning to these topics, however, I would first like to provide some background information about S&P and our credit rating business.

Background on S&P and the nature of Credit Ratings

S&P, which is a part of The McGraw-Hill Companies, Inc., began its credit rating activities ninety years ago, in 1916, and today is a global leader in the field of credit ratings and risk analysis, with credit rating opinions outstanding on approximately 500,000 issues of obligors in over 100 countries. Over that time, S&P has established an excellent track record of providing the market with independent, objective and rigorous analytical information in the form of credit rating opinions.

In every market in which we operate, including China, a rating from S&P represents our opinion, as of a specific date, of the creditworthiness (i.e., the likelihood of default) of either an obligor in general or a particular financial obligation. Once published, we monitor ratings on an ongoing basis.

Our credit rating opinions, however, are neither recommendations to buy, sell, or hold a particular security; nor are they comments on the suitability of an investment for a particular investor or group of investors; nor personal recommendations to any particular user; nor investment advisory in nature. Rather, they are, very simply, opinions of credit risk.

The main role of S&P's credit ratings is to help enhance transparency and efficiency in debt capital markets by reducing information asymmetry between borrowers and lenders. Our ratings enjoy broad market acceptance because they are independent and objective measurements of credit quality; are widely and publicly available to the market and the performance of S&P ratings has been demonstrated to be excellent. Studies on rating trends have repeatedly shown that there is a clear correlation between the initial rating assigned by S&P and the likelihood of default: the higher the initial rating, the lower the probability of default and vice versa. For this reason, they are useful to both institutional and retail investors alike and are a key element in bond market functioning. They support risk-based pricing, provide globally consistent benchmarks and coverage, link national markets and enable investors to make informed financial decisions.

Standard & Poor's has been active in the Asia-Pacific region since the 1970s. We opened our first Asian office in Tokyo, in 1985, and today have nearly 2,000 staff operating in Japan, India, China, Hong Kong, Singapore, Korea, Taiwan, Malaysia and Australia. In recognition of our activities in this region, we have been repeatedly recognized by the financial news publication, FinanceAsia, as "the most influential rating agency in Asia."

Standard & Poor's commitment to supporting the development of efficient, transparent and dynamic capital markets in China dates back to 1991 when we first rated China's US dollar denominated sovereign debt. Since then, our 45 ratings in China on corporations and banks have enabled these issuers to access the international capital markets.

Over the last 15 years, S&P has invested considerable time and resources towards educating investors about appropriate risk management practices and working with Chinese government agencies on market regulations and policies. Examples of S&P sponsorship or participation in regular investor outreach activities include a host of seminars and conferences on credit ratings, securitization, and risk management. We have also worked with Chinese banking and insurance regulators to provide training on risk control and credit risk management. Our credit rating analysts have been invited to present S&P credit ratings analysis and methodologies to senior representatives of the People's Bank of China, the Chinese Banking Regulatory Commission (CBRC) and the Chinese Insurance Regulatory Commission (CIRC). In addition, in March 2005, S&P

was invited by the Central Bank of China to provide pilot ratings for the first batch of short-term bond ratings issued through the local inter-bank bond market.

To accommodate local markets needs, S&P has hired Chinese speaking analysts and also built a Chinese language website to provide access to S&P ratings information. Early this year, we were asked to provide comments for the draft regulations on "Measures for the Administration of Securities Credit Rating Service".

As a further commitment to the Chinese market, in 2003, Standard & Poor's opened a representative office in Beijing and, in 2005, established a wholly-owned foreign enterprise (WOFE) with the expectation that, once authorized by the relevant regulatory authorities, we would be able to provide our credit ratings services to the growing domestic credit ratings market, starting with some pilot projects. Unfortunately, the likelihood of receiving this authorization is increasingly remote for reasons I will discuss in a moment.

Comparison of China's regulatory environment with those of other Asian countries

Comparing China's regulatory stance on capital markets and ratings agencies with other nations in the region, we have generally found a greater openness and recognition for the need for rating agency independence and for rating agencies to conduct domestic ratings in key Asian financial centers like Japan, Hong Kong, Singapore and Australia than in China. The governments in these markets have embraced the importance of accepting global standards in the financial services industry for both equity and debt capital markets, seeing this as the best way for building competitive and borderless capital markets for global investors.

This is the case for an assortment of industries, including credit ratings services and other financial services such as investment banking, insurance, and fund management. In a broad sense, foreign intermediaries in these countries are treated the same way as their local counterparts. Fully foreign owned institutions are allowed to operate and provide services to the local markets and investors and are subject to the same laws and regulations as domestic firms.

In Japan and Hong Kong, the respective regulatory agencies have adopted a 'recognition' approach of foreign credit ratings agencies - i.e. they recognize certain CRAs as External Credit Assessment Institutions for purposes of Basel II. This approach is in line with many other economies like the United Kingdom, Canada and some parts of Europe. Even in a smaller economy like Malaysia, regulators have adopted a recognition approach, by requiring Credit Ratings Agencies to obtain Securities Commission's recognition for purposes of conducting credit ratings for certain issuances/investments and by requiring the CRAs to adopt the IOSCO Code of Conduct Fundamental for Credit Rating Agencies.

Chinese regulators’ perception of the role of credit ratings and credit rating agencies in today’s global financial system

Chinese regulatory agencies are staffed by many highly-trained, sophisticated and well-traveled individuals who are determined to create a world-class capital market and financial system based on good governance, transparency and accountability. How they get there and how long this will take is the question.

We are generally impressed by evidence that regulators continue to review and enhance regulations by adopting best practices and international standards, such as securities legislation, risk management and corporate governance. And there is increasing emphasis on disclosure and accountability for timely, complete and accurate dissemination of information. In addition, there appears to be increasing cooperation by regulators in China with international organizations to promote high standards and to exchange information and provide mutual assistance.

The problem for rating agencies in China is less about regulators’ level of understanding of credit ratings than a lack of any clear regulatory authority over the industry. Although recent signals from the National Development and Reform Commission indicate some clarification may come in the near future, currently no agency within the Chinese government is specifically designated to regulate credit ratings. Therefore, a certain amount of confusion abounds, exacerbated by a large degree of fragmentation of authority and departmentalism.

To date, there are five government bodies that, to various degrees, oversee the credit rating space. They are the People’s Bank of China (PBOC), which regulates short-term CP in the inter-bank market; the National Development and Reform Commission (NDRC), which issues permits to corporations for issuing bonds; the China Banking Regulatory Commission (CBRC), which appears to be more receptive to direct involvement of foreign rating agencies and, for structured finance transactions, requires ratings by one local rating agency and one global rating agency; the China Securities Regulatory Commission (CSRC), which has issued a proposed regulation urging foreign agencies to cooperate with local agencies; and the China Insurance Regulatory Commission (CIRC), which regulates insurance companies’ investment requirements.

Not surprisingly, the growth of Chinese corporate bond issuance over the past two years (still a relatively small market) as well as the demand for structured finance deals is focusing Chinese regulators’ attention on the need for greater clarity among their various jurisdictions and better rules governing debt issuance. According to recent press stories in July of this year, after many years of intra-agency debate, the National Development and Reform Commission released a draft proposal entitled “Regulations on Administrating Corporate Debt Securities.” The *China Business Post* reports that these regulations will be part of the agenda for an inter-ministerial meeting later this year, a preliminary step for gaining wider support and implementation next year when China’s 2007 National Financial Work Conference takes place.

Reforming the credit environment appears therefore to have become a priority. In addition to proposing a national registration system for corporate debt issuance and allowing issuance pricing to be determined gradually by the market, draft regulations also attempt to liberalize restrictions on corporate debt issuers while also, as is the case in the United States, disallowing the issuance of non-investment grade debt to individual investors.

<u>Regulatory and other barriers that limit foreign ratings agencies to enter and compete in China's capital market</u>

Before commenting on China's regulations of ratings agencies, I would first like to address the country's changing outlook on the use of ratings. Standard & Poor's applauds the current thinking emanating from the proposed regulations that call for two ratings on certain corporate bonds and structured finance transactions, including one rating from a foreign rating agency. We believe this step is a sign that there is a growing understanding among government officials and market participants in China that a rating system built around well-established global practices and with an emphasis on transparency and analytical rigor is key for China to develop a large and dynamic capital market for both local and international investors. And we encourage China to continue moving in this direction.

Despite this progress, however, we are not optimistic that the picture for foreign rating agencies will change any time soon in China where there remains an ambivalent attitude toward foreign-owned entities. One reason for this pessimism is a draft bill circulated by the China Securities Regulatory Commission's (CSRC) late last year governing the market for credit ratings in China. Entitled "Measures for the Administration of Securities Credit Rating Service", if enacted, the CSRC's current proposals would significantly restrict the ability of international ratings agencies to participate in China's domestic credit ratings market. They impose a regulatory regime that severely limits the ability to conduct independent, high quality credit analysis and require that international credit rating agencies partner with a local Chinese firm on a minority basis.

The CSRC's draft law would effectively create a framework that makes it very difficult for international credit ratings agencies to enter the market and provide the kind of service that the market needs. In our formal response to the CSRC on January 13, 2006, Standard & Poor's raised several serious issues and we respectfully ask this Commission's further assistance in making known our position to Chinese authorities.

Among the most burdensome of the proposed regulations are 1) the requirement that foreign ratings be limited to entering the market only through a joint venture with a licensed local Chinese credit rating agency in which foreign credit rating agencies are limited to no more than 49% of ownership: (Articles 6 and 9); and 2) abundant restrictions on how foreign rating agencies conduct their rating processes, the most egregious of which would be the need to register rating committee members in the CBRC.

We believe that foreign ratings firms should not be limited to entering the market only through a joint venture with a licensed local Chinese credit rating agency. Where there may be interest in ownership of a local firm, foreign credit rating agencies should not be limited to no more than 49% of any joint venture. In addition, instead of requiring a business permit to operate, the CSRC should follow the process of other countries which recognize rating agencies that adopt a code of conduct based on the IOSCO Code mentioned above.

Also, consistent with global practices, rating agencies should be allowed to convene diverse rating committees comprised of staff best suited to opine on the relevant issue or issuer without CSRC approval of, and registration requirements for, individual committee members. In addition, regulators should allow ratings agencies to reach independent analytic opinions and should not dictate rating criteria, definitions or analytic processes. We believe that our tradition of integrity, independence, and objectivity coupled with our highly developed analytical methodologies and credit ratings services can provide China's financial markets and credit ratings industry with the tools and transparency they need to develop and grow. Similarly, we believe our practices and procedures can help to instill "best practices" in the industry – practices, which are aligned with the Code of Conduct Fundamentals for Credit Rating Agencies published in late 2004 by the International Organization of Securities Commissions (IOSCO).

Overall, we believe that a rigid and prescriptive ownership, licensing and oversight regime would not serve the best interests of the capital market and investors. A more robust system based on analytic independence, market recognition and a code of conduct would promote a healthier development of China's capital market.

Regulatory barriers that affect the banking/insurance industries

Based upon commitments to the WTO, by the end of 2006, all banking operations in China are to be opened to foreign banks. The meaning of the market being "open" to all foreign commercial banks is that foreign banks will be treated in the same manner as domestic banks, and thereby able to operate under the same rules and regulations. However, it is unlikely that the Chinese government will immediately remove all hurdles to foreign banks operations to create a level playfield. Major restrictions for foreign banks include time-consuming license application procedures, different capital requirement for branch operations, foreign debt quotas and limited equity participation in local banks. As for ownership in domestic banks, the Chinese government has given no signals that it is ready to loosen its current control any time soon. On the contrary, it continues to maintain control over the banking system in the name of national financial security. In short, Standard & Poor's expects the scope of foreign bank activities and their ability to exploit their experience, products and capital will be carefully managed post-2006.

As for the Chinese insurance industry, it has been open to foreign insurance companies since the end of 2004. Foreign insurance companies are allowed to operate in China like Chinese insurance companies, subject to the same rules and regulations under CIRC. Some barriers, however, still remain. First, foreign life insurers are not permitted to establish solely funded sub-firms in China. They can only provide services through setting up joint ventures with local partners and hold no more than 50% stake. Second, foreign non-life insurers are not allowed to engage in third party liability insurance of motor vehicles, liability insurance for public transport vehicles, commercial vehicle drivers and carriers, and other mandatory insurance services. Thirdly, foreign insurers must satisfy the following conditions before applying for licenses in China: a business history of more than 30 years in a WTO member country, operating a representative office in China for two consecutive years, and holding no less than US$5 billion in total assets as of the end of the year prior to the application.

CIRC has set rating requirements for bonds that can be invested in by insurance companies. Corporate bonds with AA or above ratings, financial bonds and subordinated bonds with A or above ratings, and short-term financing bonds with A-1 or above ratings are accepted as investable instruments by CIRC. But rating agencies recognized by the regulator are confined to domestic agencies.

Conclusion

In conclusion, there is much good news to report on China's efforts to reform its financial markets and institutions. The country's enormous and enviable economic progress over the last twenty five years is a sign both of China's determination to become a world economic power and of its understanding of the need for there to be a suitable regulatory infrastructure to guide and direct its growth and attract and retain foreign investment. And recently, this growth and development has begun to take place in China's credit markets as well, most notably with respect to the inter-bank market, corporate bonds and structured finance. But growing financial markets that will attract international investors and compete on a global stage will require additional significant contributions from many outside entities as well, including foreign ratings agencies.

Standard and Poor's clearly recognizes our role and responsibility in capital market development. Continuing this important role and extending the benefits of independent, credible rating services internationally depends on domestic regulatory agencies providing a market environment that preserves the independence of credit rating agencies and recognizes the market as the best judge of a credit rating agency's quality, objectivity and independence.