FINAL REPORT

"The International Discussions on the Credit Rating Agencies and Enhancing Infrastructure to Strengthen the Regional Credit Rating Capacity in the ASEAN+3 Region"

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Paper 1: International Discussions on Global CRAs and Current Conditions of Domestic CRAs in Europe

1. Introduction

Credit rating agencies play an indispensable role in the financial system. They are instrumental to the growth of the financial markets, as credit ratings are used in financial instruments for the issuer to borrow capital funds. In the United States, they are deeply embedded in many of the legislative, regulatory and supervisory policies which rely on credit ratings for the securities held by financial institutions and for issuers' ratings. Thus, when downgrades in the credit ratings of some financial instruments and large issuers will occur, it can destabilize and create spillover effects in the financial markets due to the markets' reaction through the divestment of their funds from the said security (Frost, 2006; Coscun, 2008; Arezki, Candelon and Sy, 2011)).

For one, the Enron and WorldCom collapse in 2001-2002 created triggers among legislators and regulators as it had shaken the financial market in the United States. The credit rating agencies were blamed for their failure to detect the problem and to warn the public of the two companies' questionable financial and accounting practices until a few days before they declared bankruptcy. Many market participants believe that oversight must have been exercised and should always be one of the primary responsibilities of the credit rating agencies ("Financial Oversight", 2002). Likewise, Sy (2009) mentioned that GCRAs have been instrumental to the global financial crisis arising from the fall of the US subprime market in 2007. This resulted from the increasing level of defaults in subprime financial instruments which were embedded in many structured finance products. The subsequent downgrades on large number of these structured products that were backed by subprime mortgages have heavily jeopardized the financial market activities.

Global Credit Rating Agencies (GCRAs) weaknesses were also highlighted in the bailout of Bear Stearns and the fall of AIG and Lehman Brothers in 2008. Many believe that some of their credit ratings led investors to take considerable risks. Concerns about potential chain reactions of these defaults have intensified after the crisis, as many investors incurred substantial losses while others begun to change benchmarks for their asset portfolio holdings. Servicing the escalating debt levels coupled with deteriorating profitability, made companies vulnerable to risks and losses in the face of protracted downturn in corporate and financial activities. Major disruptions in the financial system were also evident, as massive losses were incurred by few large financial institutions whose long-term investments were placed on these below-investment grade financial instruments. The intensifying liquidity and solvency problems among large banks led to the great financial debacle and systemic shocks. This problem had escalated into a full-blown crisis which caused major disruptions not only in the US financial system but in the global financial systems. In the Global Financial Stability report, it was indicated that in 2007 and 2008, many large "mature financial institutions" (Citigroup, UBS, Morgan Stanley, Merrill Lynch, Credit Suisse) were given financial assistance in the form of capital injection via sovereign wealth funds (SWFs). This move had provided them ample yet short-term capital buffers. However, it prompted these FIs to reduce their asset holdings (investments) in order to preserve their capital funds (IMF, 2008). Sy (2008) explained that despite GCRAs' claim that the credit ratings they provide are merely opinion and are based on the quality of information supplied by the issuers, they should still be more stable and not just "point-in-time" ratings

Against this backdrop, this research will provide comprehensive discussions on the dynamics of the credit rating industry such as their roles and functions, the issues related to independence, data quality and integrity of the rating process, transparency/disclosure, the business/economic models used by CRAs and the industry's market structure and regulation.

1.1. Roles and Functions of Credit Rating Agencies

Despite several criticisms, CRAs have been instrumental to the growth of the global financial markets. As one of the indirect market players in the financial system, credit rating agencies play a vital role in the global financial markets, especially during the early 1990s when its development had heightened at an increasing pace. The increased importance of this sector is remarkable especially when viewed in the context of globalization.

A. They help in the provision of information on the issuer's creditworthiness

Credit rating agencies provide unbiased and systematic evaluation of the creditworthiness of the issuer through rigorous assessment of various financial statements and other financial and operational data which are used in the credit risk metrics (Khanzada, 2011). They are trusted by various market participants, given that the ratings that they provide are viewed to be credible. They are capable of identifying and anticipating the risk that may not be seen and undertaken by the lenders who wish to extend credit to the issuer.

While internal risk assessment can be undertaken by financial institutions, the type and depth of scrutiny that are made by the CRAs are more advanced and comprehensive compared to these institutions. However, this does not discount the capabilities of many financial institutions for managing enterprise-wide risks. Understandably, the investments made by rating agencies in financial and human resources to build its resources are crucial. Credit and other financial information about the issuer is made available to the users of these credit ratings for free or at lower costs. For a typical investor, undertaking his own risk assessment is not an efficient move

B. Credit Ratings issued by CRAs are used as benchmarks by market participants.

Instead of just an opinion or source of information about the credit risk faced by an issuer or a financial issue, market participants look at credit ratings as benchmarks for decision making processes. Like other lenders, such as banks, assessment goes beyond mere credit risk to come up with a better analytical perspective about the company in the assignment of a credit rating. The non-credit risks are described by Cousseran et al. (n.d.) as the transactions that are linked with the company's liability structure, other risks associated with a pool of assets that can affect payment of its obligations, exogenous factors related to a third party's performance and other legal and documentation risks.

Gonzalez et al (2004) report that CRAs usually incorporate stability in their credit ratings assessments based from the demands of their core clientele base. Since the activities of the credit rating agencies and the services they offer have diversified over the years, from purely providing statistical ratings to portfolio management, financial advisory and other ancillary services, the profile of their clients and their requirements will normally dictate the quality of their credit assessments. They noted that if their core clients are portfolio managers and issuers rather than investors, the provision of information at large a scale (to various investors) will expand the CRA activities. This will encompass the provision of "monitoring signals" that can be found in a principal-agent relationship.

C. Ratings influence market prices.

Usually, an investor reacts to any information that is available in the market. Any new information about the borrower affects his investment decision, which provides an impact on the interest that will be paid by the issuer (for fixed income securities and structured finance products) and/or the market value of the financial assets/instruments held by the investor (Khanzada, 2011). Various market participants have relied so much from CRAs to the extent that the credit ratings that they provide over the past years were regarded as a "certification" for investors to make investment decisions in a particular security or equity.

D. Credit ratings issued help reduce information asymmetry.

The concept of asymmetric information has been well established and discussed in various economic and finance theories. As described by Mishkin (1991), information asymmetry exists when one party has access to information over the other party. In the credit market, the borrower has more advantage over the lender and this asymmetry leads to the lender requiring additional information from the borrower as part of its typical credit risk analytical protocols.

However, when information is scarce or not disclosed by the borrower, it leads to the lenders' difficulty in deriving reliable information about him or the financial instrument. This eventually results to credit rationing as lenders become very selective in granting loans. Bebczuck (2003) notes that there are instances where good borrowers are penalized from this as they will also be required to pay the same interest rates as bad borrowers, as part of the bank's lending provisions. Aside from credit rationing, the author considers moral hazard and monitoring costs as among the other forms of information asymmetry. The adverse selection problem caused by information asymmetry often influences borrowers to undertake risky investments. This also explains why borrowers move away from bank credit and resort to financial markets, in the hope of securing lower cost of funds for either operational activities or other capital investments.

To reduce this adverse selection problem in the financial market, a credible third party information provider can act as an intermediary between the two parties. Thus, the role of credit rating agencies come into play through the use of public and/or private data which is processed using specific methodologies to evaluate the risks associated with the financial asset or the issuer. As mentioned earlier, the task of gathering relevant this information associated with the issuer is daunting, especially for small investors whose funds are relatively smaller compared to large and institutional investors who may be able to conduct their own related researches. Credit rating agencies, on the other hand, enjoy the economies of scale in this respect for different types of issues or instruments. The overall technical capabilities that CRAs cannot be compared with the internal models or credit risk metrics used by large financial institutions. If credit rating agencies fall short in their role of providing accurate and unbiased information about the issuer, therefore, there would not be any incentive for the investors to employ their services. Over the years, the investors have relied so much on them especially with the development of financial markets in both developed and emerging market economies where various financial instruments including structured finance products are introduced.

1.2. Business Models Used by Credit Rating Agencies

To better understand how CRAs operate, it is important to establish the business models that they used. Some of the issues that were highlighted in the global financial crisis were related to conflict of interest between the payments they received for the rating services vis-a-vis their roles as providers of unbiased information.

A. Issuer-Pays Model

In this business model, the rating agencies are paid by the issuers of financial instruments for the credit rating that will be provided for the said securities. From the issuers' point of view, a credit rating is needed as a medium to borrow in the financial market. The credit rating serves as a marketing tool for them to convey the message that the security is a good investment. The issuer and the credit rating agency benefit from this type of arrangement. However, others believe that they charge high fees for issue ratings depending on the complexity of the transactions and the type of the instrument being issued in the financial market. With increased competition arising from the reduction in the barriers to entry, this reduces the reputational incentives enjoyed by GCRAs since there is an incentive for them to inflate the credit ratings in exchanges for getting the rating business and maintaining a long relationship with the issuer.

This model had raised a lot of questions due to the conflict of interest issue. Except for unsolicited credit ratings, under the issuer-pays model, a CRA normally requires the issuer to furnish the agency the required documents and other information needed to arrive at accurate and transparent company's rating assessment. Given this undertaking, it provides the investors a better perspective about the debt issuer, in case the issuer wishes to have its rating assessment published. They benefit from this business model because ratings are free. This knowledge gap problem, as described by Adelson (2012), is reduced through the credit rating agency's provision of opinionated about the issuer's creditworthiness and the riskiness of the financial instrument associated with the issuer. Despite the credit rating costs borne by the issuers, they believe that the credit rating provided them greater benefits in procuring cheaper financing at either national or international financial markets compared to those that do not have credit ratings or to the financing provided by credit institutions.

B. Subscriber-Pays Model

Under this model, the investors pay for the ratings provided by the CRA for financial securities or for the use of access to the information needed regarding the issuer or an issuance of financial instrument. It is also called as user-paid model. This model or concept started in early 1900s when John Moody started to sell credit ratings to bond investors. This subscription concept enables the investor or subscriber to make informed investment decisions in maximizing his return on investments and in increasing the value of his financial asset holdings. As capital market flourished in the United States, commercial papers and other debt instruments were offered to supplement the existing bond and other government securities offerings. However, this concept was abandoned by the GCRAs during mid 70s when they started to charge the issuers of debt instruments instead of the investors or subscribers for the credit rating services they provide.

The same type of model is typically utilized by credit bureaus which clearly highlights the role of CRAs as "risk information brokers". As emphasized by Walker (2010), it provides third-party transparent and unbiased ratings for the investors due to the CRA's independence from the rated company/issuer. This drives competition among credit rating agencies in providing better services by conducting regular reviews and update of their credit ratings and by improving the quality of their rating assessments.

Unlike the issuer-pays model, subscribers do not have sufficient information which is proprietary to the issuer since the credit rating agency can generally conduct only quantitative analysis about the issuer using publicly available information that can be processed through the use of various analytical models. It was cited that there are still some investors who utilize the services of small CRAs to rate debt instruments in their favour through the use of publicly available information. This model helps large investors to make good judgment about a prospective investment or an existing one. From the business standpoint, credit rating business is difficult to maintain since it requires investments in resources (i.e.: employment of qualified analysts, use of different models for specific credit risk assessment, etc.).

1.3. Issues Related to Credit Rating Agencies and Credit Rating Process

A. On the Independence of the CRA

The credit rating agencies' independence is very crucial as it affects the rating actions for the rated financial instruments or issuers. The Enron case and the global financial crisis showed that the independence of the rating agency and/or its analysts is sometimes compromised. It was cited in a report that in 1998, Merrill Lynch was threatened by Enron that it will withhold its investment banking business with the agency if it does not improve its rating. It was also noted that analyst behaviour (i.e.: rating recommendations or disclosure of proposed investment ratings to the issuer) creates conflict of interest problems especially if the rating is tied to their compensation ("Financial Oversight", 2002).

This conflict of interest issue has become a pressing problem among regulators. Some argue that the issuer-pays model creates greater conflicting interest problems than the subscriber-pays model. Regardless of the business model, a credit rating must be subject to high standards of independence and accountabilities among credit rating agencies. In a free market economy, there is no single set of business model that is appropriate for all credit rating agencies. First, the choice of the business model will depend on their respective goals and the business strategies they used in the provision of credit rating services and on the market structure of the company. Besides, there is no regulatory framework that neither requires the specific use of a business model nor indicates who should pay the credit ratings.

Unlike regulated industries, the credit rating business is unique. From the perspective of a CRA, building resources such as a provision of database system, hiring and training human resources (i.e.: analysts, portfolio managers) and risk assessment capabilities, is already a daunting tasks. This requires large capital investments to finance them. As had been mentioned in the preceding discussions, these investments may affect CRA independence vis-a-vis issuers due to the potential conflict of interest, especially under the issuer-pays business model. As cited by IOSCO (2008), CRAs have the responsibility to provide credit ratings in a timely manner and their dealings with the issuers must not compromise the quality of the rating. Harper (2011) cited reasons for the change in the business model:

A.1. Concerns among rating agencies on the issue of "free rider" among non-paying investors.

Credit rating agencies believe that this move will eliminate the potential free-rider problem once the rating is published. It is possible that the credit rating will be disclosed by the subscriber to relatives and friends. As a result, the credit rating business might be compromised, as it will not gain the full value of the information it creates. In other words, it undermines their income potential arising from the fees they charge to the subscriber.

A.2. Willingness among issuers to pay for their rating assessments.

Issuers welcome the idea of paying for their ratings in the hope of getting better ratings. They believe that paid ratings are better compared to unsolicited ratings given by the rating agencies. It translates to low risk associated with their debt issuances.

A.3. Increasing rating-based regulations and wide acceptance of ratings by reputable rating organization.

As most literature indicates, many regulations in the United States favour credit ratings provided by reputable rating agencies. With the introduction of Nationally Recognized Statistical Rating Organizations (NRSRO) concept in the Exchange Act, global CRAs benefitted from the rating-based regulations. This model, however, raises a conflict of interest issue which undermines the Independence of the credit rating agency. Since most of them receive compensation in the form of fees from the issuer, the pressure to inflate ratings would be high.

Since many CRAs provide ancillary services, there is likelihood that some rating actions may be compromised. To ensure that favourable ratings will be issued on their behalf, they are inclined to employ the financial advisory services or other services of the CRA, which are typically bundled with the rating services provided, at a cost. There are several criticisms that were made regarding this issue where the three GCRAs gave high rating actions to companies with rated securities that are traded in the market.

B. Quality and Integrity of the Rating Process

This aspect is very important to the investors and other market players. Lenders invest excess funds in financial assets that will provide them reasonable rates of return. On the other hand, the issuer wants to borrow funds. While several alternatives are available in the market, the issuer will choose the financing instrument that will bring his costs down by increasing the price of the security. Aside from bank loans which are difficult to access due to stringent requirements by credit institutions, the issuer borrows funds through the issuances of securities. On the other hand, the investors are interested to get information about the issuer or the security to serve as assurance that the potential investment would be safe. The disclosure of information by the issuer is viewed as biased because they have more information about the financial asset and their company than the investors. They normally or selectively disclose information that will always favour them. Since there will be unwilling investors to invest their money in the said asset, the issuer is confronted with the problem of financing its business. Thus, a credit rating is able to provide assistance in solving these issues by the investors and issuers through a credit rating assessment.

Likewise, the quality of information gathered by the CRA is crucial in the assessment. Failure to do the necessary assessment of this information may put them in a negative position. Rafailov (2011) cited that in Asia, credit ratings given to issuers or provided to securities showed that the quality of data or reports provided by the issuers were not comparable with the existing standards used in developed market. In this respect, credit rating agencies failure to undertake their crucial roles in the financial market, whether the issuer is sovereign (the government) or a corporate borrower, had affected the Asian Market. This remains a debatable issue among policymakers and researchers. Regulations are already being undertaken among countries to resolve issues on the quality of the rating process.

Flandreau, Gaillard and Packer (2010) point that the existing competition among credit rating agencies can provide adverse effects on the quality of credit assessment especially when ratings are inflated. They mention that since rating agencies receive payment from the issuers, the ratings that will be given may be compromised due to the favourable ratings that will be given. Thus, it is imperative that the third party information provided by CRAs must be reliable and credible. In other words, it must portray the quality of the financial instrument as they are believed to be unbiased. Likewise, they must be undertaken using methodologies that could interpret the riskiness of the issuer or the financial instrument.

In fact, this was already emphasized in the 2004 IOSCO's Code of Conduct Fundamentals which incorporates the quality and integrity of the rating process as an important Principle underlying the code (The Technical Committee of the IOSCO, 2004). This principle takes into consideration the reduction of information asymmetry between the issuer and the investor. The integrity of the rating process must be ensured to reflect the creditworthiness of the borrower. While several risk exposures may affect the company, CRAs typically unravel their credit risk exposure using a combination of publicly available data and those provided by the latter. It is in this context that GCRAs failed to undertake, as they claimed that it is not their responsibility to identify any fraud arising from the information supplied by the issuer (McDonald, 2006)

Especially with the growth or proliferation of structured finance products in the market, its quality may be difficult to assess compared to the traditional financial instruments, if the investor will only rely from its own research. As mentioned earlier, the credit rating agency can vouch the accuracy and reliability of the information provided in the rating for the said product whose complexity may provide difficulty among those who would like to do similar or related procedures to determine its riskiness. However, with the corporate scandals that occurred over the past years, rating agencies were accused of compromising their assessments, including the rating process they undertake, in exchange for the renewed business with the issuer by deciding on a rating that are favourable to the issuers or the rated

instrument. This undertaking lowers or downgrades the rating standards of the CRA and makes it vulnerable to risk and criticisms.

Since there are no specific rules relating to the rating methodologies that should used by a CRA, the question hinges on whether these methodologies are of good calibre or meet the minimum standard for each rating? This boils down again to the issue of the reputation of the credit rating agency as perceived by both the issuer and the investors. If the issuer believes that credit rating could provide them value for their investments, therefore, they will use the service of the said credit rating agency. In one study, Cinquigrana (2009) mentions that profit will still prevail over quality under the issuer-pays model. This was based on the WorldCom and Enron scandals, where credit rating agencies were charged of inflating the credit ratings. Where rating shopping exists, the issuer chooses a rating agency that gives him a better rating than the one with a lower rating.

C. Transparency

Credit rating agencies collect information about the issuer or the financial instrument, which help the lender in gaining information regarding the creditworthiness of the company. This way, investors can make better decisions before putting their money in portfolio of investible funds using the information provided. This credit rating can also be used to monitor the performance of the issuer or any issuance over time. Like other financial advisors, CRAs fill this information gap or problem. On the other hand, it does not discount the capability of financial institutions in conducting their own investigation. External ratings can provide FIs a better perspective about the issuer as their reputation and expertise in the analysis of the creditworthiness of the companies are known.

There were also issues on the lack of full disclosure of information on the key assumptions and methodologies used by CRAs to enable the investors to evaluate whether there are flaws or weaknesses in the rating process. Regulations on this matter were already provided. It was highlighted during the hearing held by the Committee on Financial Services of the U.S. House of Congress that improvements in the regulatory framework that focus on the transparency and reliability of the credit rating process must be undertaken by SEC. As pointed out by Fitch during the said hearing, it discloses the required information needed by the investors including the methodologies that it used. Hence, it was cited that the responsibility should not only rest on the rating agencies but also among issuers and underwriters ("Approaches", 2009).

Since most credit ratings have been paid for, the issuer or its underwriter has an incentive to provide information that would be beneficial to make its security offering attractive in the financial market. In fact, IOSCO's Statement of CRA Principles and the revised Code of Conduct Fundamentals have emphasized the provision by the credit rating agencies of relevant information disclosure regarding rating methodologies and the underlying assumptions that support them which is crucial in the effective functioning of the system (the Technical Committee of the IOSCO, 2004& 2008). Timely access to the credit rating and full disclosure of relevant information regarding the credit risk of the security or the issuer will allow investors to make informed and well-thought decisions regarding their investments. It is believed that an efficient allocation of capital is made possible when investors are able to carefully assess the merits of the investments (i.e.: accuracy, fairness, etc.). Also, the monitoring cost related to regulatory recognition of ratings will also decline. Appropriate disclosure of information will promote transparency which highlights that the information provided is free from any omission to conceal any fraudulent activity by the issuer or any misstatements and misrepresentation by the credit rating agency.

1.4. The Industry's Market Structures

A. Market Structure

Table 1.1 summarizes the distribution of credit rating agencies per region. To date, there are approximately 175 credit rating agencies operating in different countries worldwide. The Asia Pacific region has the largest number of CRAs (73), followed by Americas (46) and Europe (38). Some of these companies are owned by the three GCRAs, either as subsidiaries or affiliates. East Asia has the largest number of credit rating agencies with a total of 45 companies operating in the region, followed by EU and Latin America where 31 credit rating agencies operating in each region.

Table 1.1: Distribution of Rating Agencies (by Region)

Region	Other CRAs	MIS	Fitch Ratings	S&P	Total per Region
Africa & Middle East Area					
Africa	3	1	2	1	7
Middle East	10	1	1	2	15
Americas					
Caribbean	1				1
USA	7	1	1	1	10
Canada	1	1	1	1	4
Latin America	15	3	10	3	31
Europe					
EU	15	6	7	3	31
Non-EU	5	2			7
Asia Pacific					
South Asia and Central Asia	16	2	1	1	20
East Asia	27	6	5	7	45
Oceania	1	2	2	2	8
	101	25	30	21	177

Sources:
http://www.whichwaytopay.com/world-credit-rating-agencies.asp,
http://www.defaultrisk.com/rating_agencies.htmhttp://www.sgcreditrating.com/http://www.defaultrisk.com/rating_agencies.htm;
http://www.tax-news.com/news/Hong_Kong_Begins_Regulation_Of_Credit_Rating_Agencies____49681.html;
http://www.fsa.go.jp/en/regulated/licensed/cra.pdf
http://www.esma.europa.eu/page/List-registered-and-certified-CRAs
Note: Others were culled from different websites of CRAs

A.1. Asian Pacific Market

A.1.1. East Asia

Most of the credit rating agencies in East Asia are serving the local market. Out of the 45 credit rating agencies, approximately 42.9 percent are subsidiaries and affiliates of the three GCRAs. For example, S&P has 7 branches, Fitch has 6 branches and Moody's has 5 branches operating in this region. In developed markets, the three agencies are usually present (Singapore, Japan, and Hong Kong). In Singapore and Hong Kong, they are the only credit rating agencies operating. Despite the diversity in the ownership and profile of CRAs in China, the three GCRAs are present or operating. Unlike Hong Kong, where credit ratings are provided by foreign rating agencies, China has a mixture of foreign, domestic private and state-owned agencies. Aside from the three (3) GCRAs, CCXI is owned by Moody's while another has partnership with Fitch. To date, Dagong Global Credit Rating Agency is the

largest local credit rating agency and currently has 6 regional headquarters and 34 branches worldwide[1]. As far as the credit rating agencies in this region are concerned, the market is so diverse, including the composition of ownership in each country. In fact, most of the credit rating agencies in major financial centres and in developed economies offer various types of credit ratings, from traditional to structured finance products.

The Philippines is the only country that has one credit rating agency operating (Philippine Ratings Services Corp). Other countries with developing financial markets (Thailand, Malaysia and Taiwan) have few credit rating agencies operating and have a mixture of foreign and domestic CRAs. Unlike the European Union economies where many credit rating agencies are relatively new in the business, most of the agencies operating in East Asia have been established before or during the 1990s. Within the Asian Region, many of these CRAs are members of the Association of Credit Rating Agencies in Asia (ACRAA), which has a total membership of 30 credit rating agencies from 13 countries.[2]

A.1.2. Oceania

There are only three (3) foreign credit rating agencies operating in Oceania. These are the subsidiaries of Moody Investors Services, Standard and Poor's and A.M. Best which operate in both Australia and New Zealand.

A.1.3. South and Central Asia

The number of credit rating agencies in South Asia and Central Asia is slightly smaller than East Asia, with only 20 credit rating agencies operating. Global CRAs have fewer credit rating offices operating in this region and most of them are operating in India. Among the members of the South Asian Association for Regional Cooperation (SAARC), India has the largest number of credit rating agencies (9). This may be due to the fast pace of development of the financial markets in the country. Aside from the three GCRAs, some of these credit rating agencies are affiliated with either one of GCRAs (Crisil, Ltd is an affiliate of S&P while ICRA Ltd is an affiliate of Moody's). Crisil Ltd. is a global credit rating agency that offers various ancillary products in Europe, Asia Pacific, and North and South Americas.

On the other hand, there are four (4) domestic credit rating agencies operating in Bangladesh. Most of these agencies offer non-financial credit rating services, ranging from corporate to SME ratings. Likewise, there is a mixture of old and new credit rating agencies operating in the country. In some countries such as Pakistan and Nepal, only domestic credit rating agencies are operating while in Sri Lanka, one is a domestic CRA while the other is affiliated with Fitch. Care Ratings, for example, has regional operations in Maldives. Central Asia seemed to have poor financial infrastructure support for issuers and institutional investors, as there are only two domestic credit rating agencies (1 in Kazakhstan and 1 Uzbekistan) operating in the region.

A.2. American Market

A.2.1. North America and Caribbean

In the Caribbean region, there is only one (1) credit rating agency operating (Caribbean Information & Credit Rating Services Ltd) while ten (10) and four (4) credit rating agencies are operating in the United States and Canada, respectively. In Canada, Dominion Bond Rating Agency (DBRS Limited) is the only local credit rating agency operating. Canadian Bond Rating Agency used to be major competitor of DBRS. However, the company was acquired by Standard and Poor's in 2000 (McDonald, 2006). The other credit rating agencies are affiliated with Fitch, Moody's and S&P. In the United States,

[1]Overview. Retrieved from http://www.dagongcredit.com/dagongweb/english/aboutus/index.php
[2]http://acraa.com/acraamembers.asp

there are ten (10) rating agencies which are registered with the US Securities and Exchange Commission. All of these agencies are registered with SEC as “Nationally Recognized Statistical Rating Organizations (NRSRO). Prior to 2007, only five CRAs were recognized as NRSRO.

A.2.2. Latin America and Caribbean

In Latin America, there are a total of 31 credit rating agencies. More than half of the credit rating agencies, representing 52 percent, are owned by the three GCRAs. Compared to S&P and Moody’s, Fitch has the largest number of affiliates (10 offices) operating in this region. Fitch has branches in Uruguay, Venezuela, Mexico, Costa Rica, Dominican Republic, Brazil, Colombia and Argentina. In Argentina, only the three GCRAs provide the rating services. Colombia has three rating agencies operating and one (1) CRA is an affiliate of Moody’s. In Brazil and Mexico, there are four (4) credit rating agencies operating in each of the two (2) countries and three (3) are subsidiaries/affiliates of Fitch, S&P and Moody’s. On the other hand, three (3) credit rating agencies operating are in Chile, two (2) in Uruguay and others operate in Venezuela, Panama, Ecuador and Dominican Republic. Peru has the largest number of credit rating agencies with a total of five (5), where 2 CRAs are operating on a regional basis.

A.3. European Market

The European Market has a total of 38 credit rating agencies operating in different countries. Of this total, 31 CRAs are operating within the European Union and seven (7) CRAs operate outside the Community. Except for the three (3) global credit rating agencies, which own a total of 16 subsidiaries and/or affiliates in EU, the rest of the CRAs are mostly small and medium enterprises (see Section 3 for number of EU CRAs operating). For the non-EU countries, four credit rating agencies are operating in Russia and the rest are operating in Ukraine, Czech Republic and Slovakia.

A.4. Mediterranean and African Markets

There are only fifteen (15) credit rating agencies operating in the Mediterranean Region and another seven (7) credit rating agencies operate in Africa. Of this total, eight (8) CRAs are affiliates and/or subsidiaries of Fitch, Moody’s and S&P. Except in South Africa where the three (3) credit rating agencies operate, others are local credit rating agencies. In Middle East, a total of six (6) are local CRAs operating in Turkey, two (2) in Israel (one (1) is local CRA and another is an S&P affiliate company). The other two (2) credit rating agencies operating in the Middle East region, another two (2) CRAs operate in Dubai (one (1) local CRA and another is owned by Moody’s). The rest of the rating agencies operate in the United Arab Emirates, Kuwait, Bahrain and Lebanon.

1.5. Regulating the Credit Rating Industry

Like the securities market, levelling the playing field in the credit rating business is important in promoting greater competition among CRAs as this is important in the effective functioning of the markets. Over the past decades, credit rating agencies were not regulated. Before 1990, credit rating activities are only common in the United States of America. If there were credit rating agencies existing in a country or region, regulation is hardly existent. In the United States, the role of the US SEC in the regulation the industry was minimal. If there were regulations or standards existing 10 years ago, these were not intended for CRAs and were purely for regulatory requirements that gave reference to the use of external ratings. Thus, self-regulation exists, as very few credit rating agencies operate in one jurisdiction. The way the rating industry is structured, many of the rating agencies are operating to serve the domestic market.

For a better understanding of the CRA regulatory framework that had transpired within the last 9 years, it is better to look at the way external credit rating was used in the context of the United States experience, as this is where the concept of rating started. This is followed by the discussion of series of regulations to see how global or regional regulations have transpired, including the measures undertaken by the United States of America.

Van Laere (n.d.) notes that over the past years, the credit rating agencies had been defending that regulation is not important as users will be using the services of the rating agencies that release rating assessments which are of high standards. He also mentions that the global financial crisis can be ascribed from the weaknesses in the regulatory underpinnings of the credit rating industry as malpractices among credit rating agencies have grown and prospered over the years. The US Securities and Exchange Commission did not take stringent and definitive action to regulate the industry prior to the subprime crisis as the concept of self-regulation was still deemed crucial in the operations of the securities market.

A. The US Regulatory Framework Prior to Regulations

In the United States, being designated as a Nationally Recognized Statistical Rating Organization means a lot to credit rating agencies. It provides them an advantage over other CRAs in terms of scope of operations since much federal and state legislation give reference to ratings. Since 1975, the Securities and Exchange Commission had required financial institutions and institutional investors to invest only in securities that are rated by an NRSRO. In the case of some companies, they also prefer obtaining a credit rating made by an NRSRO. It was during this year (1975) when Fitch Inc and Moody's Corporation were granted the NRSRO status, followed by Standard and Poor's in 1976. This came about as a result of the Net Capital Rule (Rule 15c3-1 under the Exchange Act) which was implemented in 1975 that allowed brokers/dealers to take a lower capital charge for investment-grade securities rated by an NRSRO (US SEC, 2012).

Back then, the Securities and Exchange Commission issued an 'NRSRO no-action' letter to qualified CRAs whose credibility and reliability in the provision of credit ratings in the U.S. financial market is known among majority of the issuers (Rousseau (2005). Back then, the three credit rating agencies requested written assurance from SEC -Division of Market Regulation for not recommending any enforcement action against broker or a dealer. This gave exemptions to brokers/dealers from the net-capital requirement, as stipulated under Rule 15c3-1 of the Securities and Exchange Act of 1934.

Since then, many regulations were implemented which gave reference to external ratings as a pre-requisite for the compliance by financial institutions and/or companies to the regulatory mandate. This made the three GCRAs gain most of the market share in the United States. Over the past 30 years, many banking, insurance and securities laws were implemented in the United States, which also made issuers dependent on credit ratings. Not only are financial intermediaries dependent on external ratings, but many federal and state laws use the NRSRO concept. Like other credit rating agencies, they provide the opinions about the creditworthiness of an issuer or a debt instrument except that their judgement was described as "decisive for the access of an issuer to the capital markets" (Coskun, 2008).

B. The International Initiatives toward CRA Regulation

The Declaration on Fostering Growth and Promoting a Responsible Market Economy which was adopted by the G8 during the Evian Summit in 2003 called on companies to work hand in hand to promote the implementation of existing market infrastructures (i.e. efficiency of the capital market) which are crucial to the development of an economy. Instrumental to this development are the existence of sound legal systems, effective regulations and transparent corporate governance practices in order to promote investor confidence ("Fostering Growth", 2003). In line with this, it focuses on common values and principles which must be incorporated in corporate and financial institutions structures. Under the

corporate governance aspect, increased transparency and quality of information was emphasized as key element which calls on information providers such as rating agencies, to abide by the principles.

In the same year, the International Organization of Securities Commissions (IOSCO) Technical Committee issued the Statement of Principles for Credit Rating Agencies that outlines how the activities of the CRAs should be undertaken. The Principles represent international consensus that reflects intrinsic characteristics of the nature of the activities of the CRA and sound industry practices. They were aimed to be implemented through a combination of the following: government regulation, regulations that were imposed by non-government statutory regulators (i.e.: industry association or bodies), industry codes, and international rating agency policies and procedures (The Technical Committee of the IOSCO, 2003).

It focuses on four (4) major areas of CRA activities, namely, the quality and integrity of the rating process, the independence and conflict of interest, transparency and timeliness of ratings disclosure, and information confidentiality. These are deemed by the Technical Committee as high-level objectives which can be used by market participants, namely, rating agencies, regulators, debt instrument issuers, non-government regulators and other government agencies (in the case of sovereign ratings) to minimize risks and provide a fair and transparent securities market .

In 2004, the Principles were revised and the IOSCO Technical Committee issued a Code of Conduct Fundamentals for Credit Rating Agencies which was drawn from the comments and suggestions provided by rating agencies and other market participants. The standards were developed as safeguards for the investors and other market participants affected by their operations and to reduce variations across rating agencies in their application which may deteriorate the overall practice in the provision of information (The Technical Committee of the IOSCO, 2004). This Code Fundamentals can be voluntarily applied by the rating agencies that underscore the core CRA Principles mentioned in the preceding paragraph and reinforces the integrity of the rating. It is believed that applying this code will benefit them, since the comments and recommendations provided by various organizations (CRAs, BCBS representatives, IAIS, issuers and etc.) were already incorporated in the final draft of the Code Fundamentals.

Despite call for voluntary adoption, many credit rating agencies complied, as these are internationally applicable for all credit rating agencies, both with overseas or local operations. Since credit ratings are increasingly being integrated into the global markets as an important component of the financial markets and institutions, credit rating agencies are being encouraged to incorporate them in their policies and procedures. As it was highlighted by IOSCO (2004), the Code only addresses issues and principles that can be applied or used by CRAs to ensure the quality and integrity of the rating process and the effectiveness in conducting their business. The code is designed to enable market participants (investors, issuers, regulators and industry associations) to evaluate the way credit rating agencies have implemented the core principles outlined in the IOSCO's Code of Conduct. However, it does not include the issuers' obligation in the quality of the information they provide which are crucial in the credit assessment. This only means that this information will depend on how the credit rating agencies will generate the data from the issuer and other third party sources which will influence the quality of their rating assessments.

Related to the initiatives undertaken by the IOSCO and the G8 Declaration, the Principles of Corporate Governance which were adopted by OECD governments in 1999 was revised in April 2004 in response to the 2002 corporate scandals. In line with this, credit rating agencies and their analysts must complement the said Principles with the IOSCO Statement of CRA Principles that were also developed during the same year. This requires full disclosure of any potential conflicts of interest and their corresponding management which must be addressed by CRAs in the interests of the investing public. It further points out that those Principles that may be material in the provision of their services, such as employees' incentives and other related services that can influence the credibility and integrity of the rating processes should be eliminated (OECD, 2004).

The Financial Stability Board (FSB) has been constantly coordinating with national authorities and international bodies to promote financial system stability and make FIs more resilient. Since the outbreak of the global financial crisis, many authorities at the national, regional and international levels have undertaken bolder steps in reviewing and updating existing regulatory frameworks related to credit rating agencies. Likewise, the Technical Committee of the IOSCO (2008) had also revised the Code of Conduct Fundamentals in 2008 to incorporate salient measures in protecting the quality and integrity of the rating process and system, in reforming CRAs' independence and their responsibilities to the investors and issuers and in addressing potential conflicts of interest issues inherent in their activities.

In response to the request of the Financial Stability Forum (FSF) in December 2008, the Joint Forum for banking, insurance and securities sectors conducted stocktaking of member authorities in the use of ratings in their legislations (statutes), regulations, and supervisory policies/guidance. They were also asked to review whether their regulatory frameworks unintentionally provided external rating a "seal of approval" which made investors rely from it heavily thereby compromising their performance of due diligence in their investment decision making processes (Financial Stability Board, 2008). As can be recalled, the Forum was established in 1996 under the auspices of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to deal with relevant issues that are common to the three financial sectors (banking, security and insurance) which can be used in the international regulatory agenda that involve their risk exposures.[3]

The Joint Forum Working Group on Risk Assessment and Capital, as part of its stocktaking work, prepared a survey which was distributed among member authorities to gather valuable information regarding their usage of external ratings in the regulations including the corresponding explanation of what each regulation was designed to achieve. It was found that there is a widespread use of credit ratings in the regulatory framework and legislations related to banking and securities market. Many respondents ascribed it to the Basel II framework, while those from EU gave reference to the requirements of the Committee of European Banking Supervisors (CEBS).

Majority of the respondents mentioned that the CEBS and Basle's frameworks gave designated External Credit Assessment Institutions' credit ratings to be used by banks for the calculation of their capital requirements and for classifying investments. They were also asked to describe their assessments, if possible, of any unintentional effects of such uses and whether they refer to an endorsement of a credit rating. Many respondents made reference to specific credit rating agencies (GCRAs), whose services are reviewed regularly and their list is amended, if applicable, through a standard legislative or regulatory process (The Joint Forum, 2009).

Likewise, the Basel Committee also agreed to review its proposed guidelines regarding credit ratings and to see how the use of external ratings under the Basel II accord affects the banks' compliance with the International Capital Standards. While large CRAs claim that their ratings represent ordinal rankings of credit risk, they usually concentrate and move towards specific risk metrics, including the prudential regulations under the standardized approach in Basel II framework (IMF, 2010). Since it requires the use of external ratings in lieu of the internal ratings for determining capital requirements, the quality of CRA ratings must be maintained and subjected to rigorous rating calibration and validation standards to mitigate any potential problems that can adversely affect the effective functioning of the financial system. Moreau (n.d.) cites that despite the greater use of external ratings in the regulatory framework for banking, securities and insurance, there were few incentives for regulators or national authorities to regulate the industry. He points that the industry should be regulated because the credit ratings are used in regulations and they are also contributory to the global financial crisis.

As far as the insurance industry is concerned, IAIS had already initially undertaken measures to address issues related to external ratings. In February 2012, its Technical Committee discussions related to the reduction by insurance companies' of their reliance on credit ratings were undertaken. It also

[3] ______ (January 2012). Mandate of the Joint Forum. Bank for International Settlements. Retrieved from http://www.bis.org/bcbs/jfmandate.htm

delegated the Solvency and Actuarial Issues Committee (SSC) the responsibility in producing a report that will review lessons learned from the use of external ratings.[4] In May 2012, SSC tackled roadmap issues and action plans thereto[5] while the Technical Committee proposed to the Executive Committee to make reference to the plans of addressing FSB's request.[6]

All these initiatives for the three financial sectors were utilized by the Financial Stability Board in designing measures to promote globally consistent framework for the oversight and regulation of credit rating agencies. IOSCO's Code of Conduct was used as a baseline information or guide in coming up with global and holistic perspective for setting regulations which will be used by national and regional authorities in their respective regulatory and legislative jurisdictions in formulating or revising applicable CRA regulations (Financial Stability Forum, 2009). Considering all initiatives undertaken, it published its set of principles for the reduction of the reliance on external ratings which shall be used in the formulation of policy actions for addressing the issue. In its review of the initiatives undertaken both at the national and international levels, it shows that this framework is still in its nascent stage. It noted that the transition stage may take time. FSB will set up a coordination framework, in coordination with the standard-setting bodies, based on past experiences and the discussions and commitments made by government and regulatory authorities to intensify future actions and plans to speed up implementation of the Code and other applicable regulations.

It was cited that the rating-based regulations that were created and implemented over the past years, made banks, institutional investors and other market participants vulnerable for not undertaking their own credit risk assessments. They point that some regulations, such as Basel II, ECBS, etc. made reference to their use of external ratings. Upon the endorsement by G-20, the Financial Stability Board (2010) issued in October 14, 2010 issued the draft entitled "Principles for Reducing Reliance on CRA Ratings" that affect banks and central banks' standards, laws and regulation. Standard setters, regulators and/or supervisors were asked to make their assessments of any reference to external ratings in their regulatory guidance or policies and whenever possible, replace them with comparable alternatives that would be utilized by financial intermediaries and private sectors. The principle outlines broad objectives that can serve as guidelines for regulators/supervisors, standard setters (Basel Committee, IOSCO), banks, central banks, and other market participants in formulating new or in amending existing legislations, regulations and other policy guidance to either remove or minimize overreliance on credit ratings provided by external rating agencies.

C. U.S. Versus E.U. Regulations

C.1. The U.S. CRA Regulations after the Enron and WorldCom Crisis

In providing more transparent and responsive environment, government reforms were initiated after IOSCO had released its 2004 Code Fundamentals for CRAs. The major regulatory framework released by the United States of America that favoured majority of operating credit rating agencies was the Credit Rating Agency Reform Act of 2006. Section 15E of the Exchange Act indicates that where a credit rating agency elects to become an NRSRO, it shall apply for registration with SEC, subject to the specific requirements indicated in the provision of the said Act. Likewise, the credit rating agencies which were initially designated as NRSRO prior to the implementation of the Credit Rating Agency Reform Act

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[4] _____(2012). The Technical Committee (TC) met in Basel on 22-24 February 2012

http://newsletter.iaisweb.org/newsletterlink-381?newsid=718&call=1

[5] ____ (2012). The Solvency and Actuarial Issues (SSC) met in Cape Town on 16-18 May. Retrieved from http://newsletter.iaisweb.org/newsletterlink-381?newsid=790&call=1

[6] ____ (2012).The Technical Committee (TC) met on 20-21 June in the Cayman Islands. Retrieved from http://newsletter.iaisweb.org/newsletterlink-381?newsid=828&call=1

shall be exempted from the certification requirement. However, they will formally apply for registration with the Securities and Exchange Commission (US SEC, 2006).

One of the application requirements for registration by a CRA to be designated as a "Nationally Recognized Statistical Rating Organization" is the code of ethics[7] that it outlined in its policies or procedures. The requirement further stipulates that if credit rating agency does not have an existing code of ethics, it should state its justifications. This registration requirement seems to be less binding as it only indicates a statement of the reason for the absence of its code.

Another issue that was raised regarding an NRSRO designation was the inapplicability of the existing laws related to the quality of the rating process and the credit rating itself. As specified in Subsection (b) of the Act (Accountability for Rating Procedures), one of the limitations of the rules and regulations relating to NRSRO registration is stated as follows:

> ..... Notwithstanding any other provision of this section, or any other provision of law, neither the Commission nor any State (or political subdivision thereof) may regulate the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings... (SEC, n.d.)

This only reflects the problem in the existing regulatory system despite the improvements and changes that were already made over the past four years since the 2006 Act was established. Some NRSROs, especially the three (3) GCRAs, are still able to avoid from being penalized from their incorrect rating assessments for large companies or for structured financed products that were made over the past years.

The Dodd-Frank Act took effect on July 21, 2010 which aimed to restore public confidence in the financial system and promote financial sectors' resilience. Harper (2011) enumerated the following critical issues that are related to the CRAs, namely, increased accountability and transparency among rating agencies, issues on conflicts of interest and rating accuracies, reliance on external ratings by federal agencies, and public disclosure of methodologies. The aim is to enforce stringent mechanisms for monitoring credit rating agencies' activities. It also calls for the elimination of references to external ratings by many regulations to improve the regulatory framework of the industry by way of conducting a study where there will be common standards among CRAs and across different asset classes on their definition of credit ratings (Spatt, 2011). The new Act also increases the role of U.S. SEC as the industry regulator by enhancing its enforcement mechanism and by imposing additional requirements for the registration by CRAs as Nationally Recognized Statistical Rating Organizations (NRSROs). New sets of rules underlying the operations of the agencies were in line with IOSCO's CRA Principles and the Code Fundamentals for compliance by the CRAs in the industry. Van Laere (n.d.) noted that despite the desire of many regulators and legislative bodies to maintain high standards among CRAs in their business conduct within the industry through the passage of the said Act, the success in enforcing new rules for their conduct is still underway. This dilemma faced by regulatory bodies might end up futile, with rating agencies enjoying the same protection from any legal liabilities they used to enjoy under the old NRSRO concept adopted prior to the subprime crisis.

The U.S. SEC conducted a report in July 2011 on the review of reliance on credit ratings and indicated that one of the provisions in the Dodd Frank Wall Street Reform Act requires the Federal Review Board to review and eventually remove any reference to external credit ratings. Article 939A subsection (b) of the Act provides the following:

> (b) MODIFICATIONS REQUIRED. – Each such agency shall modify any such regulations identified by the review conducted under subsection (a) to remove any reference to or

[7]Section 15E of the Securities Exchange Act of 1934, as amended by the Dodd-Frank Act. *"Registration of Nationally Recognized Statistical Rating Organizations"* Retrieved on September 3, 2012 from http://www.sec.gov/divisions/marketreg/ratingagency/sea34-15e.pdf

> requirement of reliance on credit ratings and to substitute in such regulations such standard of credit-worthiness as each respective agency shall determine as appropriate for such regulations. In making such determination, such agencies shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness; and such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness; and (U.S. SEC, 2011)

It also contributed to the repeal of Rule 436(g) of the Securities Act of 1933, as amended (the "Securities Act"). Baker and McKenzie (2010) indicate that "Section 11 of the Securities Act provides that experts are subject to enhanced liability for untrue and misleading statements included in the registration statement". Under the prospectus for newly issued securities, credit rating agencies must certify or provide statement of consent for any rating report it issues. Credit ratings for newly issued asset-backed securities are adversely affected by the said legal liability. However, SEC initially issued a six-month exemption for asset-backed securities issuers to trade without a rating. In November 2010, it permanently allowed issuers of this asset to sell publicly which is again a boost in the rating activities of CRAs in the United States.

It was also mentioned in the report conducted by the Commission that some modifications were made for the removal of any reference to a credit rating or reliance upon credit ratings in the federal regulations (US SEC, 2012). This requires federal agencies to review existing regulations that require the use of external ratings or the design of applicable criteria related to credit standards for a particular debt instrument. This means that reliance by issuers and other financial institutions on the credit ratings issued by NRSROs are removed. A good example of this requirement is the credit rating issued by NRSRO for investment grade securities. This led the Securities and Exchange Commission, Commodity Futures Trading Commission and other federal agencies to subsequently review their existing regulations. Thus, they eventually came up with the amendments of existing regulations related to credit ratings.

To date, many Federal Supervisor and Regulators have already removed reference to credit rating agencies in their regulations. Likewise, the Financial Stability Board (2012), in its report to the G20 leaders, mentioned that as part of the U.S. SEC's commitment to regulate the industry, it had adopted new regulation in 2011 that requires the issuers of asset-backed securities (based on the U.S. classification of credit ratings) and the CRAs that rate these instruments to disclose representations, warranties and enforcement mechanisms. It also required issuers to review the underlying assets and make public any asset review reports that will be produced by third parties.

C.2. EU Regulations on CRAs

In line with the IOSCO Code of Conduct Fundamentals, the European Commission mentioned that it will monitor the progress made by the credit rating agencies operating in EU for the implementation of the Code Fundamentals, which were made on a voluntary basis. Aside from this, no other regulations have been made in the Community as of 2006 that relate to the activities of the credit rating agencies. In 2008, the Committee of European Securities Regulators (2008) reported that it will continue its efforts in monitoring this activity on a yearly basis and the move to regulate CRAs will be undertaken if market conditions warrant or if the credit rating agencies' compliance with the existing EU rules or the IOSCO Code is found to be unsatisfactory. Likewise, the Commission of European Communities (2008) reported that the European Commission and Regulation (EC) No 1060/2009 mentioned that prior to the said regulation; there were only two (2) regulations that gave indirect or implicit references to credit rating agencies, namely:

a. Regulations pertaining to Market Abuse Directive which involves fair presentation of investment recommendations and disclosure of conflicts of interest (Directive 2003/125/EC), directive

2003/125/EC which encourages CRAs to fairly present credit ratings and disclose any potential conflicts of interest between the agency and the issuer.

b. Directive 2006/48/EC that relates to "the taking up and pursuit of the business of credit institutions" and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions which gave reference to the use of external credit rating.

With regards to item "b" that is listed above, the Committee of European Banking Supervisors (CEBS) has highlighted the role of the External Credit Assessment Institutions (ECAI) and their effects on the decisions that will be made by regulators and financial institutions. Prior to the Global Crisis in 2007, EU's Capital Directives allowed financial institutions to use ECAI services. In compliance with the International Capital Accord by the Basel Committee on Banking Supervision, its Capital Directives permits the use of ECAI services in determining the risk weight exposure of the FIs' operations and financial transactions. This credit risk assessment assists financial institutions in identifying high calibre ECAI whose credit assessment are robust and consistent with the regulatory requirements using the Standardized Approach or the Securitisation Ratings Based Approaches. In 2006, CEBS' proposed the guidelines for the recognition of ECAIs under the Capital Requirement Directive across EU. It was cited that:

> "The intent of the guidelines is to provide the basis for consistent decision-making across jurisdictions, enhance the single-market level playing field, and reduce administrative burdens for all participants, including potentially eligible ECAIs, institutions, and supervisory authorities." (Committee of European Banking Supervisors, 2006)

What makes the recognition process more meaningful are the procedures for the application and assessment process which can either be made directly or indirectly. Under the direct supervisory recognition, the role of supervisors is more pronounced as their evaluation of the rating institution's compliance with the recognition criteria must be undertaken. This is contrary to the indirect recognition where an ECAI's recognition is based on another Member State's recognition. This recognition reduces administrative burden, as it minimizes the role of the supervisor of a Member State to undertake its own evaluation process. The guidelines set out uniform understanding among Member States and allow supervisors to coordinate efforts that are crucial in the assessment process. The use of ECAI can be aligned with Committee of European Securities Regulators' efforts in drafting the CRA guidelines.

Following the crisis in 2007, the EU finance ministers have agreed to review the role of credit rating agencies and the Commission was tasked with the assessment of issues related to conflicts of interest, the rating process (i.e.: timeliness issue, etc). As a result, it consulted CESR and the European Securities Markets Expert Group (ESME) regarding the roles and activities of the credit rating agencies to come up with a report on these issues. The two conducted an open consultation among different market participants including officials or regulatory bodies within the EU. Using this as inputs and following its impact assessment in 2008, the Commission arrived at a recommendation to regulate the credit rating agencies.

In 2009, the Council of the European Union and the European Parliament have agreed to formulate the regulations related to CRAs that are operating in the Community. Regulation (EC) No 1060/2009 was implemented in 2009. This was subsequently amended by Regulation (EC) No 513/2011. The European Securities and Markets Authority (ESMA, 2012) cited the following in its report on the supervision of credit rating agencies:

> The CRA Regulation achieves its objectives by requiring CRAs to comply with a set of requirements which include the following subjects:
> - use of methodologies, that shall be rigorous, systematic, continuous and subject to validation;
> - appropriate disclosure to the public, with particular reference to the disclosure of methodologies that are used by CRAs and the presentation of ratings;

·sound internal policies and procedures to prevent, identify, eliminate or manage and disclose any conflicts of interest; and
·arrangements for sound corporate governance.

2. The Global Credit Rating Agencies (GCRAs)

2.1. Comparison of Credit Rating Issuances in the United States by GCRAs

Table Nos. 1.2 to 1.7 show the various credit rating issued by Fitch Inc., Moody's Investors Services and Standard and Poor's in the United States for the Period 2007-2010. There are different asset classes allowed in the United States, which the credit rating agency can apply for registration with the Securities and Exchange Commission. Unlike other small credit rating agencies in the United States, the Nationally Recognized Statistical Organizations allowed CRAs not only to offer a wide range of credit ratings, but the ratings issued can be used for regulatory requirement purposes. Section 3(a)(62) of the Exchange Act defines an NRSRO as one that:

(A) issues credit ratings certified by qualified institutional buyers, in accordance with section 15E(a)(1)(B)(ix), with respect to—
(i) financial institutions, brokers, or dealers;
(ii) insurance companies;
(iii) corporate issuers;
(iv) issuers of asset-backed securities (as that term is defined in section 1101(c) of part 229 of title
17, Code of Federal Regulations, as in effect on the date of enactment of this paragraph);
(v) issuers of government securities, municipal securities, or securities issued by a foreign government;
Or
(vi) a combination of one or more categories of obligors described in any of clauses (i) through (v); and
(B) is registered under section 15E.

Table 1.2: Number of Credit Ratings Outstanding for All Issues among Selected Rating Agencies in the United States for the Period 2007-2010

Name of Credit Rating Agencies	2007[a]	2008[b]	2009[c]	2010[d]
Fitch Inc.	962,920	671,947	511,735	505,024
Moody's Investors Services	386,500	1,112,317	1,081,841	1,039,187
Standard and Poor's	1,245,900	1,255,000	1,231,600	1,190,500
Total	2,595,320	3,039,264	2,825,176	2,734,711
Market Share (percent)	97.09	97.22	97.30	98.38

Sources:
[a]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0608.pdf,
[b]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0909.pdf
[c]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0111.pdf
[d]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0312.pdf

There are various sophisticated financial instruments that were introduced over the past two decades which allowed borrowers to manage their cash flows. Most of these instruments are attached to different underlying instruments and are assigned different levels of credit risks. At the height of this capital market boom, many issuers, including small and medium enterprises, have relied from these sources of financing which have remarkably shown the relative importance of credit ratings provided by GCRAs. They facilitated in rebuilding investors' confidence through their investments on financial instruments introduced in the financial market. They were confident that credit ratings can help in distinguishing a good from bad investments.

Despite the losses incurred on structured finance products in 2008 arising from the downturn of the subprime mortgages during the crisis, Table 1.2 shows an acceptable overall gain of 17.1 percent for all issuances made by the three GCRAs in 2008. This was led by the increase in Moody's Investors Service's credit rating issuances by 187.8 percent. This was mainly driven by the increase in public finance ratings, followed by financial institutions and corporate issuer ratings. Moody's was able to obtain the market share for credit rating services in 2008, which used to be enjoyed by S&P. For the three companies, credit rating volumes in 2009 and 2010 declined subsequently, especially for Fitch Ratings which had been losing many credit rating transactions since 2008.

The Global Financial Stability Report noted that compared to Europe, the US banks incurred more losses due to their large holdings of subprime securities. This is understandable considering that many investors, especially institutional ones, were enticed in investing in structured finance products which were given AAA ratings by global credit rating agencies. The said investment gave them higher returns compared to traditional securities products (IMF, 2008). It was noted that some well-diversified portfolio investments with underlying subprime mortgage issuances have also deteriorated. This also adversely affected other structured complex products arising from the lemons that were experienced for novel or new product issuances. The World Economic Outlook Report (2008) indicates that the spreads for both low grade and high grade corporate bond issuances by nonfinancial firms rose, especially for the latter. The default rates for high-grade securities in the United States were higher compared to the 2004 level. This can be ascribed to the low liquidity experienced by financial institutions which affected many borrowers due to loan contraction and stringent requirements. Moreover, the crisis led to the increase in the borrowing costs for these firms with low-grade bond ratings.

As shown in Table 1.2, the three global rating agencies also reflected reductions in their rating transactions in 2010. Table 1.3 and Table 1.7 depict that Moody's Investors Service exhibited a 3.9 percent decrease in the total credit rating it issued in 2010 due to the drop in financial sector rating (19.8 percent) and government securities rating (2.4 percent) transactions. While the latter only showed low decline, the volume is still high, representing a total reduction of credit rating transactions by 21,000 compared to the decline in financial sector rating transactions by 15,220 (refer to Table 1.3). The plunge in S&P's total credit ratings in the United States by 3.9 percent or 41,100 can be ascribed from the 3.84 percent decelerating growth rate in asset-backed securities (refer to Table 1.6). On the other hand, the aggregate ratings issued by credit rating agencies with NRSRO licenses gradually declined by 8.8 percent, from approximately 3.12 million in 2009 to 2.81million in 2010 (US SEC 2011, 2010).

When NRSROs are grouped by scope of operations, six (6) out of ten (10) NRSROs operate globally. They represent approximately 98.9 percent of the total outstanding issuances in the United States in 2010. Of this total, 97.1 percent were rating transaction made by the three GCRAs, while DBRS, A.M. Best and JCRA only accounted to a share of 1.8 percent of the total credit ratings issued in the United States. From 2008 onwards, the market shares of the three companies have declined from 98.1 percent in 2008 to 97.1 percent in 2010. This only shows that despite the small change in the share of the three (3) rating agencies during the period vis-a-vis the other seven (7) NRSROs, the new regulation on the registration for NRSRO status in the United States had increased competition among CRAs. Considering the magnitude of the operations of these Fitch, Moody's and S&P compared to the other NRSROs, the gap between the credit rating issuance of the two groups is more pronounced.

Table Nos. 1.3 to 1.8 provide the number of credit ratings issued by Fitch Ratings, Moody's Investors Service and Standard and Poor's for each asset class in the United States.

Table 1.3: Number of Credit Ratings Outstanding for Financial Institutions Issued in the United States among GCRAs for the Period 2007-2010

Name of Credit Rating Agencies	2007[a]	2008[b]	2009[c]	2010[d]
Fitch Inc.	79,125	83,649	72,311	61,550
Moody's Investors Services	70,000	84,773	76,801	61,581
Standard and Poor's	44,800	47,300	52,500	54,000
Total	193,925	215,772	201,612	177,131

Sources:
[a]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0608.pdf,
[b]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0909.pdf
[c]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0111.pdf
[d]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0312.pdf

As depicted in Table 1.3, the results show that Moody's and Fitch have the largest outstanding credit ratings for financial institutions compared to S&P, which only represent more than half or 60 percent of the ratings generated by Fitch or Moody's. Their rating activities were adversely affected due to the diminishing rating activities from 2008 to 2010. Moody's reflected an increase in its rating activities by 21.1percent from its total outstanding volume of 70,000 issuances in 2007 to 84,773 issuances in 2008. On the other hand, S&P gained the market share with a growth in rating activities by 20.5 percent from 44,800 in 2007 to 54,000 in 2010. Standard and Poor's continued to exhibit modest increase in ratings compared to Fitch and Moody's as the two exhibited decreasing growth rates in 2009 and 2010.

As far as the rating of insurance companies is concerned, Moody's and S&P have approximately the same number of outstanding rating issuances (see Table 1.4 below). Moody's credit rating activities continuously declined during the succeeding years, from a total of 6,500 in 2008 to 4,540 in 2011. Fitch Ratings also reflected decreasing trend in the insurance ratings transactions until 2011. While the decline in outstanding insurance issuances is very modest in 2009 and 2010, it recorded significant loss in business as reflected in the declining growth of its rating issuances by 64 percent. Fitch also recorded the highest decline of 6.8 percent in 2011. Compared to its performance in financial institutions' ratings, this only proves that the company is not a popular rating agency choice among insurance companies.

Table 1.4: Number of Credit Ratings Outstanding for Insurance Companies in the United States among GCRAs for the Period 2007-2010

Name of Credit Rating Agencies	2007[a]	2008[b]	2009[c]	2010[d]
Fitch Inc.	4,871	4,797	4,599	1,657
Moody's Investors Services	6,500	6,277	5,455	4,540
Standard and Poor's	6,900	6,600	8,600	8,200
Total	18,271	17,674	18,654	14,397

Sources:
[a]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0608.pdf,

[b] http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0909.pdf [c] http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0111.pdf [d] http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0312.pdf

Standard and Poor's performed well in the insurance business not only with respect to the high volume of outstanding issues but also because of its increasing market share for the business. While a decline in the number of insurance ratings was evident in 2009, representing 4.6 percent, the substantial growth of 30.3 percent in 2010 is remarkable. For this type of rating, A.M. Best is a close competitor of the three GCRAs, as it specializes in insurance ratings.

Table 1.5: Number of Credit Ratings Outstanding for Corporate Issuers in the United States among GCRAs for the Period 2007-2010

Name of Credit Rating Agencies	2007[a]	2008[b]	2009[c]	2010[d]
Fitch Inc.	15,865	14,757	12,613	13,385
Moody's Investors Services	25,000	31,126	31,008	30,285
Standard and Poor's	28,900	26,900	41,400	44,500
Total	69,765	72,783	85,021	88,170
Sources: [a] http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0608.pdf, [b] http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0909.pdf [c] http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0111.pdf [d] http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0312.pdf				

Credit ratings for corporate issuances are listed in Table 1.5. MIS and S&P reflected different performance in nonfinancial credit ratings in 2008. The decline of 6.9 percent in the outstanding issuances made by S&P, resulted in a double-digit growth for Moody's, representing 24.5 percent. S&P, on the other hand, reflected a hefty increase in credit ratings transactions by 14,500 or 53.9 percent. Moody's showed minimal decline in the number of outstanding corporate issuers' credit ratings during the last two years (2009 and 2010).

Like Moody's Investors Services, Fitch Inc. recorded a negative growth rate of 6.9 percent in 2008 due to the plunge in credit rating transactions by 1,108 from 13,385 in 2007 to 12,613 in 2008. This is similar to the rates of decline in the credit rating transactions for S&P. Fitch Ratings' transactions also continued to decelerate in 2009, as it showed a negative growth rate of 14.5 percent which is lower than the decline in credit rating issuances in 2008.

Table 1.6: Number of Credit Ratings Outstanding for Asset-Backed Securities* in the United States among GCRAs for the Period 2007-2010

Name of Credit Rating Agencies	2007[a]	2008[b]	2009[c]	2010[d]
Fitch Inc.	72,278	77,480	69,515	64,535
Moody's Investors Services	110,000	109,261	106,337	101,546
Standard and Poor's	197,700	198,200	124,600	117,900
Total	379,978	384,941	300,452	283,981
Sources: [a] http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0608.pdf,				

[b]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0909.pdf [c]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0111.pdf [d]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0312.pdf *Note: *The term implies "Structured Finance Products" based on the US SEC's classification of credit ratings.*

The structured finance or "asset-backed securities" credit rating issuances made by the 3 GCRAs represent roughly 10 percent to 15 percent of the total issues in the United States for the period 2007-2010. The growth rate is decreasing from 14.8 percent 2007 to 10.7 percent in 2010 (refer to Table 1.6).

The performance of the three companies for "ABS ratings" in 2009 is consistent with their performance for global structured products as reflected in their annual reports. Standard and Poor's rating activities for this asset class was adversely affected, as it reflected a decline in credit rating transactions by 37.1 percent compared to Fitch's and Moody's' 10.3 percent and 2.7 percent figures, respectively. The substantial decline in US ABS transactions can be ascribed to the investors' lack of appetite for complex structured products, high interest rates arising from the high credit spreads and weaker secondary trading for these securities after the crisis started in 2007. As cited in another report, the safety of the asset should not be viewed as being directly linked to ratings provided by CRAs, as they are just rough estimates of market perceptions. As of end 2011, IMF (2012) reported that the share of securitized finance products is 17 percent of the global aggregate, which is greater than corporate debt issuances of only 11 percent.

Moody's Investors Service's ABS credit rating activities in 2010 were also adversely affected as shown in the drop in credit rating issuances by 4,791 or 4.5 percent. Compared to the two, Fitch Ratings ABS rating transactions is approximately two-thirds of Moody's credit rating issuances and more or less half of S&P's ratings. Despite its 7.2 percent growth rate in 2008, the rating transactions continuously dropped in 2009 and 2010.

Despite the substantial decline in asset-backed securities' credit rating transactions, the number of outstanding credit ratings for government securities showed favourable growth for the three (3) GCRAs during the covered period (refer to Table 1.7). Among the group of asset classes used in the United States, it recorded the highest number of credit rating transactions, with a market share of roughly 80 percent. In an IMF report (2008), it was mentioned that the subprime crisis adversely affected the municipal bond market as many issuances are insured by financial guarantors. Hence, this had not affected the US credit ratings transactions made by the GCRAs in the United States, as it reflected an increase of 428,526 transactions in 2008 (2,348,144) compared to the 2007 rating issuances (1,930,381). Fitch, Inc. reported plunging credit rating transactions for this asset class in 2009. Moody's credit rating issuances increased significantly from a total of 175,800 in 2007 to 880,880 in 2008, which is approximately four (4) times increase.

Table 1.7: Number of Credit Ratings Outstanding for Government, Municipalities and Sovereigns in the United States among GCRAs for the Period 2007-2010

Name of Credit Rating Agencies	2007[a]	2008[b]	2009[c]	2010[d]
Fitch Inc.	787,781	491,264	352,697	363,897
Moody's Investors Services	175,000	880,880	862,240	841,235
Standard and Poor's	967,600	976,000	1,004,500	965,900
Total	1,930,381	2,348,144	2,219,437	2,171,032
Sources: [a]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0608.pdf, [b]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0909.pdf				

[c]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0111.pdf
[d]http://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0312.pdf

2.2. Global Credit Rating Agencies' Characteristics and Performance Indicators

The three companies have offices in the United States and Canada. While Moody's and S & P have headquarters in the United States, Fitch Ratings Ltd. has two headquarters (one in the United Kingdom and another in the United States). Fitch Group is an indirect subsidiary of Fimalac Corporation which acquired IBCA in 1997 (Fimalac, 2011). Prior to the acquisition, IBCA is a reputable and large credit rating agency based in the United Kingdom and has branches in Europe and South America. This explains why Fitch Ratings has the largest number of credit rating offices based in South America and Europe compared to MIS and S&P (refer to Table 1.1).

A. Rating Coverage by Geographical Location

Table 1.8: Location of Subsidiaries and/or Affiliates of the Global Credit Rating Agencies

Fitch Inc.	Moody's Investors Services	Standard and Poor's
NORTH AMERICA		
USA and Canada	USA and Canada	USA and Canada
ASIA Pacific		
Philippines, Hong Kong, "Japan", South Korea, China, Australia, Indonesia, Singapore, Thailand, Sri Lanka and India	China, Hong Kong, India, Korea, Singapore, Australia and Tokyo Affiliate: South Korea	Australia, China, India, Japan, South Korea, Malaysia, Singapore, Taiwan
EMEA		
United Arab Emirates, Tunisia, Egypt, Russia and Turkey and South Africa, United Kingdom, France, Italy, Germany, Poland and Spain	Dubai, Germany, South Africa, Cyprus, UK, Spain, Italy, Russia, Germany, Italy, France, Czech Republic, *Mauritius,* Affiliates: Egypt, Russia and Israel	France, Italy and United Kingdom Germany, Spain, Russia, Sweden, Israel, United Arab Emirates, South Africa
LATIN AMERICA		
Mexico, Guatemala, Panama, Ecuador, Peru, Chile, Argentina, Uruguay, Brazil, Venezuela, "Barbados", Dominican Republic and Costa Rica	Argentina, Mexico, Brazil	Argentina, Brazil and Mexico

Source: 2007-2011 Annual Reports of Fimalac Corporation, The McGraw Hill Companies and Moody's Corporation which were compiled by the researcher.

Table 1.8 shows the locations of the different subsidiaries and affiliates of the three (3) GCRAs grouped by region, namely, North America, Latin America, Asia Pacific and EMEA. Moody's and S&P comparably have almost the same number of subsidiaries for Asia Pacific but they are only half the number of affiliates of Fitch that are operating in the region. The two agencies were also able to penetrate the EMEA region; especially Moody's which also operates outside EU through its affiliates in Egypt, Russia and Israel.

The data only proves that the three credit rating agencies had expanded their networks over the years through the acquisition of or a tie-up with domestic companies located in different countries (refer to Table 1.2). Thus, for small, medium-sized CRAs or domestic CRAs, competition may be quite difficult, especially if regulations made for financial institutions give heavy references to ratings. This will jeopardize their rating businesses, as investors and issuers would prefer to use the rating services provided by the three GCRAs because of their reputation in the industry.

Table 1.9 provides the manpower resources of the parent companies of the three GCRAs, namely, Moody's Corporation, McGraw Hill and Fimalac Corporation. Only Fitch Ratings has a separate list of its manpower resources for the period covered (2007-2011), aside from the reported employees of Fimalac Corporation. For the other two companies, only the consolidated data is available, thus, comparison among them may be difficult.

Compared to Moody's Corporation and Fimalac Corporation, The McGraw Hill Companies is the largest company with a total of roughly 22,000 employees and the employees' data for Standard and Poor's is not available. Moody's Corporation, on the other hand, has two business units, namely, Moody's Investors Service (MIS) and Moody's Analytics. MIS offers credit ratings, credit and economic related research, data and analytical tools, risk management solutions, quantitative credit risk measure services and other credit-related businesses.

Table 1.9: Number of Employees of Parent Companies of the GCRAs from 2007-2011

	2007	**2008**	**2009**	**2010**	**2011**
Fitch Ratings & Fitch Solutions	3,131	3,108	3,038	3,029	2,550
Fitch Ratings	2361	2.343	2,266	2,245	2,337
Moody's Corporation	3600	3,900	4,000	4,500	6,100
McGraw Hill	21,171	21,649	21,077	20,755	22,700

Source: 2007-2011 Annual Reports of Fimalac Corporation, The McGraw Hill Companies and Moody's Corporation which were compiled by the researcher.

On the other hand, Moody's Analytics, offer non-credit related commercial activities such as analytics business, industry studies, issuance and other investor-related researches and products and services that are related to the risk management activities of the institutional investors (Moody's Corporation, 2012). Like S&P, the number of employees of MIS is not segregated from Moody's Analytics. In contrast to S&P's parent company's organization, Moody's Corporation is not quite diversified. Moody's manpower complement increased from 3,600 in 2007 to 6,100 employees in 2011, almost double the number in 2011. It recorded a drop in the number of its employees from 2007 to 2010.

The slowdown in the economic activities in 2007 reflected low growth in the number of employees, especially in 2009 where a growth rate was only recorded at 2.6 percent compared to 8.3 percent in 2008. Since 2009, Moody's exhibited an increase in the number of its employees, especially in 2011 where it recorded an additional of 1,500 employees. Moody's reported that the increase in SG&A expenses of USD49.0 million was contributed by the boost in the compensation cost derived from an increase in compensation and benefits costs, especially with the increase in the number of employees in the Credit Group (2012).

Fitch ratings reflected continuous reduction in the number of its employees from 2007 until 2010. While Fimalac Corporation's total employees' data is available, the number of employees at Fitch Algorithm and those at Fimalac headquarters is negligible, representing 8.3 percent only. The global crisis had affected Fitch's business and resulted to a decline in the number of its employees to cut its operating costs. Fitch Ratings, however, reflected an increase in its manpower complement from 607 in 2010 to 631 in 2011, which can be ascribed to the increase in its manpower resources in EU, following the registration approval of its seven subsidiaries under the new CRA regulations. Included in the requirements for the registration and the assessment of the registration fees to be paid by the CRA is its declaration related to the "staffing of credit rating agency and its expertise" (see Box 1 below)

It can be deduced that the number of subsidiaries or affiliates a credit rating agency has will also dictate the number of employees needed for its operations. It shows that to date, the rating business has evolved as an important component of the business environment and the financial system. Likewise, these GCRAs have proven track record in the credit ratings business.

BOX 1
ANNEX II

INFORMATION TO BE PROVIDED IN THE APPLICATION FOR REGISTRATION

1. Full name of the credit rating agency, address of the registered office within the Community
2. Name and contact details of a contact person and of the compliance officer
3. Legal status
4. Class of credit ratings for which the credit rating agency is applying to be registered
5. Ownership structure
6. Organisational structure and corporate governance
7. Financial resources to perform credit rating activities
8. Staffing of credit rating agency and its expertise
9. Information regarding subsidiaries of credit rating agency
10. Description of the procedures and methodologies used to issue and review credit ratings
11. Policies and procedures to identify, manage and disclose any conflicts of interests
12. Information regarding rating analysts
13. Compensation and performance evaluation arrangements
14. Services other than credit rating activities, which the credit rating agency intends to provide 15. Programme of operations, including indications of where the main business activities are expected to be carried out, branches to be established, and setting out the type of business envisaged
16. Documents and detailed information related to the expected use of endorsement 17. Documents and detailed information related to the expected outsourcing arrangements including information on entities assuming outsourcing functions.

Source: European Securities and Markets Authority (2009). Credit Rating Agencies. Regulation (EC) No 1060/2009 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 16 September 2009 on credit rating agencies. Retrieved from http://www.esma.europa.eu/system/files/L_302_1.pdf

Parrenas (n.d.) noted that aside from the reputation of the three Global CRAs, they have also established alliances with other domestic CRAs. This enables them to capture the local market and to ensure low-cost investments for this endeavour compared to the establishment of a new branch or office to gain a market share in a particular country. Especially where emerging markets are becoming attractive investment havens among investors in developed economies, new funds are invested in these markets to get higher returns and value for their funds. The partnerships made by these Global CRAs also benefit the domestic rating agencies, as they got more business transactions through the reputation of the Global CRAs. As earlier shown and discussed in Table 1.1 and Table 1.8, Fitch, MIS and S&P have subsidiaries and/or affiliates operating in various countries and regions.

Table 1.10: M&A Activities of Global Credit Rating Agencies

Year	Fitch Ratings	Moody's Corporation	Standard and Poor's
2000	Duff and Phelps Thomson Financial Bankwatch AMR (France)	Crowe, Chizek and Company LLP (USA)	Canadian Bond Rating Service (Canada)
2001	Central European Rating Agency (Poland)	Magister (Argentina)	Charter Research (USA)
2002	Credit Ratings System (USA)	KMV (USA)	
2004	-	-	Capital IQ (USA)
2005	Algorithmics (Canada) Lombard Risk ValuSpread Business (GB)	Interfax Rating Agency (Russia) Economy.com (USA)	Assirt Research (Australia) CRISIL (India) Taiwan Ratings (Taiwan)
2006	Reoch Credit Ltd (GB)	CRA Rating Agency (Czech Republic) Wall Street Analytics (USA)	
2007	GSCS (Dubai) Korea Ratings	PT Kasnic Credit Rating Indonesia (Indonesia) CA Ratings (South Africa)	Imake Consulting (USA) ABSXchange (USA) ClariFi (USA)
2008	China Lianhe Credit Rating Duff & Phelps de Colombia (DCR)	BQuotes (USA) Fermat International (Belgium) EnB Consulting (Great Britain)	
2010		CSI Global Education, Inc. (Canada) Barrie &Hibbert Limited (Canada)	
2011		Copal Partners Ltd.; (UK) Barrie & Hibbert Limited (UK)	

Sources: Compiled by the researcher from:

a) 2009-2011 Annual Reports of Fimalac Corporation, The McGraw Hill Companies and Moody's Corporation which were compiled by the researcher.
b) European Commission (2009) – data from 2000-2008

Table 1.10 below provides the M&A activities undertaken by the three GCRAs over the past 12 years. Most of the acquisitions made by Fitch were in 2000, with two (2) medium-sized credit rating agencies operating in the United States and one (1) in France (AMR) which specializes in Asset-Management rating. The acquisition of the two rating agencies (Duff and Phelps Credit Rating Company and Thomson Financial Bankwatch), provided Fitch a niche in the industry, as Moody's and S&P have already established their business over a century already. There was only one (1) recorded acquisition in each year from 2001 to 2003 for Fitch. The acquisition of Central European Rating Agency led Fitch to establish a branch in Poland. In 2005, it also acquired Algorithmics in Canada and Lombard Risk ValuSpread Business (GB). There were also 5 acquisitions that were made from 2006 to 2007. This also increased its stake in Duff and Phelps de Colombia in 2008 (Fimalac, 2009).

In 2000, MIS acquired Crowe, Chizek and Company (in USA). S&P, on the other hand, acquired Canadian Bond Rating Services, which gave the company an advantage to gain a market share in the Canada market, especially that CBRS was a major and the only competitor of DBRS. Despite Moody's (MIS) acquisition of the two companies in Canada in 2011, they are not involved in the provision of credit ratings. Both Barrie and Hibbert Ltd. and CSI Global Education, Ltd. are part of Moody's Analytics. From 2005 until 2011, Moody's had been aggressive in its M&A activities with a total of 11 acquisitions compared to those undertaken by S&P and Fitch Ratings. As indicated in Table 1.10, most of the CRAs that were acquired were operating in the United States, especially for S&P which acquired 3 credit rating agencies in 2007.

Table 1.11: Revenues of the Global Credit Rating Agencies from 2007 to 2011 (in million USD)

Credit Rating Agencies	2007	2008	2009	2010	2011
S&P	2264.10	1754.8	1748.20	1,695	1,767
Moody's Investors	1,835.4	1,204.7	1,277.7	1,466.30	1,634.70
Fitch Ratings	827.4	672.8	614.6	657.2	732.7
Source: 2007-2011 Annual Reports of Fimalac Corporation, The McGraw Hill Companies and Moody's Corporation which were compiled by the researcher.					

Table 1.11 summarizes the revenues of the GCRAs from 2007 to 2011. Among the three, S&P generated the highest revenues from 2007 to 2011, followed by Moody's Investors Service and Fitch, respectively. In 2008, the sharp decline in total revenues can be ascribed from the large decline in structured finance products and in foreign exchange rates revenues arising from their operations abroad. Moody's experienced a 34.4 percent drop in total revenues in 2008 compared to S&P and Fitch Ratings, which only had 22.5 percent and 18.7 percent decline in income, respectively. GCRAs' income was also affected by the uncertainty over the debt crisis in Europe and the fear of a global economic downturn.

While S&P and Moody's showed positive signs of recovery in 2009, Fitch reflected a decrease in revenues by 8.7 percent from US$ 672.8 million in 2008 to US$ 614.6 million in 2009. There was a decline in the income of S&P and Moody's in 2010; however, their 2011 income increased. S&P's revenue growth can be ascribed from the increase in non-transaction revenues (McGraw Hill, 2011) while Moody's revenue growth by 11.5 percent was due to the increase in its rates and fees, the changes in the combination of fee types and new rating services it provided. Fitch, on the other hand, showed steady total revenues growth from 2009 to 2011, especially in 2011 where it recorded an income growth by 11.5 percent.

Table Nos. 1.12 and 1.13 summarize the selected operating results for Standard and Poor's period 2010-2011 (whichever is applicable). The total revenues of S&P for transaction and non-transaction activities are depicted in Table 1.12. Income growth was driven by the increase in non-transaction revenues, non-issuance related activities at corporate ratings and by the increase in one of its subsidiaries' operations. This offsets the decline in revenues for structured finance ratings (refer to Table 1.13), especially in the United States where the issuances of U.S. residential mortgage-backed securities,

collateralized debt obligations and asset-backed securities were large, both in volume and value (The McGraw Hill Companies, 2011).

Income growth in 2011 was driven by entity credit ratings, "ratings" evaluation services and surveillance fees. In 2011, only 37 percent of the income came from the rating business while in 2010, it only accounted to 39 percent. Operating margin was lower in 2011 (41 percent) compared to 2010 (45 percent), as there was an increase in operating expenses that was driven by the share of salary expense arising from the increase in manpower and some incremental compliances and regulatory costs.

Table 1.12: Revenues, Operating Expenses and Income of Standard and Poor's for 2010 and 2011 (in million USD)

	2010*	**2011***
Transaction	662	651
Non-Transaction	1,033	1,116
Total Revenue	1,695	1,767
Operating Expenses	933	1,048
Operating Income	762	719

Source: 2007-2011 Annual Reports of The McGraw Hill Companies which were compiled by the researcher.
Note: Only 2011 and 2010 financial data are utilized as there are discrepancies in the values reflected in the 2010 Annual Report for the detailed information for 2009 and 2008.

Table 1.13: Comparison between S&P's Structured Finance in the United States and Europe (Percentage Change from 2010 to 2011)

Structured Finance Products	**U.S.**	**Europe**
Residential Mortgage Backed Securities (RMBS)	(60)%	19%
Commercial Mortgage Backed Securities	71%	(42)%
Collateralized Debt Obligations (CDO)	(14)%	(37)%
Asset-Backed Securities	(3)%	27%
Covered Bonds	-	54%
Total New Issue Dollar – Structured Finance	(7)%	43%

Source: 2010 and 2011 Annual Reports of The McGraw Hill Companies which were compiled by the researcher.
Note: Only 2011 and 2010 financial data are utilized as there are discrepancies in the values reflected in the 2010 Annual Report for the detailed information for 2009 and 2008.

The cost incurred for its EU operations contributed to the low operating income of $719 million only, as the company was granted its registration for the three subsidiaries in EU in 2011 where registration and supervision fees must be paid (The McGraw-Hill Companies, Inc., 2012). S&P's non-transaction revenues comprise fees for the surveillance of a credit rating and entity credit ratings and the annual fees for customer relationship-based pricing programs.

The decline in the transaction revenues by $9 million (refer to Table 1.12) was due to the decline in public finance and structured finance income, which was partly offset by an increase in corporate rating revenues arising from the growth in bank loan ratings and high-yield corporate bond rating revenues (The McGraw Hill Companies, Inc., 2011). As shown in Table 1.13, RMBS declined significantly for the United States (61 percent) compared to the increase in EU's income by 17percent. However, the drop in income was compensated by a 71 percent increase in commercial mortgage-backed securities compared to the 2010 figure. Despite the decline in the total new issuances for structured finance products in the United States, EU showed positive growth rate of 43 percent. Covered bond transactions also gained favourable

acceptance in the EU Market and the approval of its registration in 2011 might have contributed to the increase in the issuances for this security.

Table 1.14: Revenues and Operating Income of MIS from 2007-2011 (in million USD)

	2007	2008	2009	2010	2011
Revenues	1,835.4	1,204.7	1,277.7	1,466.30	1,634.70
Less: Expenses	824.7	667.7	714.7	816.6	872.0
Operating Income	1,010.7	537.0	563.0	649.7	762.7
Source: Compiled by the researcher from the 2007-2011 Annual Reports of Moody's Corporation					

Table 1.14 shows the operating results of Moody's Investors Service, Inc. while Table 1.15 provides a summary of the income generated for structured finance from 2007 to 2011. Moody's Investors Service's revenue was driven by the Corporate Finance credit ratings, which increased from 2009 to 2011 (Moody's Investors Service, Inc., 2009 and 2011).

Its operating margin declined by 88.2 percent in 2008, despite a lower decline in operating expenses (19 percent) compared to the drop in revenues by 34.4 percent. The operating income gradually increased from 2008, which gave the company increasing profit margins from 2009 to 2011. It reported the highest operating margin of 46 percent in 2011, compared to the 44.6 percent margin in 2008; hence, it is still lower than the 2007 level, representing 55 percent.

Table 1.15: Moody's Investors Service Revenues for Different Rating Segments From 2007-2011 (in million USD)

	2007	2008	2009	2010	2011
Corporate Finance	416.4	307.0	408.2	563.9	652.1
Structured Finance	868.4	404.7	304.9	290.8	344.6
Financial Institutions	274.3	263.0	258.5	278.7	294.9
Public, Project and Infrastructure Finance	220.8	230.0	246.1	271.6	277.3
Intersegment Royalty			60.0	61.30	65.8
TOTAL	1,779.9	1,204.7	1,277.7	1,466.30	1,634.70
Source: 2007-2011 Annual Reports of Moody's Corporation which were compiled by the researcher.					

The income of MIS from structured finance product credit ratings and other related services was not good since 2008 as the contraction in revenue continued to be felt until 2010, arising from the significant disruption in the global financial markets and the global economic slowdown. There was a significant decline by 114.5 percent in the revenues for structured products from US$868.4 million to US$404.7 million in 2008. This can be ascribed from the alleged mismanagement by MIS on its credit

rating transactions for different structured finance products and the decline in revenues which continued until 2010.

The demand for Financial Institutions' credit ratings and public, project and Infrastructure finance credit ratings were among the lowest for the entire period. These services represent roughly more than two-thirds of the credit rating revenues of the company. The Public, Project and Infrastructure Finance credit ratings showed increasing growth over the years especially in 2009 where a 10.4 percent was recorded compared to financial institutions' ratings which reflected a decline in credit ratings revenue until 2008. Like S&P, demand for rating services increased for the international market since 2008, as contrasted to the decline in the US Market. However, the total revenues generated in the U.S. Market are still higher compared to the international market. This is driven by large revenue from the EMEA area, especially with the presence of 6 subsidiaries of Moody's in the European Community. Hence, a growth of 18.5 percent was evident in 2011, arising from the improvements that were made by the agency for this specialized product which made the credit rating transactions bounce back from their fall (Moody's Corporation, 2011). The income was driven by corporate finance ratings. Despite the decline in its income for this credit rating in 2008 by $109.4 million, the income is still impressive or acceptable, as MIS was able to recover with remarkable growth rates pegged at 33 percent and 38.1 percent in 2009 and 2010, respectively.

Table 1.16: Revenues and Operating Profits of Fitch Ratings for the Period 2008 to 2011 (in million USD)

	2008	2009	2010	2011
Revenue	672.8	614.6	657.2	732.7
Less: Expenses	489.5	392.1	461.7	505.7
Operating Profit	185.3	222.5	195.5	227
Source: 2008-2011 Annual Reports of Fimalac Corporation which were compiled by the researcher.				

Like Moody's and S&P, the total revenues of Fitch Ratings in 2008 were affected by the economic slowdown and global crisis. However, the impact on the credit rating agency is not high compared to the two GCRAs, as it only declined by 8.6 percent. Table 1.16 also reveals that its operating profit increased in 2008, arising from the large decrease in operating expenses by 20.1 percent compared to the drop in its revenues. However, Fitch's operating profits for the period was not as high as Moody's and S&P where it only reported the highest profit margin of 36.2 percent in 2008. Despite the improvement in revenues for the succeeding years, the operating expenses also escalated, especially in 2010 where it accounted to 70.2 percent of Fitch's revenues.

Prospects remain high for Fitch Ratings since revenue in 2011 revealed a growth rate of 11.4 percent which was driven by the demand from the US and EMEA markets, where it reported revenues of US$ 288.2 million and US$284.7 million, respectively. The Asian market's share to the company's total revenues (13.3 percent) is still high compared to Latin America's revenue market share (8.5 percent) (Fimalac, 2012).

3. The European Credit Rating Industry

This section reviews and examines the credit rating agencies operating within the European Union. As discussed earlier, the formal regulation of the credit rating agencies in the Community only started in 2010 in response to the problems caused by the global financial crisis. The European Union

aims to promote financial system resilience and in response to the Code Fundamentals issued by IOSCO for all types of credit rating agencies and the call of the Financial Stability Board. While other international organizations and national authorities have issued regulatory guidance in the past, most of these were related to the regulatory reference to the use of credit ratings by financial institutions.

3.1. Registration and Supervision of CRAs

A. Applicable Fees for the Registration and Supervision of CRAs:

The European Securities and Markets Authority (2012) was given full authority by the European Parliament and Council to supervise the credit rating agencies' operations. Among these relate to the authority to request relevant information from CRAs, to conduct the hearing of persons, to examine records of CRAs and to conduct on-site inspections. This is in contrast to the United States where supervision for the credit rating activities is undertaken by the Securities and Exchange Commission which was given greater power to supervise CRAs, more specifically, Nationally Recognized Statistical Rating Organizations (NRSROs).

With its rigorous requirements for the application for registration or certification credit rating agencies and the stringent regulatory framework, oversight by ESMA may initially be minimal as the regulation only took effect in 2009 and there are corresponding administrative sanctions and fines that can be imposed among errant CRAs. As indicated in Box 1 in the preceding section, several requirements that must be accomplished by any credit rating agency that wishes to apply for registration with competent authorities or ESMA.

The European Commission's regulation on the fees charged to credit rating agencies may vary depending on the following criteria:

(a) whether a credit rating agency intends to issue ratings for structured finance instruments;
(b) whether a credit rating agency has a branch in another Member State or in a third country;
(c) whether a credit rating agency intends to endorse ratings. (European Commission, 2012)

If any of these criteria do not apply to the present circumstance of a CRA, the criterion for the assessment of fees will be based on the number of its employees. On the other hand, for the certification fees to be paid by a credit rating agency from a third country, such as Japan Credit Rating Agency, the value is EUR 10,000. It was also cited that the fees are not fixed over time and will be reviewed regularly.

The role played by ESMA for centralizing supervision at the EU level is already a move for simplifying CRA oversight. With the administrative burden on the part of ESMA, credit rating agencies are also required to pay annual supervisory fees; hence, the fees will also vary depending on the reported turnover generated from the rating activities and the provision of ancillary services, if applicable. In recognition of the potential entry barriers arising from CRA operations, ESMA has provided the appropriate threshold for providing exemptions to small credit rating agencies. Article 5 of the Regulation for registered CRAs provides that if a CRA or a group of CRAs' latest audited account reveals that the total revenues is less than EUR 10 million, an exemption will be provided. However, this does not discount the fact that a regular assessment by the supervisor will be undertaken to determine whether a CRA is qualified or not for the said exemption. On the other hand, certified rating agencies pay a fixed amount of EUR 6,000 for their supervision, which is less than the amount to be paid by registered CRAs (European Commission, 2012).

B. List of Registered Credit Rating Agencies and their Regulatory Framework

Table 1.17 below provides the list of credit rating agencies registered in the European Union to operate a credit rating business and provide ancillary services within the Community. It also provides the list of registering supervisory authorities and the respective dates the registration by the credit rating agency was approved. Upon the approval of Regulation (EC) No 1060/2009 on credit rating agency on December 7, 2010, the credit rating agencies that were operating at that time were encouraged to register starting September 7, 2010 subject to their compliance with the applicable requirements (see Box 1 above). With the approval of the CRA regulation, the European Securities and Markets Authority was given the full supervisory power over the CRAs and their registration.

Table 1.17: List of Credit Rating Agencies by Country of Operation and the Registering Authorities

Country	Credit Rating Agency	Date of Registration Approval	Registering Authorities
Bulgaria	Bulgarian CRA	April 6, 2011	Financial Supervision Commission (FSC)
Cyprus	Moody's Investors Service Cyprus Ltd	October 31, 2011	Cyprus Securities and Exchange Commission (CySEC)
	Capital Intelligence	May 8, 2012	
France	Fitch France S.A.S.	October 31, 2011	Autorité des Marchés Financiers (AMF)
	Moody's France S.A.S.	October 31, 2011	
	Standard & Poor's Credit Market Services France S.A.S.	October 31, 2011	
	Japan Credit Rating Agency Ltd	January 6, 2011	
Greece	ICAP Group SA	July 7, 2011	Hellenic Capital Market Commission (HCMC)
Germany	Euler Hermes Rating	November 16, 2010	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)
	Feri EuroRating Services AG	April 14, 2011	
	Creditreform Rating	May 18, 2011	
	Scope Credit Rating	May 24, 2011	
	GBB-Rating	July 28, 2011	

	Assekurata Assekuranz	August 16, 2011	
	Fitch Deutschland GmbH	October 31, 2011	
	Moody's Deutschland GmbH	October 31, 2011	
Italy	Fitch Italia S.p.A.	October 31, 2011	Commissione Nazionale per le Società e la Borsa (CONSOB)
	Moody's Italia S.r.l.	October 31, 2011	
	Standard & Poor's Credit Market Services Italy S.r.l.	October 31, 2011	
	CRIF S.p.A.	December 22, 2011	
Poland	Fitch Polska S.A.	October 31, 2011	Komisja Nadzoru Finansowego (KNF)
Portugal	Companhia Portuguesa	September 8, 2011	Comissão do Mercado de Valores Mobiliários (CMVM)
Slovakia	ERA, a.s.	July 30, 2012	National Bank of Slovakia
Spain	Fitch Ratings España S.A.U.	October 31, 2011	Comisión Nacional del Mercado de Valores (CNMV)
	Moody's Investors Service España S.A.	October 31, 2011	
United Kingdom	AM Best Europe	September 8, 2011	Financial Services Authority (FSA)
	DBRS Ratings Limited	October 31, 2011	
	Fitch Ratings Limited	October 31, 2011	
	Fitch Ratings CIS Limited	October 31, 2011	
	Moody's Investors Service Ltd	October 31, 2011	
	Standard & Poor's Credit Market Services Europe Limited	October 31, 2011	
Source:http://www.esma.europa.eu/page/List-registered-and-certified-CRAs			

To date, there are 30 credit rating agencies registered by the competent registering authorities in the Community. Among these CRAs, 16 are subsidiaries of the three (3) GCRAs (Fitch [7], Moody's [6] and S&P [3]). They all got their respective registration approvals on October 31, 2011. Two agencies of Fitch Ratings (Fitch Ratings Limited and Fitch Ratings CIS Limited) are operating in the United Kingdom.

France and Italy, respectively, have four (4) credit rating agencies registered under the EU regulations. Table 1.17 also indicates that these GCRAs' subsidiaries and/or affiliates are operating in each jurisdiction. In Italy, there is one local rating agency that got its registration approved (CRIF, S.p.A.).

The competent registering authorities listed in Table 1.17 were requested by ESMA to do the initial assessment for registration by CRAs in their respective jurisdiction. Since there are mixed supervisory framework and set-ups within the EU, the approval was made different competent authorities. The United Kingdom, Germany, Poland, Bulgaria and Slovakia are the only countries that have unified financial supervisory authority. For these countries, the respective supervisory authority is the one responsible for approving the registration applications of the CRAs in their jurisdiction before ESMA took over on July 1, 2011. On the other hand, the respective securities market authority in each jurisdiction was the one given the approving authority for the other CRAs, since they have a separate regulatory framework for securities, insurance and banking sectors. Only the National Bank of Slovakia still approved the pending application of the European Rating Agency (ERA) at the time ESMA took over.

Euler Hermes Rating GmbH is the first credit rating agency to be awarded the approval of its registration on November 16, 2010, followed by Feri EuroRating Services on April 14, 2011. Both of them are operating in Germany and their applications were approved by BaFin or the Federal Financial Supervisory Authority. It had approved additional six (6) registration applications where two (2) CRAs are subsidiaries of Fitch and Moody's. The country has the largest number of registered rating agencies, followed by 6 registrations processed by the Financial Services Authority in the United Kingdom.

Another rating agency (Bulgaria Credit Rating Agency) also got its registration in April 2011. By the end of the first semester of 2011, only four credit rating agencies were successfully registered. Many CRAs, representing 23 or 76.7 percent, got their registration approved by the second half of 2011. Since then, only Capital Intelligence (Cyprus) Ltd. and European Rating Agency (ERA), got their approval in 2012. It took several months before many credit rating agencies got the approval of their respective registration since the EU CRA Regulation stipulates stringent registration requirements as shown in Box 1. The Comisión Nacional del Mercado de Valores approved the registration of Fitch Ratings España S.A.U. and Moody's Investors Service España S.A. One of the subsidiaries of MIS, which operates in Cyprus, was registered with the Cyprus Securities and Exchange Commission (CySEC). With the approval of Capital Intelligence Rating registration by the European Securities and Markets Authority (ESMA), there are already two CRAs operating in the country.

C. Existing Cooperation Arrangements with Foreign Countries

To date, Japan Credit Rating Agency is the only agency that is certified in the European Union through the Autorité des Marchés Financiers (AMF). The certification which was issued on January 16, 2011 permits EU companies, financial institutions (banks, insurance companies and undertakings, investment companies, etc) and other organizations to the use of credit ratings issued by JCRA for regulatory compliance purposes. This certification regulation came about when the European Commission (2010) has decided that Japan's legal and regulatory frameworks for credit rating agencies meet the standards set by the Commission under Article 5 of Regulation (EC) NO 1060/2009. This gives credit rating agencies registered in Japan the opportunity to apply for certification, as long as they meet the applicable requirements.

Aside from Japan, eight other countries were accorded with the equivalence status similar to that of EU. These are the United States, Canada, Australia, Argentina, Singapore, Hong Kong, Chile and Brazil. This means that their legal and regulatory frameworks for credit rating agencies were in line with and are as stringent as EU's regulations for CRAs. This provided CRAs established outside the Community (third countries) to be given either an endorsement by EU-Registered CRAs or certification by ESMA under the EU Regulation on Credit Rating Agencies (ESMA, 2012).

This CRA regulatory equivalence's overall objective issued by the European Securities and Markets Authority (2012) is for "assuring that users of ratings in the EU would benefit from equivalent

protections in terms of the credit rating agencies integrity, transparency, good governance and reliability of the credit rating activities". To date, memoranda of understanding (MoUs) between ESMA and the respective competent authorities for CRAs in the United States, Canada, Argentina, Singapore and Argentina was already undertaken on July 19, 2011. Thus, CRAs from these countries who would intend to be certified can already submit their respective application for certification. Hence, it is important that the credit rating agencies in the respective countries are licensed or registered and subject to supervision by the corresponding regulatory authority before they can apply with ESMA.

Article 5 (b) of EC Regulation (EU) 272/2012 also provides that upon the approval of the CRA's certification, it can also apply for exemption from the physical presence requirement with ESMA, depending on the present circumstance of the rating agency and if it will be burdensome for the CRA applicant to establish an office in EU (EC, 2012). To date, there are no pending applications for certification from credit rating agencies belonging to these countries.

Another form of cooperative arrangement with the supervisory authorities in third-countries where a credit rating issued by registered credit rating agencies from these countries is the endorsement arrangement. Like any regulatory arrangements, one of its prerequisites is the cooperation arrangement between competent supervisory authorities from the two countries, namely, EU and the third-country. Under this arrangement, the credit rating agencies that are already established in EU and are registered in accordance with the requirements for CRA, whether they are local or entities of foreign CRAs, can endorse credit ratings that were issued in third countries. Box 2 provides the specific conditions that must be met under this type of arrangement where both the credit ratings and the credit rating activities undertaken by the CRA in the third-country shall be evaluated in terms of their systematic importance to the financial stability or integrity of the financial markets of one or more Member States. issued by the credit rating agencies in the third-country will be use in the assessment of the credit rating agency's systemic importance. Usually the endorsements are being made by EU credit rating agencies that belong in the same group of companies.

Table 1.18: Cooperation Arrangements Established by EU related to Credit Rating Agencies

Country	Progress of Co-operation with 3rd Country Supervisor*	Through Certification	Through Endorsement
Japan	MoU Signed	Japan Credit Rating Agency	*Fitch Ratings Japan Ltd.*
United States	MoU Signed	None	DBRS, Inc., Fitch Inc.
Canada	MoU Signed	None	DBRS Limited
Australia	MoU Signed	None	*Fitch Australia Pty Ltd.*
Singapore	MoU Signed	None	*Fitch Singapore Pte. Ltd.*
Hong Kong	Pending	None	*Fitch (Hong Kong) Ltd.*
Argentina	MoU Signed	None	*Fitch Argentina Calificadora de Riesgo S.A.*
Mexico	Pending	None	*Fitch Mexico S.A. de C.V.*
Brazil	Pending	None	*Fitch Ratings Brasil Ltda.*

Source: European Securities and Markets Authority (n.d.). *"Credit Rating Agencies*". Retrieved from http://www.esma.europa.eu/page/CRA-documents, ESMA (2012). ESMA allows EU-registered CRAs to endorse credit ratings issued in the US, Canada, Hong Kong and Singaporehttp://www.esma.europa.eu/system/files/2012-158.pdf

The endorsing credit rating agency has the responsibility to ensure that the credit ratings issued by these agencies possess the same quality being demanded for, as these ratings will be used by companies operating in the Community. Since this will be utilized by these companies to comply with regulatory requirements in the Community, the credit ratings that are endorsed would be the credit ratings that were issued in countries where the requirements for the CRAs operating in a third country are as stringent as the requirements set forth under the EU Regulations. This type of arrangement provides benefits both to the credit rating agencies and the company using the endorsed credit ratings.

As shown in Table 1.18, DBRS Ratings Limited (n.d.) has applied for endorsement with ESMA with regard to some of the public ratings issued by DBRS Limited in Canada and DBRS, Inc. in the United States. As part of its application for the endorsement mechanism, it will establish or determine which of the credit ratings issued by these two entities will be considered and the said ratings shall be constantly monitored to comply with the requirements of ESMA.

BOX 2
Conditions to be Satisfied Under the Endorsement Regime

Article 4: Use of Credit Ratings

4. A credit rating agency established in the Community and registered in accordance with this Regulation may endorse a credit rating issued in a third country only when credit rating activities resulting in the issuing of such a credit rating comply with the following conditions:

(a) the credit rating activities resulting in the issuing of the credit rating to be endorsed are undertaken in whole or in part by the endorsing credit rating agency or by credit rating agencies belonging to the same group;
(b) the credit rating agency has verified and is able to demonstrate on an ongoing basis to the competent authority of the home Member State that the conduct of credit rating activities by the third-country credit rating agency resulting in the issuing of the credit rating to be endorsed fulfils requirements which are at least as stringent as the requirements set out in Articles 6 to 12;
(c) the ability of the competent authority of the home Member State of the endorsing credit rating agency or the college of competent authorities referred to in Article 29 (college) to assess and monitor the compliance of the credit rating agency established in the third country with the requirements referred to in point (b) is not limited;
(d) the credit rating agency makes available on request to the competent authority of the home Member State all the information necessary to enable that competent authority to supervise on an ongoing basis the compliance with the requirements of this Regulation;
(e) there is an objective reason for the credit rating to be elaborated in a third country;
(f) the credit rating agency established in the third country is authorised or registered, and is subject to supervision, in that third country;
(g) the regulatory regime in that third country prevents interference by the competent authorities and other public authorities of that third country with the content of credit ratings and methodologies; and
(h) there is an appropriate cooperation arrangement between the competent authority of the home Member State of the endorsing credit rating agency and the relevant competent authority of the credit rating agency established in a third country. The competent authority of the home Member State shall ensure that such cooperation arrangements shall specify at least:
    (i) the mechanism for the exchange of information between the competent authorities concerned; and
    (ii) the procedures concerning the coordination of supervisory activities in order to enable the competent authority of the home Member State of the endorsing credit rating agency to monitor credit rating activities resulting in the issuing of the endorsed credit rating on

an ongoing basis.
Source: European Securities and Markets Authority (2009). Credit Rating Agencies. Regulation (EC) No 1060/2009 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 16 September 2009 on credit rating agencies. Retrieved from http://www.esma.europa.eu/system/files/L_302_1.pdf

3.2. Legal Structure and Scope of Operations of EU CRAs

A. Legal Structure of Registered and Certified Credit Rating Agencies in EU

Table Nos. 1.19 -1.20 provide the characteristics of the different credit rating agencies operating in the European Union in terms of their legal structure, scope of operations and the source of income (business model used).

Table 1.19 shows that only three (3) credit rating agencies are organized as public companies, namely, Creditreform Rating Agency in Germany, Companhia Portuguesa de Rating, S.A. ("Historia", n.d.) and Moody's Investors Service Espana S.A. The latter is a wholly-owned indirect subsidiary of Moody's Corporation. The affiliates of Fitch Ratings and the subsidiaries of S&P in EU are all privately-held companies. Together with the six (6) EU subsidiaries of Moody's Corporation, each group of companies are classified as a "group of credit rating agencies". This is defined in Article 3(1m) of the EU CRA Regulations as:

> For the purpose of this Regulation, the following definitions shall apply: ...
> (m) group of credit rating agencies' means a group of undertakings established in the Community consisting of a parent undertaking and its subsidiaries within the meaning of Articles 1 and 2 of Directive 83/349/EEC as well as undertakings linked to each other by a relationship within the meaning of Article 12(1) of Directive 83/349/EEC and whose occupation includes the issuing of credit ratings. For the purposes of Article 4(3) (a), a group of credit rating agencies shall also include credit rating agencies established in third countries; (ESMA, 2009)

As can be gleaned in the Table 1.19, the other CRAs are organized as private companies where most of them are operating as limited liability companies (Capital Intelligence in Cyprus, Assekurata Assekuranz, Euler Hermes, CRIF S.p.A. in Italy and BCRA of Bulgaria) while only one CRA is operating as a joint stock company (European Rating Agency).

Creditreform Rating Services was organized in 1879, but it only started its operations for the credit rating business in Year 2000. Like Creditreform, Feri EuroRating Services AG was established in 1987; hence, it started its credit rating operations in 2002. Like the subsidiaries/affiliates of the three (3) GCRAs (Moody's, Fitch and S&P), DBRS and AM Best are also formally registered under the EU law. AM Best Europe, a subsidiary of AM Best Inc. which was established in 1899, had only started its operations in the United Kingdom in 1997 as part of the company's expansion. DBRS Ratings Limited is established and registered under the laws of the United Kingdom and is the only rating agency among the five (5) whose parent company was established in 1976.

Table 1.19: Ownership Structure of Credit Rating Agencies

Rating Agency Name	Ownership Structure	Date Established
Bulgarian CRA	Limited Liability Co.	2002*/2003**
Capital Intelligence	Limited Liability Co.	1985
ICAP Group SA	Private Company	1971*/1992**
Euler Hermes Rating	Limited Liability Co.	2001

Feri EuroRating Services AG	Private Company	1987*/2002**
Creditreform Rating	Public Company	1879*/2000**
Scope Credit Rating	Limited Liability Company	2002
GBB-Rating	Limited Liability Company	1996
Assekurata Assekuranz	Limited Liability Co.	1996
CRIF S.p.A.	Limited Liability Co.	1988
Companhia Portuguesa	Public Company	1988
ERA, a.s.	Joint Stock Company	2007
Japan CRA Ltd	Private Company	1985
AM Best Europe	Private Company	1997
DBRS Ratings Limited	Private Company	2010
Fitch Ratings Limited	Private Company	-
Fitch Ratings CIS Limited	Private Company	-
Fitch France S.A.S.	Private Company	-
Fitch Deutschland GmbH	Private Company	-
Fitch Italia S.p.A.	Private Company	-
Fitch Polska S.A.	Private Company	-
Fitch Ratings España S.A.U.	Private Company	-
Moody's Investors Service Ltd	Private Limited Company	-
Moody's Investors Service Cyprus Ltd	Private Limited Company	-
Moody's France S.A.S.	Private Limited Company	-
Moody's Deutschland GmbH	Private Limited Company	-
Moody's Italia S.r.l.	Private Limited Company	-
Moody's Investors Service España S.A.	Public Company	-
Standard & Poor's Credit Market Services France S.A.S.	Private Company	-
Standard & Poor's Credit Market Services Italy S.r.l.	Private Company	-
Standard & Poor's Credit Market Services Europe Limited	Private Company	-

Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies
Legend:
* - It refers to the date the company was established while
** refers to the date when the credit rating business formally started.

In countries such as Bulgaria and Slovakia, the credit rating business is relatively new since credit rating agencies were established in 2002 (Bulgaria Credit Rating Agency) and 2007 (European Rating Agency), respectively (please refer to Table 1.19). Even in Germany where there are many credit rating agencies operating, the industry only started in 1996 with the establishment of Assekurata Assekuranz and GBB Rating Agency. Most of the credit rating businesses in EU (52 percent) are undertaken by Fitch, Moody's Services Investor and Standard and Poor's whose operating are evident in many countries in the region. In fact in Italy, the United Kingdom, France and Germany, these GCRAs are operating, respectively. Unlike in the United States where regulation had been going on prior to the global financial crisis, CRAs were initially not formally regulated in the EU. This made these GCRAs to gain a big market

share within the Community through the establishment of its branches in different parts of the EU. It was only after the Enron Crisis when the Community has started conducting its investigations in designing measures toward CRA supervision.

B. Scope of Operations

Table 1.20 shows that ten (10) credit rating agencies are operating locally. Unlike Scope Credit Rating, Moody's EU entities and Fitch EU Entities, the other CRAs are German domestic companies that do not have branches within the region or other countries. Capital Intelligence (Cyprus) Ltd. is a local CRA that operates on a global basis by serving selected markets in Europe, Middle East and Asia. CRIF S.p.A. is also a local CRA based in Italy which operates on a global basis through its subsidiaries and affiliates. These are located in Europe (Czech Republic, Hungary and Slovak Republic), Americas (Florida and Jamaica) and Asia (China)[8]. Only Scope Rating Agency is operating on a regional basis, with branches in Luxemburg, Poland and Amsterdam. Aside from its branches outside Germany, it has also local branches in Berlin and Greater Stuttgart.[9]

Table 1.20: Rating Scope of EU Credit Rating Agencies

Rating Agencies	Type of Operation	Number or Location of Offices
Bulgarian CRA	Domestic	None
Capital Intelligence	Global	2
ICAP Group SA	Domestic	3
Euler Hermes Rating	Domestic	None
Feri EuroRating Services AG	Domestic	None
Creditreform Rating	Domestic	None
Scope Credit Rating	Regional	Poland and Netherlands
GBB-Rating	Domestic	None
Assekurata Assekuranz	Domestic	None
CRIF S.p.A.	Global	6
Companhia Portuguesa	Domestic	None
ERA, a.s.	Domestic	None
Japan CRA Ltd	Global*	1
AM Best Europe	Subsidiary*	None

[8] "About Us". Retrieved from http://www.crifdecisionsolutions.co.uk/About-Us/Pages/about-us.aspx

[9] "Scope Figures and Facts". Retrieved from http://www.scope-group.com/presse/scope-zahlen-fakten;jsessionid=7449301184130E8D80341BB33F5BD117?lang=en

DBRS Ratings Limited	Subsidiary*	None
Fitch Ratings Subsidiaries	Subsidiaries*	None
MIS Subsidiaries	Subsidiaries*	None
S&P Subsidiaries	Subsidiaries*	None
Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies		

Aside from the above mentioned CRAs, there are also other foreign GCRAs that have established operations in the European Union through their subsidiaries, namely, A.M. Best Inc. and DBRS Limited. As previously mentioned, AM Best Europe and DBRS Ratings Limited are subsidiaries of global rating agencies, with headquarters in the United States and Canada, respectively. DBRS Limited is a full-service rating agency established in Canada which operates in the United Kingdom and the United States. AM Best Inc., on the other hand, also operates through its other subsidiaries in Hong Kong, New Zealand and Australia.[10] On the other hand, Japan Credit Rating Agency is also a global rating agency based in Japan, with an overseas operation specifically in the United States as an NRSRO. In the EU, its influence is lesser because of its certification status compared to other foreign GCRAs which established branches or operate within the Community.

Fitch operates in six (6) countries within the EU, with a total of seven (7) companies. They are registered and incorporated in accordance with each country's laws. Two of these credit rating agencies operate in the United Kingdom, namely, Fitch Ratings Limited and Fitch Ratings CIS Limited. Six (6) of these agencies are owned by Fitch Ratings Limited in EU which is wholly owned by Fitch, Inc. Fitch is 60 percent owned by Fimalac SA (France) and 40 percent indirectly owned by the Hearst Corporation. Moody's Investors Service has six (6) subsidiaries and S&P has three (3) subsidiaries operating in EU, respectively. All these subsidiaries do not own any subsidiary, affiliate or branch within and outside the Community.

The European Rating Agency, on the contrary, acquired Slovak Rating Agency, and is currently operating in Slovakia. It serves the Central, Eastern Europe and the Balkans markets.[11] Like ERA, ICAP Group's credit rating service is not only limited in Greece but it also extends in South Eastern Europe (Bulgaria, Romania and Serbia) especially with its existing databank that covers 3 million companies. It strengthened its operations since the establishment of its partnership with Dun and Bradstreet as it allows the agency to serve other markets in various regions[12]. .

It must be noted that most of the other credit rating agency's existing resources are not sufficient to compete with the three (3) GCRAs. Hence, the growing number of CRAs in the Community is already a sign of progressive business which allows competition among them. Although in other jurisdictions, few domestic and foreign credit rating agencies compete with each other. Other companies and institutions still prefer to use the services of these GRAs due to their reputation in providing credit assessment services for a wide array of issuers of debt securities. To date, the rating business has not really transpired yet in other countries within the Community despite the growing presence of small- and medium-sized CRAs in some countries.

C. Type of Business Model Utilized

Table 1.21 reveals that most of the credit rating agencies use the issuer-pay rating or economic model, including Fitch Ratings, Moody's Investors Service and Standard and Poor's. For this type of system, CRAs' credit rating income comes from the payments made by the issuers for the credit rating and the other ancillary services they provide, if there are any. This is usually common among credit rating

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[10]A.M. Best Europe – Rating Services Ltd (2011).European Union Transparency Report.
[11]"Slovak Rating Agency". Retrieved from
http://www.euroratings.co.uk/index.php?option=com_content&view=article&id=91%3Aslovenska-ratingova-agentura&catid=44%3Ao-spolocnosti-era&Itemid=48&lang=en
[12]Credit Risk Services. Retrieved from http://www.icap.gr/Default.aspx?id=7296&nt=19&lang=2

agencies especially when viewed in the context of the structured finance and corporate ratings. Xia (201) notes that competition among CRAs becomes intense since each of them wants to get as much business as it can from the issuers of the financial instruments. This is where many researchers find the greatest conflict of interest issue because CRAs become threatened to lose clients in the future if issuers are unhappy with the credit rating they receive.

The issuers typically utilize credit ratings to borrower in the securities market or from credit institutions. For companies that issue bonds and other financial instruments, an external credit rating adds value to the company or the security. Besides, this also serves as one of the requirements in accessing credit. Thus, the credit rating issued can be accessed by the investors in the CRA website. There are also instances where large investors pay the agency to obtain additional information related to rating processes, etc. ICAP Ratings and Euler Hermes are few among the companies which are contracted by investors or subscribers to conduct credit ratings of other companies. Unlike ICAP where most of the ratings it issue are unsolicited, Euler Hermes' credit ratings are paid by the issuer; hence, they also conduct ratings for other investors. Some large or institutional investors use credit ratings as part of their competitive strategies to maximize returns or minimize losses.

Table 1.21: Business Model Used by Credit Rating Agencies in the European Union

Rating Agency	Business Model
Bulgarian CRA	Issuer Paid
Capital Intelligence	Issuer Paid
ICAP Group SA	Issuer Paid
Euler Hermes Rating	Issuer Paid
Feri EuroRating Services AG	User Paid
Creditreform Rating	Issuer Paid
Scope Credit Rating	Issuer Paid
GBB-Rating	Issuer Paid
Assekurata Assekuranz	Issuer Paid
CRIF S.p.A.	User Paid
Companhia Portuguesa	Issuer Paid
ERA, a.s.	Issuer Paid
Japan CRA Ltd	Issuer Paid
AM Best Europe	Issuer Paid
DBRS Ratings Limited	Issuer Paid
Fitch EU Subsidiaries	Issuer Paid
MIS EU Subsidiaries	Issuer Paid
S&P EU Subsidiaries	Issuer Paid
Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies	

With the increasing costs of conducting credit ratings, many CRAs prefer the issuer-pays business model vis-a-vis the subscriber- or user-pays model. As reflected in Table 1.21, other companies such as Feri Euro and CRIF S.p.A. charge investors or users for the credit ratings. The users either pay the CRA using online subscription or on a per company/use basis. Some financial institutions (lending companies, financing companies, or small banks use this form to verify the creditworthiness of borrowers), request the rating agency to conduct a credit assessment for a particular company or group of companies as part of their credit investigation or activities. Aside from the GCRAs, there are also

CRAs that charge users or subscribers such as Creditreform[13] and Euler Hermes Ratings. However, in the case of Creditreform Rating (2012), it had not yet generated income from subscriptions, based on its 2011 Transparency Report where it reported that it has no subscribers yet.

Country or sovereign ratings are not paid by the government being rated and are classified as unsolicited ratings. However, some CRAs conduct credit ratings for paying investors to conduct a country rating to assess certain country-specific risks associated with any potential investment. Aside from the differences in the business models used by CRAs, pricing also varies. In the case of Assekurata, a fixed rate is already agreed upon before a contract is made. The fee would differ in terms of the complexity of the business of the rated company and the extent of the credit assessment to be made (i.e.: survey). Likewise, pricing also varies between initial and succeeding credit ratings.[14]

To date, CRAs can utilize whatever business model will suit them. In fact, IOSCO (2008) emphasized that since the Code Fundamentals apply to all types of CRAs, it does not give prescriptions for a specific type of business models that must be utilized; hence, variations would exist depending on the legal and market frameworks that exist in a specific jurisdiction, on the firm-specific circumstance, etc. Since the Code is only serves as a guideline, every country or jurisdiction may apply only some of the principles which are applicable to them. As long as the business model does not result to potential conflicts of interests, a CRA may use whatever business model is applicable to its present circumstance.

3.3. Services Offered

Article 5 of Regulation (EU) No. 449/2012 (Regulatory Technical Standards on Information for Registration and Certification of Credit Rating Agencies) provides three (3) major classifications of credit ratings that can be provided within the EU (European Commission, 2012a):

> Any information regarding the class of credit ratings shall use the following ratings classes:
> (a) sovereign and public finance ratings;
> (b) structured finance ratings;
> (c) corporate ratings:
> (i) financial institution including credit institutions and investment firms;
> (ii) insurance undertaking;
> (iii) corporate issuer that is not considered a financial institution or an insurance undertaking.

Table 1.22 summarizes the classes of credit ratings offered by CRAs that are registered with and/or certified by ESMA, whichever is applicable. All affiliates/subsidiaries of Fitch, Moody's and S&P in the European Union are full service credit rating agencies.

As can be gleaned above, all credit rating agencies provide corporate credit rating assessments; however, the types of services provided vary across agencies. Aside from the three (3) GCRAs, only Bulgarian Credit Rating Agency and Companhia Portuguesa provide all types of corporate credit ratings. Except for AM Best, DBRS and Assekurata Assekuranz, the other companies offer "corporate issuer ratings that are not considered as FIs or insurance companies". Some of them specialize in certain market or industry. GBB-Rating, for example, offers credit ratings to medium-sized enterprises in the manufacturing, service and trading sectors[15], while Companhia Portuguesa offers credit ratings for entrepreneurial entities only. There is a wide diversity among CRAs in the provision of corporate credit ratings under the "c-iii" classification listed. Unlike other credit ratings for specific issues such as bonds,

[13] "The Rating Process". Retrieved from http://www.creditreform-rating.de/Deutsch/Rating/2_Produkte_und_Leistungen/Externes_Rating/Unternehmensrating/Rating-Prozess/index.jsp
[14] "Profil". Retrieved from http://www.assekurata.de/content.php?baseID=8
[15] "Rating Medium Companies". Retrieved from http://www.gbb-rating.de/unternehmen.htm

commercial papers or fund, Scope Credit Rating offers portfolio ratings for risks associated with a combination of investments.[16]BCRA offers other specialized credit ratings such as project ratings and the ratings for holding companies.[17]Real estate rating is offered by Creditreform Rating while medical and educational institutions' ratings are offered by JCRA. In the case of JCRA, there is no information available as to the types of credit ratings it can provide under the certification program or facility.

Table 1.22: Credit Rating Services Provided by Credit Rating Agencies in the European Union

Name of Credit Rating Agency	Corporate Ratings			Sovereign & P. Fin.		Structured Finance
	FIs	Insurance	Corporate	Sovereign	Public Finance	
Bulgarian CRA	X	X	X	X	X	
Capital Intelligence	X		X	X	X	
ICAP Group SA			X			
Euler Hermes Rating		X	X	X		
Feri EuroRating Services AG			X	X		X
Creditreform Rating			X			
Scope Credit Rating	X		X			
GBB-Rating	X		X			
Assekurata Assekuranz		X				
CRIF S.p.A.			X			
Companhia Portuguesa	X	X	X	X	X	
ERA, a.s.	X		X	X	X	
Japan CRA Ltd	X	unknown	X	X	X	X
AM Best Europe		X				
DBRS Ratings Limited	X			X		X
Fitch EU Subsidiaries	X	X	X	X	X	X
MIS EU Subsidiaries	X	X	X	X	X	X
S&P EU Subsidiaries	X	X	X	X	X	X
Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies						

Financial Institutions ratings, another type of corporate issuer ratings, are offered by most of the credit rating agencies except ICAP Group, Euler Hermes, Feri Euro, Creditreform, Assekurata, CRIF

[16]"Portfolio Rating". Retrieved from http://www.scope-group.com/creditrating/leistungsspektrum_portfoliorating
[17]"Credit Rating" Retrieved from http://www.bcra-bg.com/products.php

S.p.A and AM Best. There are also wide diversities in the types of financial institutions ratings offered by rating agencies. Some of them did not provide the type financial institutions ratings they provide in their websites. Other rating agencies offer specialized FI ratings. BCRA, Capital Intelligence and JCRA offer bank financial strength credit ratings, two credit agencies offer credit ratings of leasing companies and Companhia Portuguesa offers fund ratings.

Aside from the 3 GCRAs, only AM Best, Companhia Portuguesa, Assekurata Assekuranz and BCRA offer insurance credit ratings. Both AM Best Europe and Assekurata only offer one type of credit rating. In the case of AM Best Europe, its services are consistent with the ratings offered by its parent company and other subsidiaries. They also offer other related insurance services. Only five (5) agencies offer sovereign credit ratings (JCRA, BCRA, Feri Euro, Capital Intelligence and DBRS), aside from the subsidiaries of Fitch, MIS and S&P. Other rating agencies offer public finance ratings. Very few CRAs offer structured finance ratings. Among the GCRAs, DBRS and JCRA also offer this type of rating. The only difference between the two CRAs is the type of credit rating operations they applied in EU (JCRA got its certification while DBRS is registered to operate in the United Kingdom). Given the diversity of the services offered by its parent company, DBRS Limited offers structured finance ratings and financial institutions ratings in the Community. Feri EuroRating Services AG is the only local agency that offers commodity ratings.

The EU market is large and the diversity of the services offered by the rating agencies only proves the types of market each agency wishes to capture. One agency may offer one class of credit rating while others offer various rating classes. Many offer various types of “financial institutions and non-insurance corporate ratings.

Table 1.23 provide information on whether or not a rating agency offers unsolicited ratings. Most of the credit rating agencies provide unsolicited credit ratings. These are generally unpaid credit ratings that are undertaken for companies, governments and other institutions. This type of credit rating usually utilizes publicly available documents supplied by a third party. Although there are instances where some documents are supplied by the issuer, similar to the practice used for solicited credit ratings. Companhia Portuguesa de Rating (CPR) and Assekuratura Asserkuranz are the only CRAs that do not conduct unsolicited ratings. However, in the case of CPR, it does not discount the possibility of assigning this type of credit ratings (“Divulgações”, n.d.).

Credit rating agencies have almost similar policies as far as the assignment of this rating is concerned. EU CRAs are required to have a clear policy on this type of rating at the onset of their registration. As stated in their regulations, they should clearly disclose whether the issuer participated in the credit rating process and whether it had access to the relevant internal documents of the rated company and other related accounts. Likewise, it was also cited that it should be clearly identified in the credit rating assessment (ESMA, 2009).

The rationale behind the assignment of this rating also varies among CRAs. JCRA, for examples, believes that it will contribute to the improvement of the credit rating accuracy for a business or industry. These ratings are only published by the company with the consent of the issuer (JCRA, n.d.). The same reason is provided by DBRS (n.d.) in initiating the assignment of unsolicited rating especially if it deems that it will benefit many investors and there is a “meaningful credit market” for the said issue. However, it can assign a credit rating even without the issuer’s participation, similar to Fitch, Moody’s and S&P.

Like solicited ratings, it is provided only when there is sufficient information available to form credible opinion on the issuer’s creditworthiness. This policy is also undertaken by Capital Intelligence. In the case of GBB Rating, unsolicited rating is used for internal purposes (i.e.: benchmarking, etc.). In its effort to avoid any conflict of interest arising from its issuance of this rating, any other unsolicited credit rating that will be provided for a rated company will be disclosed to it. If the latter wishes to have its rating published and to improve its rating, the company is required to provide a rating order to the agency (GBB-Rating, 2012). Whether it is a corporate or sovereign credit rating, the assignment of this credit rating is usually undertaken with the rated company’s consent. The criteria used in arriving at a credit rating

assessment are similar to a solicited credit rating. Among the credit rating agencies that that provide this rating, only ICAP and CRIF S.p.A charge the investors or subscribers under the user-paid business models.

Table 1.23: Survey on Whether or No CRAs provide Unsolicited Ratings

CREDIT RATING AGENCY	Unsolicited Ratings
Bulgarian CRA	Yes
Capital Intelligence	Yes
ICAP Group SA	Yes
Euler Hermes Rating	Yes
Feri EuroRating Services AG	Yes
Creditreform Rating	Yes
Scope Credit Rating	Yes
GBB-Rating	Yes
Assekurata Assekuranz	No
CRIF S.p.A.	Yes
Companhia Portuguesa	No
ERA, a.s.	Yes
Japan CRA Ltd	Yes
DBRS Limited	Yes
AM Best Europe	Yes
Fitch EU Subsidiaries	Yes
MIS EU Subsidiaries	Yes
S&P EU Subsidiaries	Yes

Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies

Despite the claims of many rating agencies that they are unbiased information or opinions similar to solicited credit ratings, Poon (2003) cited that many researchers believe that they are bias and destructive to the reputation of the rated company, especially, if it uses capital market as a venue for its financing needs. This was also affirmed by Fulghieri, Strobl and Xia (2010) where they describe it as a hostile rating for a company that did not employ their services. To date, many CRAs continue to publish unsolicited ratings, as these enhance their reputation in the industry and help investors make informed decisions. As explained by the authors, the ratings implicitly increase its revenues by charging higher

fees to the company who will be willing to pay for the ratings. Their findings show that under certain conditions, unsolicited ratings are more stringent which may be associated with non-inflated ratings given.

Table 1.24 also shows the provision for ancillary services by the credit rating agencies. The IOSCO Code provides that a credit rating agency must define what it considers and does not consider as an ancillary service. Most of the credit rating agencies operating in EU provide ancillary services. Under the EU CRA Regulations, ancillary services are defined as the other services offered by CRAs, which are not parts of their credit rating activities. Specifically, Article (6) of the CRA Regulation provides that: "In addition to issuing credit ratings and performing credit rating activities, credit rating agencies should also be able to perform ancillary activities on a professional basis. The performance of ancillary activities should not compromise the independence or integrity of credit rating agencies' credit rating activities" ("Regulation EC 1060/2009", 2009).

Table 1.24: Survey on Whether or No CRAs offer Ancillary Services

CREDIT RATING AGENCY	Ancillary Services
Bulgarian CRA	Yes
Capital Intelligence	No
ICAP Group SA	Yes
Euler Hermes Rating	Yes
Feri EuroRating Services AG	Yes
Creditreform Rating	Yes
Scope Credit Rating	Yes
GBB-Rating	Yes
Assekurata Assekuranz	Yes
CRIF S.p.A.	Yes
Companhia Portuguesa	No
ERA, a.s.	Yes
Japan CRA Ltd	unknown
DBRS Limited	No
AM Best Europe	Yes
Fitch EU Subsidiaries	No
MIS EU Subsidiaries	No
S&P EU Subsidiaries	Yes

Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies

Among domestic CRAs, only Capital Intelligence and Companhia Portguesa do not provide ancillary services. It is quite striking that all the subsidiaries of Fitch Ratings and Moody's Investors Service do not provide an ancillary service. This can be ascribed from the controversies that were associated with the rating activities in many financial instruments' issuances in the past which had caused problems. These were believed to provide conflicts of interest in the provision of credit rating and ancillary services. There is a likelihood that misinterpretations regarding the composition of the ancillary services may happen, especially with the stringent regulations of EU related CRAs activities. Together with DBRS,

the two GCRAs opted not to offer ancillary services in their branches within the Community. While JCRA offers ancillary service in Japan and in the United States, information regarding the coverage of its certification for the provision of ancillary services is not also available.

To avoid any potential conflict of interest, the operational requirements for CRAs also prohibit rating agencies to give any advisory or consultancy service to rated companies or related third parties with regard to their corporate or legal structure and other related activities. Fitch Ratings (n.d.), for example, does not provide advisory and consultancy services to companies. Among the examples of ancillary services that can be provided are market forecasts, estimates of economic trends, pricing analysis and other analysis of general concerns ("Regulation EC 1060/2009", 2009). Scope Rating Agency offers ancillary services in the form of commercialization of the rating and R-cockpit software analysis. BCRA (2011) provides market analysis and scoring models/Cards services while Euler Hermes (2012) provides ancillary services in the form of industry analysis, health-quality ratings, workshops and training of analysts.

In its transparency report, ERA (2011) claimed that it provides ancillary services which are not related to the provision of advisory or consultancy services to avoid any potential conflicts of interest. A.M. Best Europe (2011), on the other hand, mentioned that it does not provide these types of services. While it provides insurance credit ratings, its credit rating business is totally separate from related services it provides to insurance companies such as news services, data products, publications and etc.

3.4. The Rating Process

a. Persons Involved

The assignment of analysts in a credit rating process is critical to the success of the rating assessment. Table 1.25 indicates that most credit rating agencies use a team approach in assigning credit rating projects. Usually, a team of at least two analysts is responsible in conducting a credit rating. The primary analyst conducts the analysis or rating assessment and the lead analyst or the team leader verifies the work of the former before it is presented to the rating committee. This approach using peer analysis is effective in ensuring that the credit rating is at par with the standards set by the agency for a specific class of rating and it complies with the regulations and the laws in a jurisdiction where it operates within the EU.

Each credit rating agency has its own policies in the selection of the Rating Committee. For large or global CRAs, they have complex selection processes compared to small- or medium-sized rating agencies. Standard and Poor's Rating Services (2012c) have Voting Analysts who are empowered to vote a Rating Committee Chairperson, while the latter can vote in a rating committee and can also be assigned as a primary or lead analyst, as long as it does not serve as the primary analysts of the rated issuer. If he is in the committee, he should not serve as the chairperson. This is understandable as conflicts of interest may arise which can potentially undermine the objectivity of the rating decision.

DBRS, for example, assigns a lead analyst and a back-up analyst, while CRIF S.p.A. assigns a team of an analyst and a supervisor. Stringent measures are also undertaken by GBB-Rating where a lead analyst conducts the initial rating. Another analyst from Data Control Department and a Project Supervisor are assigned to check the work done by the former. On the other hand, ICAP group and Capital Intelligence assign only an analyst to conduct the initial rating. ICAP Group's analyst makes the final decision of the credit rating and the latter is submitted to the head analyst (supervises the rating process and approves the credit ratings) who will either agree or disagree with the analyst's decision. Upon the agreement by the head analyst, he will begin to input the rating in the agency's database together with the corresponding justifications and notifies the company about the rating. The Rating Committee is not involved in a typical credit rating process except if there are disagreements between the two parties or in relation to merger-related credit rating merger (ICAP Group, 2012). The rating process is quite unique for European Rating Agency as it is done by an analyst, senior analyst and chief analyst. Only the analyst and senior analysts are the ones involved before the credit rating recommendation is

presented to the Rating Committee. The same applies with Feri EuroRating where there are three members of the rating committee, namely the rating analyst who is responsible for the issuance of a rating, a senior rating analyst and another employee who has the related expertise and experience or anyone who is not involved

In order to eliminate subjectivity or conflicts in the rating process, the credit rating assessment is presented to the Rating Committee or Authorities who will decide on the final credit rating. For most of the CRAs, rating decisions are undertaken by the rating committee as shown in Table 1.25. Some credit rating agencies' rating committees are either a team of board of directors and senior analysts (Euler Hermes), senior officers (AM Best), expert accountants and managing director (GBB-Rating), senior rating analysts and external experts (Assekurata)[18] or senior analysts who are not involved in the credit rating. With regards to the European Rating Agency (2011), the rating committee comprises a team of 2 to 5 individual experts who are neither connected with the agency or nor employees. The same concept in the assignment a rating committee applies to Creditreform Rating (2011) where the Board heads the Committee together with the qualified representatives of the agency and an independent member, if possible. In the case of Companhia Portuguesa de Rating (2011), on the other hand, the Rating Committee comprises the members of its Executive Board except the Director of the commercial unit. Capital Intelligence (2012) has separate rating committees for bank and sovereign ratings and for corporate ratings.

It can be deduced that the assignment of a Rating Committee will vary from one company to another. The number of people assigned to undertake this task may also vary depending on the specific circumstance of the company (i.e: manpower complement) or the complexity of the rating project (structured finance vs. traditional finance, mergers or business combinations, industry, etc). Usually, the credit rating process that will be applied for the different types of ratings or sectors are almost the same, as it will be discussed in Table 1.26 below. Its objective is to generate unbiased assessment of the issuer's creditworthiness since the people assigned in the committee are believed to be experts and can make rating decisions based on the agency's rating procedures and policies.

Table 1.25: Rating Process – Assignment of Analyst and Rating Committee

	Assignment of Analyst	**Person/Group Responsible for making a Rating Decision**
Bulgarian CRA	Team of Analysts	Rating Committee
Capital Intelligence	Analyst	Rating Committee
ICAP Group SA	Analyst	Rating Committee
Euler Hermes Rating	Team of Analysts	Rating Committee
Feri EuroRating Services AG	Analytical Team	Rating Committee
Creditreform Rating	Team of Analysts	Rating Committee
Scope Credit Rating	Rating Team	Rating Committee
GBB-Rating	Team of Analysts	Rating Committee
Assekurata Assekuranz	Team of Analysts	Rating Committee
CRIF S.p.A.	Team of Analysts	Rating Committee
Companhia Portuguesa	Analyst/(s)	Rating Committee
ERA, a.s.	three level analyst	Rating Committee
Japan CRA Ltd	rating team*	Rating Committee
AM Best Europe	Team of Analysts	Rating Committee

[18]"Beurteilung". Retrieved from http://www.assekurata.de/content.php?baseID=219

DBRS Ratings Limited	Team*	Rating Committee
Fitch EU Subsidiaries	Team of Analysts	Rating Committee
MIS EU Subsidiaries	Team of Analysts	Rating Committee
S&P EU Subsidiaries	Team of Analysts	Rating Committee
Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies		

b. The Rating Process

Credit rating assessments and credit scorings may vary among CRAs; however, the EU CRA regulations clearly indicate the necessity of maintaining credit rating quality within the Community. Section (11) of the CRA Regulations provides the following on data quality:

> It is necessary to lay down a common framework of rules regarding the enhancement of the quality of credit ratings, in particular the quality of credit ratings to be used by financial institutions and persons regulated by harmonised rules in the Community. In the absence of such a common framework, there is a risk that Member States take diverging measures at national level having a direct negative impact on, and creating obstacles to, the good functioning of the internal market, since the credit rating agencies issuing credit ratings for the use of financial institutions in the Community would be subject to different rules in different Member States. Moreover, diverging quality requirements as regards credit ratings could lead to different levels of investor and consumer protection. Users should, furthermore, be able to compare credit ratings issued in the Community with credit ratings issued internationally. ("Regulation (EC)", 2009)

This implies that all credit rating agencies operating within the EU should be subjected to a common standard. The ratings issued on the financial instrument or issuer may impact not only on the markets in one country but also in other markets or jurisdiction within the Community, since they can also provide services in any country within the EU.

As shown in Table 1.26, most of the credit rating agencies have the same "credit rating processes". In most instances, the complexity of the rating process would depend on the asset class (i.e.: traditional product ratings versus structured finance product ratings), the diversity of the rated firm's business and other factors. Likewise, the business model may also dictate the rating procedure used, such that unsolicited ratings may demand lesser work or procedures (i.e.: meetings and interviews/surveys with company management) compared to solicited ratings. However, some of these CRAs are contracted by by the user or investor to undertake a credit rating for specific companies or issuers. As part of their rating process, they also conduct interviews with the management of the rated company to verify their findings and provide accurate credit ratings. Other rating agencies will arrange a meeting with the company or provide them the results of the unsolicited ratings before they release the same for dissemination (i.e.: ICAP Group, GBB Rating, etc.), either on a private or public basis.

Except for BCRA, ICAP and Capital Intelligence, CRAs normally start the credit rating assessment with the issuer or its dealer/investment banker contacting the credit rating agency to conduct a credit rating. The credit rating agency's representative and the company will meet to formalise the credit rating services to be provided and discuss the terms and conditions of the contract and the fees for the services (to be dealt with the CRAs marketing or business section). Once a contract have been agreed upon, the CRAs marketing office will coordinate with the CRA Analytical or Credit Group Head about it. The latter will assign a credit rating team that will undertake the project and discuss with them how the credit rating will be undertaken (deadlines/timeframes, expectations, etc.). They will serve as the primary contact of the rated company and the people responsible in the preparation of the rating assessment.

The rated company will be contacted and sent a list of information regarding the documents and information that the agency needs. This usually applies to solicited credit ratings; however, there are instances where some credit rating agencies already seek data from the issuer even for unsolicited credit ratings. If the company refuses to provide the pertinent information, the rating agency will relyon publicly available documents. The agency will indicate in the report whether or not the company participated in the rating process for unsolicited credit ratings. A meeting with the client will also be arranged by the team of analysts to conduct rating interviews or surveys.

Table 1.26: Rating Processes Employed by the Credit Rating Agencies

	Initial Contact by the Issuer	Letter of Engagement	Selection of Analysts	Collection of Data	Meeting with Company	Draft Report & Rating Proposal	Presentation with the Rating Committee	the Company of the Credit Rating	Rating Appeal	Final Report	Announcement
Bulgarian CRA[19]	X	X	X	X	-	X	X	X	X	X	X
Capital Intelligence	X	X	X	X		X	X	X	X	X	X
ICAP Group SA				X		X	X	X	X	X	X
Euler Hermes Rating	X	X	X	X	X	X	X	X	X	X	X
Feri EuroRating Services AG	X	X	X	X	X	X	X	X	X	X	X
Creditreform Rating	X	X	X	X	X	X	X	X	X	X	X
Scope Credit Rating	X	X	X	X	X	X	X	X	X	X	X
GBB-Rating	X	X	X	X	X	X	X	X	X	X	X
Assekurata Assekuranz	X	X	X	X	X	X	X	X	X	X	X
CRIF S.p.A.				X		X	X	X	X	X	X
Companhia Portuguesa	-	-	-	-	-	-	-	-	-	-	-
ERA, a.s.	X	-	-	X	X	X	X	X	X	X	X
Japan CRA Ltd	X	X	X	X	X	X	X	X	X	X	X
AM Best Europe	X	X	X	X	X	X	X	X	X	X	X
DBRS Ratings Limited	X	X	X	X	X	X	X	X	X	X	X
Fitch EU Subsidiaries	X	X	X	X	X	X	X	X	X	X	X

[19] "Process for Preparing a Credit Rating" Retrieved from: http://www.bcra-bg.com/process.php

MIS EU Subsidiaries	X	X	X	X	X	X	X	X	X	X	X
S&P EU Subsidiaries	X	X	X	X	X	X	X	X	X	X	X

Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies

Note: The procedures shown above may not come in the same order.

It must be noted however, that the chronology of the rating process may vary across credit rating agencies. One thing about it is that once a decision is made by the committee, the decision to publish the said rating will depend on the rated company. Once the pertinent information is gathered, the analyst can already proceed with the analysis and will prepare a draft which shall be checked by a supervisor or the team leader. There may be instances where the interview or survey will be undertaken immediately after the initial draft is made. Sometimes, another or series of meetings will be arranged by the team.

A group of experts, which is called the Rating Committee, will be convened to debate and vote on the approval of the credit rating. In most cases, the majority decides the assessment and the committee will reach to a final conclusion. The practice is different for Assekurata where all members of the committee must unanimously agree on a rating decision.[20] Once the approval is made, the result of the credit rating is communicated to the company to give them opportunity to dispute any potential errors or omissions in the credit rating. If there are no errors or problems, the final report is submitted to the client and its publication will be made upon the instruction of the issuer (see Table 1.29 on rating disclosure). Since the issuers paid for the credit rating, they have prerogative in deciding whether the credit report shall be published or kept confidential or private.

As shown in Table 1.27, all CRAs have policies for the different methodologies and models used in their credit rating assessments for each asset class. This practice is critical because it will guide analysts in the preparation of credit reports and the top management will be able to verify whether the methodologies and models were consistently applied for that particular type of credit rating. The credit rating agencies also publish the aforementioned policies on the rating procedures, methodologies and/or models. This is imperative because it will provide vital information to the investor, issuers and the market participants. Issuers will be able to judge the quality of the rating process and to choose which among the CRAs it will deal with for its credit rating assessment. Investors can determine the robustness of the rating process and be able to make informed decisions from a wide range of portfolio of investments available to them. While a single set of methodologies and models does not apply in the analysis used for all types of credit ratings, regulators, on the other hand, can verify if the CRA is undertaking what it has committed.

This practice is in line with the EU CRA Regulation which requires credit rating agencies to document and disclose the rating methodologies by prominently publishing them in their webpage. This regulation requires CRAs to ensure that sufficient information is provided. Second, they are also required to indicate in their credit rating reports the appropriate information about the rating procedures, methodologies, models and relevant key assumptions that were used by the analyst or team of analysts, considering that these are the key elements underlying a credit rating. As contrasted to the first requirement that relates to the company's specific policies involving methodologies and models which are used in the rating process for each credit rating class, the second disclosure requirement relates to the ones that were actually utilized to produce a credit rating assessment which is indicated in the credit rating report.

Article 8 of the EU CRA Regulations (2009) indicates that "A credit rating agency shall disclose to the public the methodologies, models and key rating assumptions it uses in its credit rating activities as defined in point 5 of Part I of Section E of Annex I." Likewise, when they publish a credit rating, the

[20] "Beurteilung" Retrieved from http://www.assekurata.de/content.php?baseID=219

methodology that was used must be clearly indicated in the credit rating assessment. This is underscored in Section D 2(b) on the Rules on the Presentation of Credit Ratings as follows:

> ...the principal methodology or version of methodology that was used in determining the rating is clearly indicated, with a reference to its comprehensive description; where the credit rating is based on more than one methodology, or where reference only to the principal methodology might cause investors to overlook other important aspects of the credit rating, including any significant adjustments and deviations, the credit rating agency shall explain this fact in the credit rating and indicate how the different methodologies or these other aspects are taken into account in the credit rating (ESMA, 2009);

Table 1.27: Practices on Policies related to Rating Methodologies/Models Used and to the Use and Disclosure of the Methodologies/Models and the Key Assumptions in the Preparation of a Credit Rating

	Policies Related to Rating Methodologies and Models		Policies Related to the Preparation of Credit Rating			
	Existence of Policies	Disclosure of Documented Policies	Use of Appropriate Methodologies/Models	Disclosure of Methodologies/Models Used	Use of Key Assumptions	Disclosure of Key Assumptions used in the credit rating
Bulgarian CRA	Yes	Yes	Yes	Yes	Yes	-
Capital Intelligence	Yes	Yes	Yes	-	-	-
ICAP Group SA	Yes	Yes	Yes	-	-	-
Euler Hermes Rating	Yes	Yes	Yes	Yes	Yes	Yes
Feri EuroRating	Yes	Yes	Yes	Yes	Yes	Yes
Creditreform Rating	Yes	Yes	Yes	Yes	Yes	Yes
Scope Credit Rating	Yes	Yes	Yes	-	-	-
GBB-Rating	Yes	Yes	Yes	Yes	Yes	Yes
Assekuratura Assekuranz	Yes	Yes	Yes	Yes	Yes	Yes
CRIF S.p.A.	Yes	Yes	Yes	Yes	Yes	Yes
Companhia Portuguesa.	Yes	Yes	Yes	-	-	-
ERA, a.s.	Yes	Yes	Yes	Yes	Yes	Yes
Japan CRA Ltd	Yes	Yes	Yes	Yes	Yes	Yes

AM Best Europe	Yes	Yes	Yes	Yes	Yes	Yes
DBRS Ratings Limited	Yes	Yes	Yes	-	-	Yes
Fitch EU Subsidiaries	Yes	Yes	Yes	Yes	Yes	Yes
MIS EU Subsidiaries	Yes	Yes	Yes	Yes	Yes	Yes
S&P EU Subsidiaries	Yes	Yes	Yes	Yes	Yes	Yes
Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies						

Credit rating agencies also use underlying assumptions in the preparation of a credit rating report and correspondingly include them, together with the methodologies and models, in their credit rating reports (refer to Table 1.27) Generally, they are required to explain how certain assumptions were used in the preparation of the credit rating, including any sensitivity analysis of the key assumptions (i.e.: mathematical or correlation assumptions).

Table 1.28: Policies on whether or not CRAs use Rigorous Methodologies and Qualitative and/or Quantitative Analyses/Data in the Rating Process

	Use of Rigorous Methodologies/Models	Use of Qualitative Analysis	Use of Quantitative Analysis
Bulgarian CRA	X	X	X
Capital Intelligence	X	X	X
ICAP Group SA	X	X	X
Euler Hermes Rating	X	X	X
Feri EuroRating	X	X	X
Creditreform Rating	X	X	X
Scope Credit Rating	X	X	X
GBB-Rating	X	X	X
Assekurata Assekuranz	X	X	X
CRIF S.p.A.	X	X	X
Companhia Portuguesa.	X	X	X
ERA, a.s.	X	X	X
Japan CRA Ltd	X	X	X
AM Best Europe	X	X	X
DBRS Ratings Limited	X	X	X
Fitch EU Subsidiaries	X	X	X
MIS EU Subsidiaries	X	X	X
S&P EU Subsidiaries	X	X	X

Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies

Most of the credit rating agencies usually provide news publications or press releases and other pertinent reports to inform their clients about a credit rating that is issued and clearly state the underlying reasons behind the derivation of the said rating. Japan Credit Rating Agency (2012), for example, discloses its procedures, methodologies and underlying key assumptions to enable third parties such as investors, readers, analysts, etc. to know how it derives the rating assessments. Among the salient information it publishes are the rating categories and their corresponding meanings, default rates, and the length of time it takes the agency to arrive at a decision. DBRS, for instance, prominently displays its rating methodologies for each type of asset, issuance, industry or specific sector (i.e.: methodologies for rating companies belonging to the industries such as airline, onshore oil and gas drilling, Canadian grain-handling or whichever is applicable). It incorporates a very comprehensive report (both quantitative and qualitative) of the rating process including the different stages in the preparation of a credit rating report. It aims to give information how the ratings are derived to help market participants in understanding the rating processes and perform due diligence in making an assessment on whether to rely or not in the credit ratings issued by the agency (2012).

This process enables the market participants to evaluate whether they can utilize the rating in making investment or analytical decisions. It is believed that rating transparency is usually associated with the transparency of the rating agencies' internal processes. It was indicated that despite its aim of increasing the transparency of the rating and its process, the EU CRA regulation (2009) stipulates that as far as models are concerned, the disclosure of information should not take into account the provision of sensitive business information. In an attempt to increase transparency, the qualities of disclosure that the credit rating agencies provide are already manifestations of their commitment to improve their services. This is confirmed by ESMA (2012a) in its report which suggests that credit rating agencies should provide the maximum transparency level through a comprehensive disclosure of methodologies, key assumptions and the models used in deriving the credit rating assessment.

All credit rating agencies cited that the methodologies and models that they use are rigorous. Whether the credit ratings are undertaken to serve the national or international markets, the methodologies used by CRAs are still systematic, rigorous and are subject to validations using historical experience. As can be gleaned In Table 1.28, all credit rating agencies mentioned that they use both quantitative and qualitative analytical techniques in the assessment of the creditworthiness of the firm or the issuer.

Since the regulation mandates that neither ESMA nor any competent authority does not have the authority to interfere with the content and the methodologies/models that are used in the credit rating assessments made by the CRAs, the latter have the responsibilities in ensuring that assessment methods are rigorously and are either of par or surpass the national or international standards. This non interference by the respective authorities can be viewed as a way of providing the levelling the playing field within the industry. This will enable a credit rating agency to identify, design and update its methodologies or the models that it uses in the rating process. In fact, incorporated in the EU Commission's mandate on CRA Regulations that a credit rating agency must consistently apply or use the methodologies and/or models based on what is defined in their policies and procedures, including the applicable changes that are made.

c. *Disclosure of Rating Actions*

Table 1.29 provides the forms of media or communications used by CRAs to disseminate the credit rating results to the public. For most of the companies, credit ratings are publicly available in the respective CRA's website. Included in the assessment are the rating methodologies, models and/or key assumptions that were used in the preparation of the said report, whichever is applicable. In most instances, they are prominently published in the agency's websites for a maximum of 12 months from the

date of its publication or posting. This practice used by Creditreform (2011), ERA, BCRA, and other rating agencies provides the issuer the opportunity to have its ratings available to the public for free.

As mentioned earlier, the dissemination of the rating report is done with the consent of the client. For the other rating agencies that utilize the "user-pays business model", such as ERA, the rated company's rating is still published as long as the latter agrees to it. DBRS (n.d.) and JCRA (n.d.), for example, publish final credit rating assessments not only in the website but also through press/news releases. The benefits of electronic communication media provided credit rating agencies with other alternatives that they can harness. Among these communication media are the Bloomberg, Reuters, Euronext, Telerate, and other forms (these are employed by DBRS, AM Best, Companhia Portuguesa, MIS, Fitch and S&P EU entities) which are used to announce a new credit rating or provide revised credit ratings for any amendments that were made on a previously published report, in the form of news releases. Companhia Portuguesa, for instance, also utilizes other forms such as email, media, Euronext, public reports, newswire and other data providers or vendors ("Passos da").

Table 1.29: Policies of the Disclosure or Enforcement of Credit Ratings by the CRAs

Credit Rating Agency	Enforcement of Rating
Bulgarian CRA	Company Website
Capital Intelligence	Company Website, News Media, Electronic and Print Services
ICAP Group SA	Company Website, any other available mean
Euler Hermes Rating	Company Website
Feri EuroRating Services AG	Company Website
Creditreform Rating	Company Website
Scope Credit Rating	Company Website, Press/Analysis Releases, Newsletter
GBB-Rating	Company Website
Assekurata Assekuranz	Company Website, Press Release
CRIF S.p.A.	Company Website
Companhia Portuguesa	Company Website, email, media, Euronext, public report, company/subscriber
ERA, a.s.	Company Website
Japan CRA Ltd	Company Website, News Release, media
AM Best Europe	Company Website, Press Releases, and other diff data providers and new vendors
DBRS Ratings Limited	Company Website, newswire and other electronic and print services
Fitch EU Subsidiaries	Company Website, News Release, media
MIS EU Subsidiaries	Company Website, and other diff data providers and new vendors
S&P EU Subsidiaries	Company Website, newswire and other electronic and print services
Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies	

It must be noted, however, that they do not disclose credit ratings that are classified as private placements/transactions, as the rating services and/or the reports were paid for by these companies or organization for their own use. DBRS, for instance, conducts its own credit rating assessments for internal use as part of the agency's regular activities (2012). As far as Scope Credit Rating is concerned, it publishes most of its credit ratings in the website; there are instances where they are also disseminated through press or news releases. On the other hand, when a user pays the CRA for the services (i.e.: Companhia Portuguesa), the rating is only published in the subscriber's website or a pin is given to the company or the contractor to access the CRA's website for that particular rating/(s) until the duration of its subscription expires. For many CRAs, the credit rating is published for one year until the rating contract expires or a subsequent rating is conducted.

Table 1.30 summarizes the EU CRAs' practices in the review of the credit rating. All credit rating agencies conduct regular credit rating reviews, as mandated by the CRA Regulation, until the rating is withdrawn or renewed. It must be noted that an EU credit rating agency is required to review the ratings that were made as part of its oversight or surveillance activities. Section 23 of the CRA Regulation provides the obligations of the credit rating agencies to monitor the credit rating on an ongoing basis and to review the said rating at least once a year ("Regulation (EC)", 2009). Most of the credit rating agencies comply with the annual requirement review while for others, the review frequency varies. For ICAP Group (2012), the review process for solicited ratings is undertaken once a year while the review for unsolicited rating is done at least twice a year. However, aside from the regular review, they also conduct review process upon the receipt of a written request from the client to review its rating. Companhia Portuguesa has separate review process for short-term issue ratings (at least two times a year) and for long term issuances (once a year). Only ERA conducts the credit rating reviews every quarter. The role of the credit rating agency in conducting this surveillance is emphasized to check any material changes that are critical in the assessment such as company-specific events, event-specific developments (i.e. market conditions) or the revision of the rating criteria, and the key assumptions or models used.

Table 1.30: Policies Related to the Review of the Credit Ratings

Credit Rating Agency	Review of Ratings	Frequency of Review
Bulgarian CRA	Yes	Regularly
Capital Intelligence	Yes	Annually (every 12 months)
ICAP Group SA	Yes	Periodically; and at least Twice a year for Unsolicited Credit Ratings
Euler Hermes Rating	Yes	Periodically
Feri EuroRating Services AG	Yes	Regularly
Creditreform Rating	Yes	Annually (every 12 months)
Scope Credit Rating	Yes	Annually
GBB-Rating	Yes	Annually
Assekurata Assekuranz	Yes	Regularly
CRIF S.p.A.	Yes	Annually
Companhia Portuguesa	Yes	Twice a year for Short Term Instruments; Once a year for LT/MT Instruments
ERA, a.s.	Yes	Quarterly monitoring
Japan CRA Ltd	Yes	Periodically
AM Best Europe	Yes	Annually

DBRS Ratings Limited	Yes	Annually
Fitch EU Subsidiaries	Yes	Annually
MIS EU Subsidiaries	Yes	Annually
S&P EU Subsidiaries	Yes	Annually
Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies		

In most instances, the rating review is undertaken by the same analyst or team of analysts that were initially assigned to the credit rating project. This monitoring exercise enables the CRA to adjust the rating by either downgrading or upgrading the initial rating issued as a result of these developments. This also promotes transparency which allows the market to judge the performance of the rating that was initially issued.

3.5. Internal Control Mechanism

Table 1.31: Policies Related to the Company's Code of Conduct

Name of the Credit Rating Agency	Existence of CoC	Enforcement of Code of Conduct	Name of the Code of Conduct
Bulgarian CRA	Yes	Employees & Company	Code of Professional Conduct
Capital Intelligence	Yes	Employees & Company	Code of Business Conduct; Code of Ethics
ICAP Group SA	Yes	Employees & Company	Code of Conduct
Euler Hermes Rating	Yes	Employees & Company	Code of Conduct
Feri EuroRating Services AG	Yes	Employees & Company	Code of Conduct
Creditreform Rating	Yes	Employees & Company	Code of Conduct
Scope Credit Rating	Yes	Employees & Company	Code of Conduct
GBB-Rating	Yes	Employees & Company	Code of Conduct
Assekurata Assekuranz	Yes	Employees & Company	Code of Conduct
CRIF S.p.A.	Yes	Employees & Company	Code of Conduct
Companhia Portuguesa	Yes	Employees & Company	Code of Conduct
ERA, a.s.	Yes	Employees & Company	Code of Conduct; Employee Code of Ethics
Japan CRA Ltd	Yes	Employees & Company	Code of Conduct
AM Best Europe	Yes	Employees & Company	Code of Conduct
DBRS Ratings Limited	Yes	Employees & Company	Business & Employee Code of Conduct
Fitch EU Subsidiaries	Yes	Employees & Company	Code of Ethics; Code of Conduct
MIS EU Subsidiaries	Yes	Employees & Company	Codes of Conduct (Code of Business Conduct and MIS Code of Professional Conduct)

S&P EU Subsidiaries	Yes	Employees & Company	Code of Conduct
Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies			

All credit rating agencies have articulated Codes of Conduct. Others (Capital Intelligence, ERA and DBRS) have separate Codes of Conduct for the business and its employees (please refer to Table 1.31). As mentioned earlier, the EU CRA regulation does not impose CRAs to formulate their own Code of Conduct and enforce the same within the organization. However, as can be gleaned in Table 1.31, all credit rating agencies complied with the call by ESMA and indicated that their respective Code of Conduct was formulated in consistent with the international Code issued by IOSCO
.

The IOSCO Code of Conduct Fundamentals specifies that while its compliance is not mandatory, the participation by CRA management is crucial to ensure that their implementation is made through the provision of compliance and enforcement mechanisms (The Technical Committee of the IOSCO, 2008). This is what the EU CRAs did and to ensure transparency of their activities, they also publish their Code of Conduct in their respective website (see Table 1.32 below). To date, the Credit Rating Agencies' Codes of Conduct are strictly being enforced within the organization and followed by the employees.

Table 1.32: Policies Related to the Publications and Review of the CRAs' Code of Conduct

Credit Rating Agencies	Publication of Code of Conduct	Review of Code of Conduct
Bulgarian CRA	Yes	Yes
Capital Intelligence	Yes	Yes
ICAP Group SA	Yes	Yes
Euler Hermes Rating	Yes	Yes
Feri EuroRating Services AG	Yes	Yes
Creditreform Rating	Yes	Yes
Scope Credit Rating	Yes	-
GBB-Rating	Yes	Yes
Assekurata Assekuranz	Yes	Yes
CRIF S.p.A.	Yes	Yes
Companhia Portuguesa	Yes	-
ERA, a.s.	Yes	Yes
Japan CRA Ltd	Yes	Yes
AM Best Europe	Yes	-
DBRS Ratings Limited	Yes	Yes
Fitch EU Subsidiaries	Yes	Yes
MIS EU Subsidiaries	Yes	Yes
S&P EU Subsidiaries	Yes	Yes
Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies		

Since all the registered credit rating agencies adopted the IOSCO Code of Conduct Fundamentals and incorporated the said Code in their own CoCs, they are also required to publish them. Table 1.32 summarizes the results on whether they publish and review their Codes of Conduct. All CRAs

publish their respective CoC which is prominently displayed in their respective websites. They also provide brief information about it in their leaflets and other print media. This practice serves as a means by which a credit rating agency can implicitly show its commitment towards the adoption and enforcement of the said Code. This way, market participants can better judge if they are adhering to and enforcing the Code published in their websites.

Likewise, many credit rating agencies also conduct a periodic review of their Codes of Conduct (see Table 1.32). In the case of DBRS, it conducts the review on an ongoing basis. Usually, a specific department or section is assigned to conduct the review process (i.e.: ICAP Group's Internal Audit Department reviews its Code while the CRA Executive Committee reviews CRIF S.p.A.'s Code).

A credit rating agency's compliance function is regarded as a natural extension of the governance which is usually included in the duties and responsibilities of the CRA's top management and Board of Directors. Table 1.33 depicts that all credit rating agencies have a compliance function that is independent from the agency's commercial activities and from the analytical department or section provides credit ratings. This is undertaken to come up with an unbiased, just and effective enterprise-wide compliance evaluation of the different aspects of the agency's business.

Different credit rating agencies have different compliance set-ups. For most of the CRAs, the compliance function undertaken by a Compliance Officer who reports directly to the management of the company, as can be gleaned in Table 1.34. Usually, it is a "one man" department or unit with a Compliance Officer functioning independently in performing his duties and responsibilities.

Table 1.33: Policies Related to the Compliance Function of the Credit Rating Agencies

Credit Rating Agencies	Existence of an Independent Compliance Function	Existence of a Compliance Department
Bulgarian CRA	Yes	None
Capital Intelligence	Yes	-
ICAP Group SA	Yes	None
Euler Hermes Rating	Yes	None
Feri EuroRating	Yes	None
Creditreform Rating	Yes	None
Scope Credit Rating	Yes	None
GBB-Rating	Yes	None
Assekurata Assekuranz	Yes	None
CRIF S.p.A.	Yes	Yes
Companhia Portuguesa.	Yes	None
ERA, a.s.	Yes	None
Japan CRA Ltd	Yes	Yes
AM Best Europe	Yes	Integrated
DBRS Ratings Limited	Yes	Yes
Fitch EU Subsidiaries	Yes	Yes

MIS EU Subsidiaries	Yes	Yes
S&P EU Subsidiaries	Yes	Yes
Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies		

However, larger credit rating agencies have compliance department or division responsible for the compliance function. Only foreign CRAs have a department, group or unit that is responsible for the overall compliance activities of the agency. A compliance department typically has staff and compliance officers responsible for a particular business unit or branch who reports to the Chief Compliance Officers. Fitch Inc. and Standard and Poor's have a global compliance group that is responsible for the compliance activities while Moody's, JCRA and DBRS have compliance department at the head office which is responsible for the said function. Since JCRA does not have an office in any EU country for its certification or license, therefore the compliance department is responsible for the compliance of the organization and its employees with the policies, regulations and the Code of Conduct. In the case of AM Best Europe, the compliance function runs as an integrated function across the AM Best business worldwide. Fitch (2012), for instance, has Global Compliance Group that is responsible for the agency's compliance activities, thereby ensuring that the group of companies and its employees conform to its policies and Code of Conduct and manages conflicts of interest issues, etc. In the case of ICAP Group S.A. (2012), the Supervisory Board is responsible for the compliance function which is independent from the CRA's other business activities.

Table 1.34: Policies on the Implementation of the Compliance Function by Credit Rating Agencies

Credit Rating Agencies	Person Responsible	Reporting Lines
Bulgarian CRA	Conformance Supervisor	Superintendent of Conformance
Capital Intelligence	Compliance Officer	Managing Director and Other members of Supervisory Committee
ICAP Group SA	Compliance Officer	Supervisory Board and BOD
Euler Hermes Rating	Compliance Officer	Management Board
Feri EuroRating Services AG	Compliance Officer	BOD and the independent members of the Supervisory Board.
Creditreform Rating	Compliance Officer	Supervisory and Executive Board
Scope Credit Rating	Compliance Officer	Unknown
GBB-Rating	Chief Compliance Officer	Board of Managing Directors
Assekurata Assekuranz	Compliance Officer	Not specified
CRIF S.p.A.	Compliance Officer	CRA Executive Committee
Companhia Portuguesa	Chief Analyst	Not specified
ERA, a.s.	Compliance Officer	BOD and Supervisory Board
Japan CRA Ltd	Chief Compliance Officer	Supervisory Committee
AM Best Europe	Compliance Officer	CEO and BOD
DBRS Ratings Limited	Compliance Officer	President
Fitch EU Subsidiaries	Regional Compliance Officer	Chief Compliance Officer

MIS EU Subsidiaries	Compliance Officer	Designated Compliance Officer/Global Chief Regulatory and Compliance Officer
S&P EU Subsidiaries	Compliance Officer	Chief Compliance Officer/Global Chief Compliance Officer
Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies		

The appointment of a Compliance Officer is critical to the success of its compliance function. Table 1.34 shows that all credit rating agencies have a Compliance Officer who is responsible for the independent compliance function of the company, its employees and other tasks that may be assigned to him. Some companies, such as GBB-Rating and JCRA, have Chief Compliance Officers (CCO), respectively, and for other companies such as BCRA (2012), a Conformance Officer is appointed for it and will be responsible in ensuring that the company and its employees strictly comply with the regulations and policies related to its credit rating functions and activities. Likewise, he also administers and monitors any potential conflicts of interest involving employees' activities and the company and its clients.

Fitch's EU entities' compliance function is undertaken by the Regional Compliance Officer who reports directly to the Chief Compliance Officer at the company's home office. He ensures that the company and the employees adhere with its Code of Ethics, the EU Regulatory Compliance and monitors any personal conflict of interest issues (2012). With regards to the different companies of S&P (2012), the Global Compliance Officer monitors the overall compliance by each of its company operating worldwide and its employees' compliace with the agency's policies and procedures and its Code of Conduct. For its EU operations, it has a Compliance Officer in each of the three companies who is responsible in the overall compliance function. Each of the EU companies of Moody's Investors Service (2011) has a Compliance Officer who reports directly to the Designated Compliance Officer (DCO) for its EMEA operations. Since the EU Compliance Department is integrated in the Global MIS Compliance Department, the Designated Compliance Officer reports to the Senior Compliance Officer who is apparently the Head of Compliance of the organization. With this kind of structure and reporting lines, any decisions that are related to business practices within the region are handled by its EU Compliance Department, which shall be uniform for all MIS companies. Likewise, any changes in the EU CRA regulatory framework must be communicated with the Head of Compliance. This way, there is standardized or common practices across all MIS entities. The same applies with other global CRAs such as Fitch, JCRA and S&P, where the Compliance Head at the main office shall oversee the overall adherence by each entity or business unit to the organization's policies and procedures and the regulatory framework at the jurisdiction where an entity operates.

The European Rating Agency (ERA), on the contrary, has appointed the Chief Analyst to monitor the compliance function. While the compliance with the company's code of conduct is not a requirement under EU CRA Regulations, the Compliance Officer still monitors compliance by the company and its employees with its Code of Conduct, which is in line with the Code Fundamentals issued by IOSCO (ESMA, 2009).

Generally, EU credit rating agencies have clear and almost common definition of the compliance functions and how they should be undertaken within the organization. It was clear that the appointed Compliance Officer has primary responsibility for managing compliance and other control functions as outlined in the CRA's policies and procedures. Moreover, Table 1.34 above shows that mixed results were generated for the reporting line of the compliance function since there is diversity among the CRA's activities and organization. As mentioned earlier, the four US Based CRAs (Fitch, Moody's, S&P, AM Best) have Compliance Officers (CO) who are assigned to each CRA office operating in one jurisdiction and reports directly to a senior officer or committees based at the agency's headquarters. Like the four GCRAs, Japan Credit Rating has also a Chief Compliance Officer who reports directly to the Supervisory Committee, while the Compliance Officer of ICAP Group reports to the Supervisory Board and the Board of Directors. In CRIF S.p.A. and Capital Intelligence, the CO reports to the Executive Committee, the

Managing Director and other members of the Supervisory Committee. This is also being practiced by Creditreform Rating (2011) where its Compliance Officer reports to the Supervisory and Executive Board regarding the compliance by the agency and its employees' with the policies and credit rating procedures in accordance with EU Regulations. The Compliance Officer of DBRS reports directly to the President and is responsible for overseeing the administration of the agency's compliance measures.

For the other seven locally domiciled companies, they also have their respective Compliance Officer who is responsible not only in monitoring compliance with the provisions of the Company's code of conduct but also the compliance with applicable CRA laws and regulations of the Community. For European Rating Agency (2011), the Compliance Officer reports to the agency's SR in relation to the adherence by the employees and the agency of its Code of Conduct and to its regulatory compliance. He checks if the plan and implementation by the credit department's review process were done in accordance with its policies and Code.

It must be noted that a Compliance Officer's responsibility is not only limited to overseeing the implementation of the compliance with the company's policies and Code of Conduct and/or its internal and EU regulations, but he is also expected to provide guidance to the employees regarding these issues. This explains why the qualification requirements for a Compliance Officer are high. Bulgaria Credit Rating Agency, on the other hand, has appointed a conformance supervisor to monitor the employees' compliance with the standards set by the agency. He shall also report directly to the Superintendent who is in charge of monitoring the overall employees' conformance with the agency's Code and internal regulations and the company's compliance with supervisory or domestic legislations. He reports directly to the Board of Directors and submits annual status report (Bulgaria Credit Rating Agency, n.d.).

Table 1.35: Policies Related to the Annual Compliance Review Function

	Annual Compliance Review	**Person or Unit Responsible for the Compliance Review**
Bulgarian CRA	Yes	Not specified
Capital Intelligence	Yes	Non-executive Members of the Supervisory Committee
ICAP Group SA	Yes	Internal Audit
Euler Hermes Rating	Yes	not specified
Feri EuroRating	Yes	-
Creditreform Rating	Yes	Not Specified
Scope Credit Rating	Yes	-
GBB-Rating	Yes	Not specified
Assekurata Assekuranz	Yes	Not specified
CRIF S.p.A.	Yes	Internal Audit
Companhia Portuguesa.	Yes	-
ERA, a.s.	Yes	Chief Analyst
Japan CRA Ltd	Yes	-

AM Best Europe	Yes	Compliance Officer
DBRS Ratings Limited	Yes	General Counsel
Fitch EU Subsidiaries	Yes	Compliance Audit Staff
MIS EU Subsidiaries	Yes	MCO Internal Audit Department
S&P EU Subsidiaries	Yes	Compliance Examination Group
Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies		

An independent review of the compliance function is undertaken across the business of the credit rating agencies to ensure that it is undertaken smoothly and effectively. It must be noted that this annual review process done by top management or the Compliance Officer, if the agency is small and has limited number of employees, is incorporated in the governance and control function of the organization. As reflected in Table 1.35, all CRAs undertake independent review made by different bodies or authorized officers. As far as ICAP Group, CRIF S.p.A., MIS EU Subsidiaries and Fitch EU subsidiaries are concerned, the review is undertaken by the Internal Audit Department or the Compliance Audit Staff.

Typically, the Compliance Officer prepares the report at the end of the year and the authorized representative/s of the company reviews the report (refer to Table 1.35). A good example is the case of Fitch (2012) where the annual compliance report is prepared on the organization's global compliance with CRA regulations in every jurisdiction it operates. The compliance report, which is also in line with Fitch's policies and procedures related to international credit ratings, is presented to the Board of Directors of Fitch Inc. As far as its EU operation is concerned, the findings related to each of the EU entities' compliance are provided, including any material findings or changes that occurred during the covered period. For DBRS, the function is undertaken by the General Counsel while the non-executive members of the Supervisory Body conduct annual review for Capital Intelligence. For S&P EU Subsidiaries, the Compliance Examination Group conducts the review based on the reports submitted by each Compliance Officer and are integrated to the overall global compliance of the international credit rating agencies. The European Rating Agency (2012) has a peculiar review process since its Chief Analyst is the one responsible for the annual internal review. Since he is also responsible for reviewing and approving the credit rating reports prepared by the analyst/(s), the control mechanism becomes weaker and ineffective.

As far as the other CRAs are concerned, the information is inadequate to determine how their review process is undertaken. This requirement by the European Securities and Markets Authority (ESMA) is quite effective since it creates awareness and due diligence among credit rating agencies on the importance and benefits of undertaking this task. It serves as a monitoring or oversight function by top management and the Board of Directors, which is an integral part of their corporate governance activities. In fact, effective compliance management and/or good corporate governance are not only undertaken in the credit rating business; many financial institutions, academia, private and public companies have also adopted this mechanism. While it is crucial for CRAs to adhere with policies, procedures and regulations, this process has becomes an initial step towards holistic assessment and management of potential risks arising from their transactions and dealings. Likewise, this annual compliance review is separate from the review of the methodologies, models, assumptions and credit ratings being required by ESMA under the EU CRA Regulations.

To ensure the quality of the rating process, CRAs must conduct a review of the various facets of the rating activities. Table 1.36 shows that CRAs have an independent review function in their organization. The independence of the review process is one of the control mechanisms used by CRAs to ensure the objectivity and integrity of the rating process. This is also included in the CRA regulatory requirements where the independent review function must be separate from the business activity and the one responsible for it shall report to the members of the administrative or supervisory board. In instances where this function is not undertaken, the CRA will be liable as having infringed Article 6(2), in conjunction with point 9 of Section A of Annex I of the CRA Regulations (European Securities and Markets Authority,

2011). For a review process to be successful, it must effectively and efficiently assess not only of the credit ratings and methodologies and/or models, but also credit rating's key assumptions, records/files, and other transactions made by the credit rating agencies. In fact, this was stressed by Cinquegrana (2009) in his discussion about EU CRAs where the person responsible for the review function must be competent to conduct regular assessment or review of the methodologies, especially for new financial asset where the methodologies have not been tested.

S&P Ratings Services EU entities' review process, for instance, is undertaken by its Quality Officers assigned to a Practice Area who report directly to the board of directors of each of the three entities. It is different to other of its international entities where the Quality Officers report to the S&P Ratings Services' Chief Quality Officer (Standard and Poor's Rating Services, 2012). In the case of AM Best Europe (n.d.), the independent review function is undertaken by a group of senior managers who have the relevant or corresponding expertise. There are also instances where they also conduct a review for a particular type of credit rating that is entirely different from what it currently offers to improve its credit rating process.

Table 1.36: Policies Related to the Independent Internal Review Process

	Independent Review Function
Bulgarian CRA	Yes
Capital Intelligence	Yes
ICAP Group SA	Yes
Euler Hermes Rating	Yes
Feri EuroRating	Yes
Creditreform Rating	Yes
Scope Credit Rating	-
GBB-Rating	Yes
Assekurata Assekuranz	Yes
CRIF S.p.A.	Yes
Companhia Portuguesa.	-
ERA, a.s.	Yes
Japan CRA Ltd	Yes
AM Best Europe	Yes
DBRS Ratings Limited	Yes
Fitch EU Subsidiaries	Yes
MIS EU Subsidiaries	Yes
S&P EU Subsidiaries	Yes

Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies

The executive directors/Board of Directors and the independent analyst are the authorities who are responsible for conducting the independent review function for European Rating Agency and DBRS, respectively. It is believed that this review process enables the agency to provide more responsive and enhanced rating process. Like the independent compliance review requirement by ESMA as shown in Table 1.35, this review function is usually separate from the rating agency's business activities which are generally responsible for undertaking the rating assessments. Tables 1.37 to 1.39 provide the specific activities or aspects of the credit ratings being regularly reviewed by the credit rating agencies.

When a rating is issued and published following the instruction of the issuer, the credit rating agency is bound to monitor the credit rating and update the same to ensure that adequate information is provided to the readers or users. As shown in Table 1.37, all credit rating agencies review their credit rating assessments.

The complexity of the review process depends on various factors, especially when a rating assessment is derived from more than one methodology. Whether the methodology that will be changed or updated is a principal or secondary methodology, the review is likewise important. As outlined in the EU CRA Regulations, the agency may, at anytime, conduct a review when it deems necessary. This is crucial because there is a possibility that investors may overlook salient aspects of the credit rating that needs to be changed or updated, especially that they are usually dependent upon the judgement of the credit rating agency through the credit rating reports they issued. This is the reason why EU CRA regulations and IOSCO Code Fundamentals emphasize the importance of including in the credit rating report the appropriate methodologies, models and key assumptions that were used, to enable the investors to understand and verify how the rating was derived by the CRA. They can also undertake some due diligence checks involving the credit rating assessment.

Table 1.37: Policies Related to the Review of the Rating and Rating Performance

	Existence of Policies	**Ratings Reviewed by**
Bulgarian CRA	Yes	Rating Committee
Capital Intelligence	Yes	Internal Review Officer and the Quantitative Research and Validation Unit.
ICAP Group SA	Yes	Internal Review Function Personnel
Euler Hermes Rating	Yes	Rating Committee
Feri EuroRating	Yes	Rating Committee
Creditreform Rating	Yes	Review Panel
Scope Credit Rating	-	-
GBB-Rating	Yes	Review Panel
Assekurata Assekuranz	Yes	Review Board Member
CRIF S.p.A.	Yes	Rating Committee
Companhia Portuguesa.		-
ERA, a.s.	Yes	Rating Team
Japan CRA Ltd	Yes	Team of Analysts

AM Best Europe	Yes	Corporate Rating Policy Committee
DBRS Ratings Limited	Yes	Rating Committee
Fitch EU Subsidiaries	Yes	Credit Policy Group
MIS EU Subsidiaries	Yes	Analytical Team assigned for the credit rating except for structured finance and public finance
S&P EU Subsidiaries	Yes	Quality Officers
Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies		

Moody's Investors Services EU entities, for example, typically conduct regular review of the credit ratings until they are withdrawn, except when the rating contract clearly stipulates that the said review is not required. The team that was initially assigned to conduct a rating for an issuer or a financial instrument is also responsible for the review, except for structured finance products where another surveillance team will be assigned that also belong in each entity's Structured Finance Group.

Table 1.38 shows that almost all credit rating agencies review their methodologies and models, whether the respective policies thereto are those that were utilized for a particular credit rating assessment. This review process on policies is applied for each credit rating class or industry.

Table 1.38: Policies Related to the Review of the Rating and Rating Performance

	Review Methodology	Methodologies and Models review done by
Bulgarian CRA	Yes	Compliance Superintendent
Capital Intelligence	Yes	Internal review officer
ICAP Group SA	Yes	Internal Review Function/Department
Euler Hermes Rating	Yes	Review Panel
Feri EuroRating	Yes	Internal Review Group
Creditreform Rating	Yes	Employees assigned in formulating and reviewing methodology
Scope Credit Rating	-	-
GBB-Rating	Yes	Methods Committee
Assekurata Assekuranz	Yes	Review Board
CRIF S.p.A.	Yes	Internal or Validation Unit
Companhia Portuguesa.	-	-
ERA, a.s.	Yes	Reviewer of the Supervisory Board
Japan CRA Ltd	Yes	Formal Collegial Body
AM Best Europe	Yes	Corporate Rating Policy Committee /Senior Managers
DBRS Ratings Limited	Yes	Corporate Finance Criteria Committee &Structured Finance Criteria Committee
Fitch EU Subsidiaries	Yes	Credit Policy Group
MIS EU Subsidiaries	Yes	MIS model appraisal team; MIS Chief Risk Officer (methodologies)

S&P EU Subsidiaries	Yes	Model Quality Review Group
Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies		

Each agency has its own review personnel or units responsible for it credit ratings and rating performance. For most companies such as S&P, ERA, Asserkurata Asserkarenz, Euler Hermes, Capital Intelligence and Feri EuroRating, the review panel or board is responsible. For others, the agency's methods committee (GBB-Rating), formal collegial body (JCRA), internal or validation unit (CRIF, S.P.A.) or authorized personnel assigned for reviewing the methodologies and models (Creditreform) are assigned for the task.

Credit rating agencies such as AM Best Europe, DBRS Ratings and Fitch EU entities have a committee or people from the credit policy or rating group to conduct the review process related to methodologies and models used in the preparation of the credit rating report. Moody's Model Appraisal team, on the other hand, is responsible for reviewing the organization's global models which are utilized in the credit ratings. With regards to the verification of the models that were used as part of the methodologies, its Chief Risk Officer is responsible for reviewing the policies related to the methodologies, including the new or proposed methodologies and the changes related to the existing methodologies (Moody's Corporation, 2011). On the other hand, BCRA's Compliance Superintendent is the one responsible for the said review.

On a regular basis, they must regularly review and update any changes that may be found material, which can be utilized for the enhancement of the said methodologies/models. The changes made by the credit rating agency must be immediately disclosed in their respective websites and any form of communication to provide information to the public as soon as possible. Likewise, they are required under the EU CRA Regulations that any change in the methodologies and models that affect the ratings that were initially issued must be applied which requires a revision of the credit rating (ESMA, 2009). This is crucial especially when the risk characteristics of the underlying product or asset change materially.

To date, many EU CRAs conduct rigorous and regular review, usually every year (AM Best Europe, DBRS, Capital Intelligence, etc.) to ensure that they are up-to-date and responsive to the different types of credit ratings. The independent review function of DBRS (2010) is undertaken every year by its Corporate Rating Policy Committee /Senior Managers who are in charge of reviewing and validating its methodologies and models, including any new and proposed methodologies. It is quite crucial that significant changes are noted and where appropriate and possible, these changes must be applied to credit ratings that were issued and were affected by the said methodology.

Table 1.39: Policies Related to the Review of the Key Assumptions Utilized by CRA

	Conducting a Review	Person/Unit Responsible for the Review
Bulgarian CRA	Yes	Compliance Superintendent
Capital Intelligence	Yes	Internal review officer
ICAP Group SA	Yes	Internal Review Function/Department 1 personnel only
Euler Hermes Rating	Yes	Review Panel
Feri EuroRating	Yes	Internal Review Group
Creditreform Rating	Yes	Employees assigned in formulating and reviewing methodology

Scope Credit Rating	-	
GBB-Rating	Yes	Methods Committee
ASSEKURATA Assekuranz	-	-
CRIF S.p.A.	Yes	Internal or Validation Unit
Companhia Portuguesa.	-	-
ERA, a.s.	Yes	Reviewer of the Supervisory Board
Japan CRA Ltd	Yes	Formal Collegial Body
AM Best Europe	Yes	Corporate Rating Policy Committee
DBRS Ratings Limited	Yes	Corporate Finance Criteria Committee & Structured Finance Criteria Committee
Fitch EU Subsidiaries	Yes	Credit Policy Group
MIS EU Subsidiaries	Yes	MIS Chief Risk Officer
S&P EU Subsidiaries	Yes	Quality Officers

Source: Compiled by the researcher using the information found in the respective websites of the credit rating agencies

Similar to the review of methodologies and models used in the credit rating process mentioned in Table 1.38, many credit rating agencies review the underlying assumptions that are utilized in the preparation of a credit rating/assessment (refer to Table 1.39). As contrasted to the policies on methodologies and models, there are no specific policies relating to key assumptions to be used in the rating process, since the description of the assumptions varies among issuers, asset classes, the data that is available in the credit rating preparation, and etc. If there are existing policies, these will probably apply to the consistent application by the CRA in clearly describing key assumptions in the credit rating report.

Usually, a summary of the underlying assumptions related to the financial statements or other data that were used, is indicated in each of the credit rating reports a CRA issues. If applicable, a sensitivity analysis of the underlying assumptions that were used must be incorporated in the report to highlight material deviations from what are publicly available (i.e.: financial statements). Failure to do the review may lead to potential misinterpretation or misunderstanding of the content of the report by the market participants or readers. For the reviewers of the assumptions, usually the same team of authorized officers/personnel who were responsible for reviewing the methodologies and models are assigned to undertake this task.

4. Conclusions

1. The credit rating business started in the United States and still plays a major role in many transactions made by companies and institutions in the country. The globalization and liberalization of financial services provided an impetus for the development of the financial markets and the widespread use of credit ratings for regulatory, financing and investment purposes. This led to its expansion into a global business activity, where many local credit rating agencies are continuously being established in various countries, worldwide. Thus, the important roles played by CRAs in reducing information asymmetry and as third party information providers are indispensible.

2. The global credit rating industry is diverse. To date, there is an increasing presence of many but small- and medium-sized domestic credit rating agencies in many countries and regions. The number and types of CRAs operating in each country also vary per region, where the Asia Pacific region accounts for the largest number of credit rating institutions, followed by Latin America and the European Union. This growth can be associated with the development of the financial markets and the Capital Requirement guidelines for banks under the Basel II accord, which attracted some local credit reporting

companies or credit bureaus to shift into a new business dimension; however, GCRAs still dominate in many countries due to their resources and reputation.

3. Global credit rating agencies, namely, Standard and Poor's Rating Services, Moody's Investors Service and Fitch Ratings, have generally shown large influence in the financial markets through the provision of forward looking predictions on the creditworthiness of an issuer through credit ratings. The magnitude of their operations provided them competitive advantages over their competitors not only in the United States but worldwide. This made them acquire more assets and businesses over the past years as many companies and institutions relied heavily on the diversified services they offered. Despite these benefits, these GCRAs performed poorly during and after the crisis as reflected from the decreasing revenues they generated from both their credit rating transactions and ancillary services. This can be ascribed to the decline in credit rating transactions, especially for structured finance products, which provided them higher profits, as only few CRAs provide this type of credit rating and advisory services.

4. To date, both Standard and Poor's and Moody's dominate the market with a combined share of approximately 80 percent while Fitch Ratings only accounts to approximately 15 percent share of the entire market. GCRAs' activities grew drastically especially during the past three decades due to their alliances or affiliations with other companies, arising from their mergers with or acquisitions of domestic CRAs, credit reporting companies or credit bureaus in different countries, worldwide. Their influence can be ascribed to the market participants' heavy dependence on the credit ratings they issued. Likewise, their increasing popularity and use by many market participants led to their failure in performing due diligence checks related to the rating processes they utilized and the quality of the credit rating they issued.

5. There is no doubt that the credit ratings issued by S&P, MIS and Fitch are very robust and are classified as the most sophisticated credit ratings in the industry. However, many of the market failures and financial crises that occurred over the past three (3) decades were associated with credit ratings issued by one or a combination of these GCRAs. The fast growth of structured finance products and the widespread provisions of various advisory and ancillary services to the rated clients resulted to various conflicts of interests in their credit rating activities and transactions. They did not only rate these instruments but they also advised issuers on how to design the trust structures. Likewise, many scholars claim that they provided favourable credit rating assessments to companies which were in the brink of failure. Their failure to continuously monitor and re-evaluate the creditworthiness of these companies and to apply the appropriate changes in their credit rating assessments were described as a great disregard for the public welfare.

Various market participants are also responsible for the systemic failures or financial crises. The Securities and Exchange Commission, as the regulator of the U.S. CRAs, is partly responsible for the recent financial crisis, as the CRA regulations were not clearly articulated, especially with the increasing number and volume of credit ratings for structured finance products. Likewise, investors' too much reliance on credit ratings led to their failure to perform due diligence checks before making investment decisions.

6. Over the past years, the International Organization of Securities Commissions (IOSCO) had vigorously formulated and enhanced the Code of Conduct Fundamentals for Credit Rating Agencies. The Financial Stability Board (FSB) also acted as the central locus for coordination among international organizations, standards setting bodies and national authorities in putting forward global policy reforms related to the credit rating agencies' activities by publishing sets of principles for reducing reliance on external ratings.

7. In the United States of America, the government introduced reforms in the regulation of NRSROs through the Dodd-Frank Wall Street Reform Act while the European Union had formulated and implemented its regulation for credit rating agencies in light of the IOSCO's Code of Conduct Fundamentals. The European Securities and Markets Authority (ESMA), as the supervisory authority for CRAs, had also established cooperation arrangements with other regulatory authorities in third countries

whose regulatory regime for CRAs are regarded as stringent as the EU CRA Regulations. It provided CRAs from these countries to apply for registration and certification with ESMA. It also allows EU credit rating agencies to apply for endorsement of credit ratings issued by CRAs operating in third countries where the equivalence assessment has been approved. The certification and endorsement mechanisms provide an economical, convenient and efficient means whereby EU domiciled companies can use these ratings for regulatory purposes. This objective-based approach utilized for the equivalence assessments have fostered the convergence of the legal and supervisory frameworks for CRAs in the international level.

8. Compared to the United States, the credit rating business in the European Union is relatively new, where 16 out of 30 credit rating agencies are affiliates or subsidiary entities of the three (3) GCRAs. Many of the other registered credit rating agencies are small and medium-sized companies and are mostly operating locally within the Community. Majority of these CRAs provide corporate credit rating services, mostly in the financial services and non-insurance businesses. They are heavily dependent from the fees paid by the issuers for the credit rating services (issue-pay business model) and from the provision of ancillary services.

9. EU credit rating agencies have stringent policies regarding credit rating processes especially those that relate to rating methodologies, models, key assumptions and other criteria that are utilized in the preparation and the disclosure of credit ratings. The European Union CRA regulations currently employ a policy of non-interference by ESMA or by any competent authority with the content of the credit ratings, including the methodologies and models used in the assessments. The application requirements for the registration by CRAs with competent authorities or with ESMA are considered as entry barriers due to its restrictive and stringent requirements to ensure that compliance by the credit rating agencies are undertaken.

EU CRAs currently implement the IOSCO Code of Conduct Fundamentals in their respective Codes of Conduct, both for the organization and employees. Many of the credit rating agencies have clearly articulated policies and procedures related to their operations, code of conduct and management of conflict of interest issues. Internal control mechanisms are also implemented, which include among others, the independent Compliance Function, the role of the Supervisory Committee and the Rating Committee, periodic surveillance and reviews of credit ratings, methodologies/models and rating performance and reporting arrangements. These uniform standards currently being implemented by EU CRAs with the guidance of the European Securities and Markets Authority provides an inspiration

5. Recommendations:

1. The global crisis must serve as a lesson among credit rating agencies in their business activities and in performing due diligence in their credit assessments. While investors rely from credit ratings, due diligence must also be exercised in making investments decisions through a better understanding of the risk profiles of the different financial instruments by performing their own researches about the issuer or instrument, wherever possible.

2. To date, the EU CRA Regulatory Framework is one of the most robust frameworks worldwide, as the existing regulations are more prescriptive among EU CRAs. Likewise, the registration, certification and endorsement mechanism used by EU for CRAs in third countries created an alliance among supervisory authorities for the convergence of their regulatory framework for CRA and allowed CRAs from these countries to be used by companies within the Community. In Asia, other countries in the region must consider enhancing their regulatory framework similar to Hong Kong, Singapore and Japan where the operations and activities of CRAs must have legally binding supervisory and regulatory frameworks. While self-regulation is important for the effective functioning of the credit rating agencies operating in a particular country, regulation or supervision of CRAs is equally important especially if their credit ratings will be used for regulatory purposes and if they want to be competitive.

3. The use of credit ratings for regulatory purposes will still continue, especially for transactions that are related to the requirements of the international regulatory bodies for financial sectors such as the Basel II International Capital Accord, IOSCO and IAS. The establishment of and/or improvements undertaken on the regulatory framework for CRAs in EU, Canada, U.S.A., Australia, Singapore, Hong Kong, Japan and other countries must serve as an impetus among credit rating agencies in the formulation or revision of their internal policies and codes of conduct.

At the regional level, ACRAA can facilitate in seeking assistance from Supervisory Authorities in these countries whose framework were considered as equivalent and stringent as EU CRAs regulations. They can provide technical advice among supervisors and credit rating agencies in the region, if possible, with regard to the extent of the regulations to be undertaken, management of conflicts of interest, qualities of the credit rating processes such as the methodologies and models used, internal control and governance mechanisms, disclosure and review of credit ratings, methodologies, and rating performance.

4. Given the diverse profiles of credit rating agencies in Asia, the convergence of regulatory framework may not be possible to undertake in the near future. However, the way forward on how to achieve a holistic perspective towards an effective legal and supervisory framework for CRA activities is quite possible. An important consideration in accomplishing this would be the involvement by the responsible Supervisory Authorities in the formulation and implementation of the regulations and principles that can be applied for the effective and efficient functioning of the credit rating agencies' activities. At the regional level, they can help in facilitating the growth of the credit rating market in the region, such that the use by financial institutions of the credit ratings provided by GCRAs for regulatory purposes will be protected.

5. As far as the use of external ratings by financial institutions is concerned, national supervisory authorities should review their existing regulatory framework or policies related to these credit ratings. Since the transition of removing or reducing reliance of external ratings will take time, wherever possible, supervisors and regulators should promote their efforts in replacing reference to credit rating assessments with regulations that will allow and enhance banks' capabilities in conducting their internal credit risk assessments that are robust and acceptable.

National authorities should also expedite decision making processes related to the establishment and improvement of the legal and supervisory frameworks for local CRAs to ensure that they are also protected by law and the users of the credit ratings will also benefit from its protection against any problems arising from the credit ratings issued by CRAs. Likewise, the principles provided in the IOSCO Code of Conduct Fundamentals related to the integrity and transparency of the rating process, the quality and reliability of the credit ratings and the CRA activities must be addressed and assured. The achievement of these core issues can facilitate in the convergence of regulatory framework for CRAs within the region and the possible use of credit ratings issued by CRAs by companies, investors and institutions both within the region and worldwide, as this will ensure support and involvement by the government.

6. In the absence of a regulatory framework for CRA, individual credit rating agencies must start reviewing and enhancing their internal policies that will address issues related to the quality of data, methodologies/models and credit ratings, the use of internal control and enforcement mechanisms, management of conflicts of interests, disclosure of credit ratings and other issues. They should aim in providing and enhancing high-level market confidence, in protecting the investors and in facilitating in the stability of the financial markets within the region. Self-regulation may limit the activities that can be undertaken by the local CRA, especially the market it can capture for their credit rating services.

At the national level, both the CRA and the supervisory or regulatory authorities must have a round table discussion on how regulations will be undertaken, including its scope. At the regional level, a round table discussion between ACRAA and national authorities in the region can be undertaken to discuss pertinent issues that can be addressed to speed up any potential move towards a unified supervisory approach for CRA regulation similar to the approach used by the European Union. Alternatively, the existing role of ACRAA in advancing high ethical standards among credit rating

agencies in Asia can provide inputs among national authorities in designing a workable regulatory framework for the industry in the region. Any decision that will be made at the regional level can be used in fostering the use by local companies, institutions and international investors of credit ratings issued by CRAs in the region using the certification and registration of CRAs in a member country.

7. As far as integrity and quality of the rating is concerned, there should be stringent policies with regard to the information provided by the issuer to ensure its quality, integrity and reliability. Credit rating agencies and the issuer must provide their commitment to this effort, by adopting pertinent measures that will ensure that the data to be used in assigning a rating is reliable, complete and of utmost quality. A more stringent alternative is an enforcement of policies or standards that can be used to measure potential civil liabilities for rating agencies similar to that of the audit industry (i.e.: standard of gross negligence or intent.) The importance of enforcement and its subsequent supervision and oversight are meant to ensure that appropriate mechanism can be utilized in pursuing liabilities.

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Paper 2: Domestic Credit Rating Agencies & Local-Currency Bond Markets in the ASEAN Region

I. Introduction

Local-currency (LCY) bond markets in the ASEAN+3 region have expanded rapidly since the 1997-98 Asian financial crisis. The outstanding sizes of both government and corporate bonds have grown impressively since then. Certain factors can be attributed to the growth in the region's LCY bond markets during this period. One is the robust economic growth experienced by most ASEAN+3 economies. Another would be the improvements in the regulatory environment governing capital markets and banking systems. Market microstructures were likewise further developed through the establishment of trading platforms, payment and settlement systems, and securities exchanges. A widening of the investor base was witnessed, as shown by greater participation of institutional investors – such as contractual savings institutions, non-financial corporates, mutual funds – as well as increased investment by foreign investors. Increased demand for LCY bonds has resulted in greater variety of fixed-income products and more types of bond issuers. The availability of hedging instruments has spurred bond investment and trading. Regional initiatives have also played an important role in bond market development, particularly, the Asian Bond Markets Initiative (ABMI), which promotes regional cooperation to spearhead bond market integration and development in the ASEAN+3 region.

Despite the stellar growth of the ASEAN+3 LCY bond market, cross-border bond investment within the region, or intra-ASEAN+3 bond investment, remains relatively small. This is a challenge for bond market integration. One proposal to spur cross-border bond investment is to have a regional credit rating facility for ASEAN+3. Another is to establish mutual recognition and ratings harmonization across different jurisdictions. Here, it is important to understand the role and characteristics of domestic credit rating agencies (DCRAs) in the region.

Credit rating agencies are important for bond market development, since they assess and rate the creditworthiness of bond issuers and bond issues, thus helping address the asymmetric information between borrowers and investors. However, the 2008-09 global economic and financial turmoil and the ongoing European sovereign debt and banking crises, exposed the frailties of the credit rating industry, amid several criticisms on the validity and timeliness of the rating decisions and the robustness of rating methodologies used by the big three global credit rating agencies (GCRAs)—Fitch Ratings, Moody's

Investor Service, and Standard & Poor's. Partly, this has led to a revisit of DCRAs' rating definitions, methodologies, and processes, to determine its veracity and to check for its consistency with international standards.

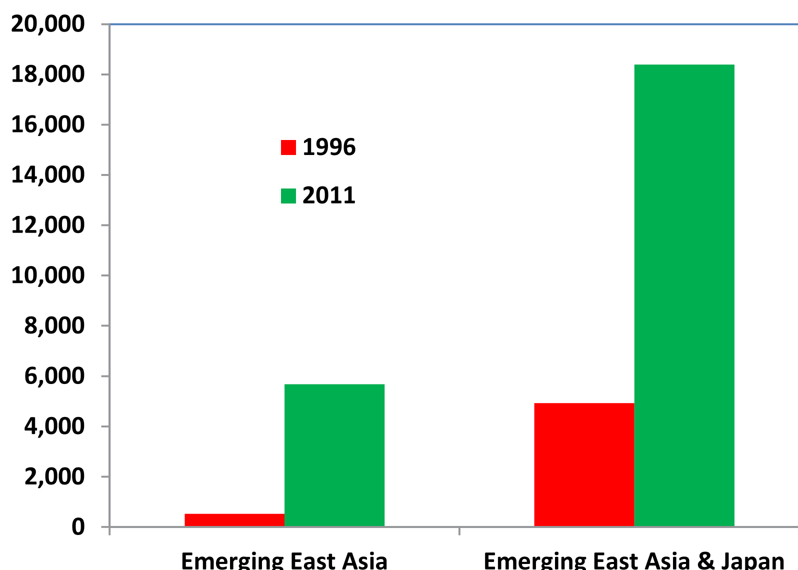
The next section of this paper provides an overview and recent trends in the ASEAN+3 bond markets, focusing on the market size for both government and corporate bonds, trading activity and liquidity of these markets, and yield movements across all tenors of government bonds. Section III discusses the DCRAs in ASEAN-4 countries, focusing on individual backgrounds, rating symbols and definitions, rating methodologies, and rating process. Section IV then looks at the accomplishments of the Association of Credit Rating Agencies in Asia (ACRAA), of which many of the DCRAs in ASEAN are members. Finally, the conclusion is stated in Section V.

II. Local-Currency Bond Markets in East Asia and ASEAN

A. Bond Market Size

Asia's local-currency (LCY) domestic bond market has expanded remarkably since the late 1990s. Based on data culled from the Asian Development Bank's (ADB) *AsianBondsOnline*, the outstanding size of the LCY bond markets in emerging East Asia—which covers the People's Republic of China (PRC), Indonesia, the Republic of Korea, Malaysia, the Philippines, Singapore, Thailand, Viet Nam, and Hong Kong, China—stood at US$5.7 trillion by the end of 2011, a sharp improvement from the region's end-1996 level of US$466 billion. For emerging East Asia plus Japan, the bond market size has levelled off at US$18.4 trillion at end-2011, versus US$4.9 trillion at end-1996 (**Figure 1**).

Figure 1: Outstanding Size of Local-Currency Domestic Bond Market in emerging East Asia & Japan
1996 and 2011
(US$ billion)

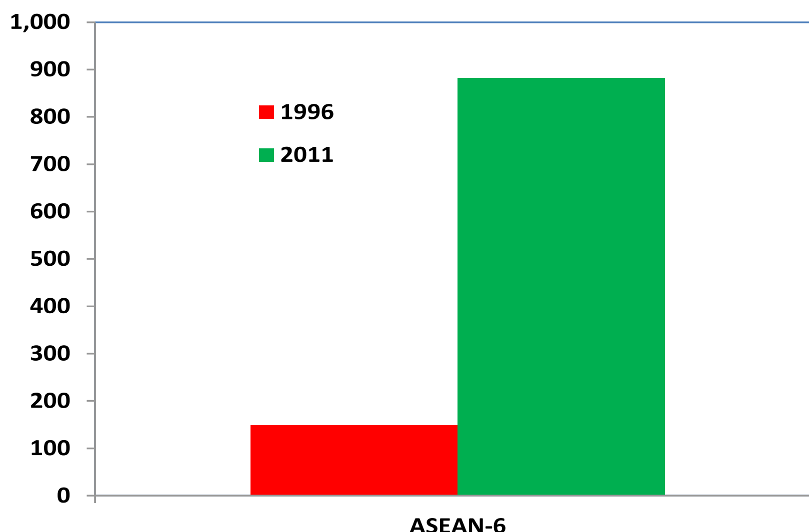


Note: Emerging East Asia comprises the People's Republic of China, Indonesia, Republic of Korea, Malaysia, Philippines, Singapore, Thailand, Viet Nam, and Hong Kong, China.
Source of basic data: ADB (2012a)

For ASEAN countries with available bond market statistics—namely, Indonesia, Malaysia, Philippines, and Singapore, Thailand, and Viet Nam—the combined size of their domestic bond market

totalled US$882 billion at end-2011, also substantially larger than the size of US$149 billion registered by the end of 1996 (**Figure 2**).

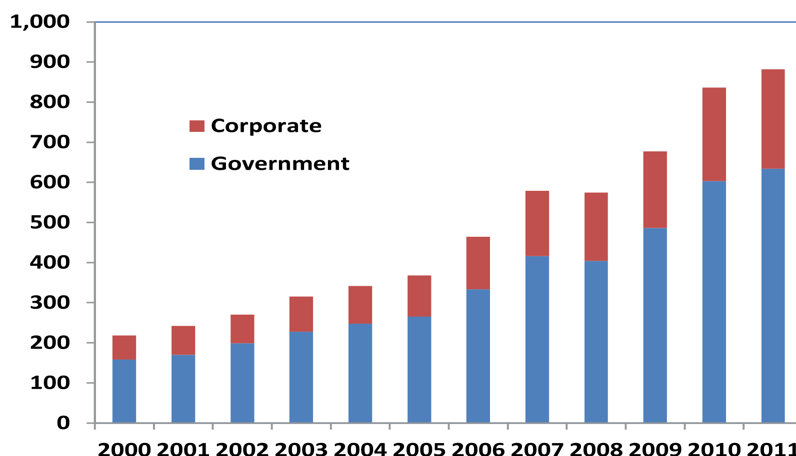
Figure 2: Outstanding Size of Local-Currency Domestic Bond Market in ASEAN, 1996 and 2011
(US$ billion)



Note: ASEAN-6 comprises Indonesia, Malaysia, Philippines, Singapore, Thailand, and Viet Nam.
Source of basic data: ADB (2012a)

Using the *AsianBondsOnline* data, the outstanding size of the ASEAN-6 LCY bond market grew from US$218 billion at end-2000 to US$882 billion at end-2011, recording an average annual growth of 14% over the 2001-2011 period. **(Figure 3)**. As of the end of 2011, about 71% of the total LCY bonds outstanding in the region or US$634 billion are in LCY government bonds, while the rest are in lcy corporate bonds. Both LCY government and corporate bonds outstanding have grown by an average of about 14% each, during the same period.

Figure 3: Outstanding Size of Local-Currency Domestic Bond Market in ASEAN-6, 2000-2011
(US$ billion)

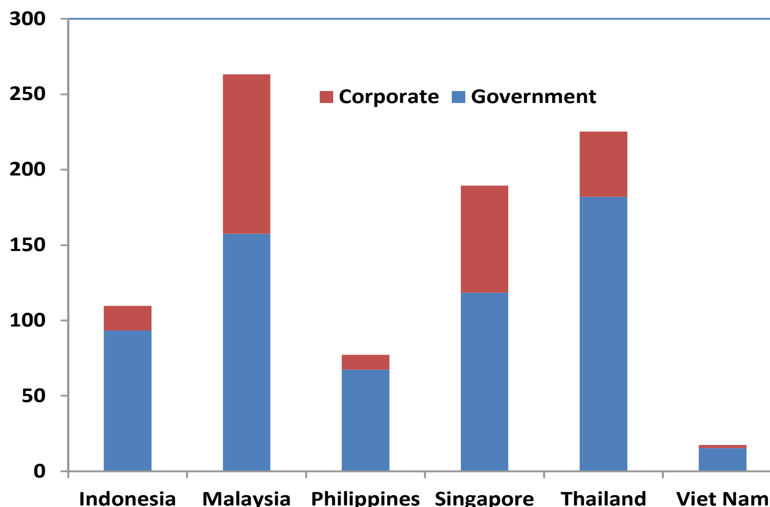


Note: ASEAN-6 comprises Indonesia, Malaysia, Philippines, Singapore, Thailand, and Viet Nam.
Source of basic data: *AsianBondsOnline.*

By individual ASEAN-6 countries, the total LCY bond outstanding size as of end-2011 ranges from US$17.4 billion for Viet Nam to US$263.2 billion for Malaysia (**Figure 4**). Government bonds

outweigh corporate bonds in each of the ASEAN countries, with the percentage share of the outstanding size of LCY government bonds to the total ranging from 60% for Malaysia to 88% for Viet Nam.

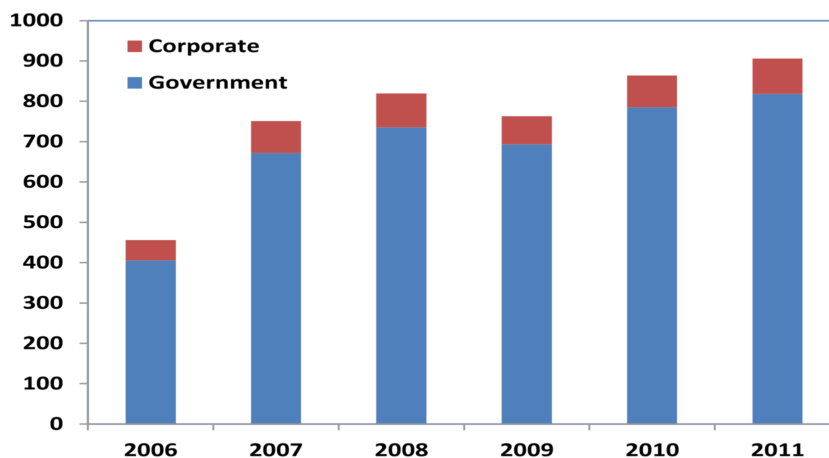
Figure 4: Outstanding Size of Local-Currency Domestic Bond Market by ASEAN Country, end-2011
(US$ billion)



Source of basic data: *AsianBondsOnline.*

Recent years saw an expansion in annual LCY bond issuance in the ASEAN-6 region (**Figure 5**). Based on *AsianBondsOnline* data, LCY bond issuance in ASEAN-6 totalled US$456 billion in 2006, and soared 65% to US$751 billion in 2007. It rose further to US$819 billion in 2008, posting a 9.1% increase. However, LCY bond issues slipped 6.9% to US$763 billion in 2009, partly due to the global economic and financial turmoil. But in 2010, ASEAN-6 LCY bond issuance rebounded to reach US$864 billion, a 13.2% increase, and further climbed in 2011, by 4.9% to US$906 billion. It is worthwhile to note that about 90% of the LCY bond issuance in the ASEAN-6 region came from the government, while the remaining 10% came from the corporate sector.

Figure 5: Local-Currency Bond Issuance in ASEAN-6, 2006-2011
(US$ billion)

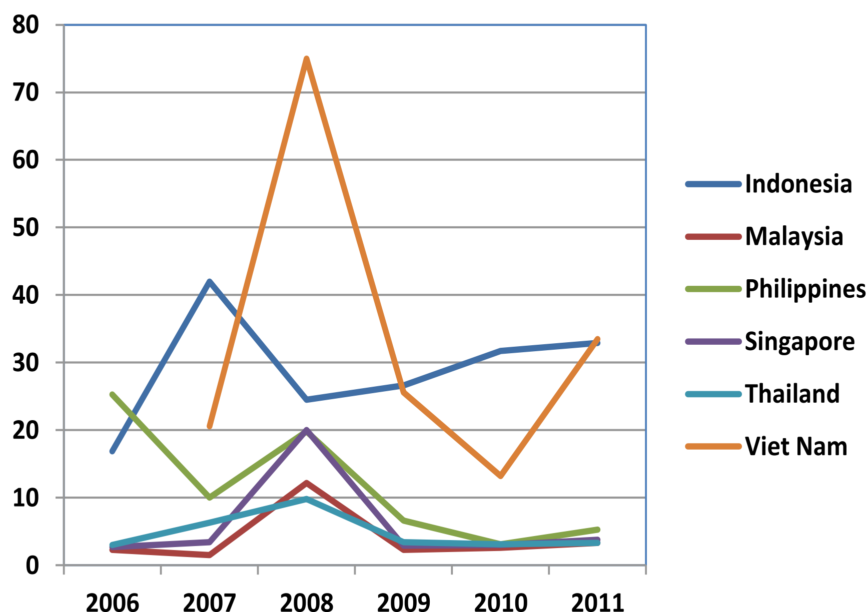


Note: ASEAN-6 comprises Indonesia, Malaysia, Philippines, Singapore, Thailand, and Viet Nam.
Source of basic data: *AsianBondsOnline.*

B. Bond Market Liquidity

Liquidity in ASEAN bond markets appears to have tightened at the height of the 2008 global financial crisis, but had improved since then. The bid-ask spread for LCY government bonds, a bond market liquidity measure, had widened in most ASEAN markets in 2008, but had significantly narrowed a year later(**Figure 6**). Between 2009 and 2010, the bid-ask spread rose for Indonesia, Malaysia, and Singapore, while it fell for the Philippines, Thailand, and Viet Nam. Between 2010 and 2011, the bid-ask spread rose for all 6 ASEAN markets, with Viet Nam registering the largest hike.

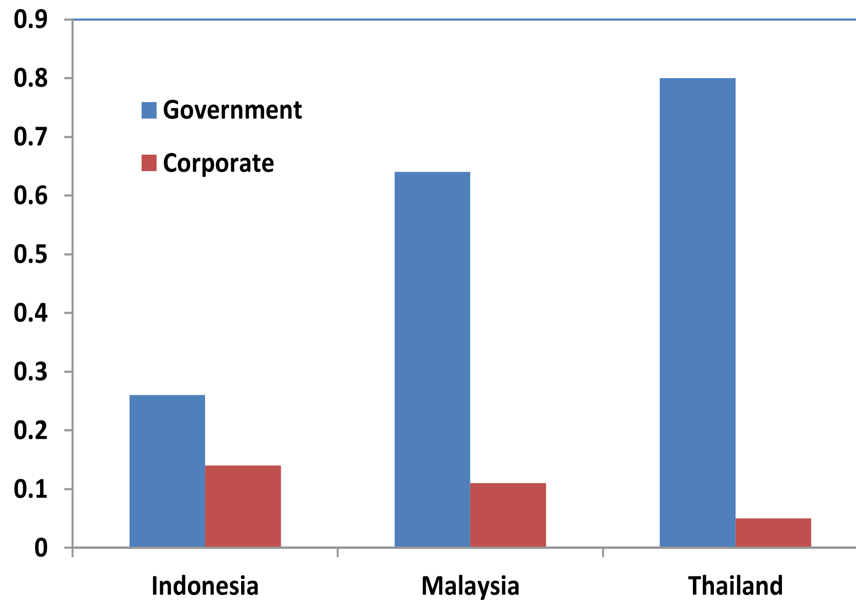
Figure 6: Bid-Ask Spread of Local-Currency Government Bonds Issues in ASEAN-6, 2006-2011
(basis point)



Source of basic data: *AsianBondsOnline.*

Government bonds are relatively more liquid than corporate bonds, and this is confirmed by the former's higher turnover ratio for 3 ASEAN markets—Indonesia, Malaysia, and Thailand—in the second quarter of 2012 (**Figure 7**).

Figure 7: Turnover Ratio for Government & Corporate Bonds in ASEAN, 2Q12

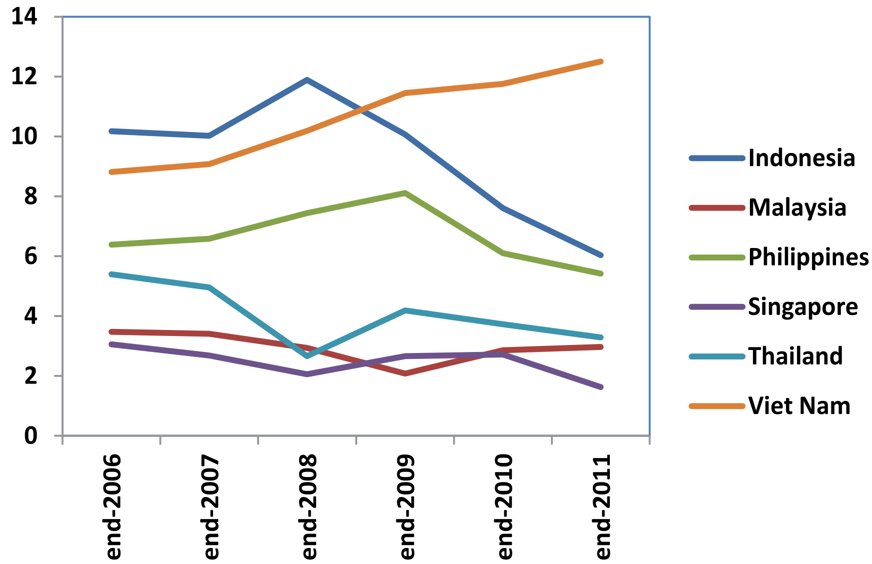


Note: Data not available for Brunei Darussalam, Cambodia, Lao PDR, Myanmar, the Philippines, Singapore, and Viet Nam.
Source of basic data: *AsianBondsOnline.*

C. Yield Movements & Yield Curve Trends

Yields of LCY government bonds were on a downward trend for several ASEAN countries in recent years. Specifically, between end-2006 and end-2011, yields on 10-year LCY government bonds of Indonesia, Malaysia, the Philippines, Singapore, and Thailand, fell, albeit at different degrees (**Figure 8**). On the other hand, Viet Nam registered an increase in the 10-year government bond yield.

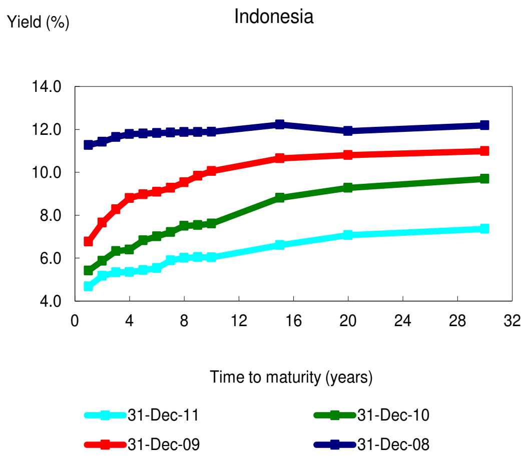
Figure 8: 10-year Government Bond Yields in ASEAN, end-2006 – end-2011
(percent)

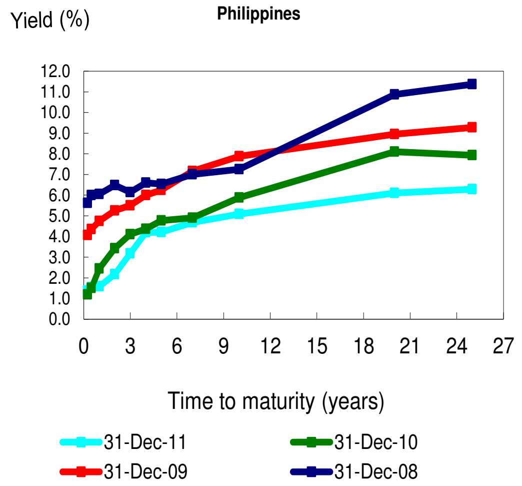


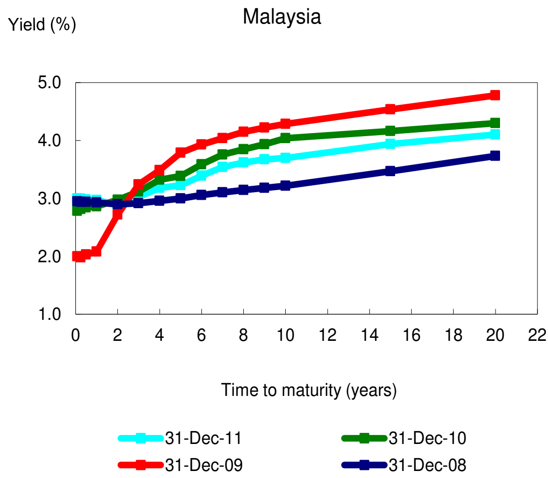
Source of basic data: Bloomberg LP.

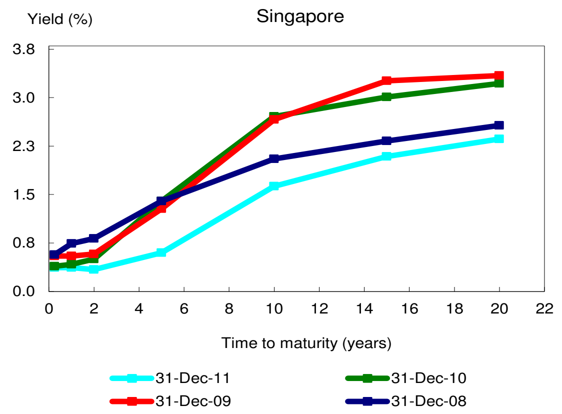
Government bond yield curves shifted downward for several ASEAN economies since the onset of the global financial turmoil in 2008 (**Figure 9)**. This was especially true for Indonesia, the Philippines, and Singapore. Thailand's government bond yields were higher for all tenors along its yield curve between end-2008 and end-2011, on the back of expectations of a glut in government bond supply in financing post-flooding infrastructure projects. In the case of Viet Nam, increases in government bond yields for all tenors can be attributed to expectations of higher inflationary pressures.

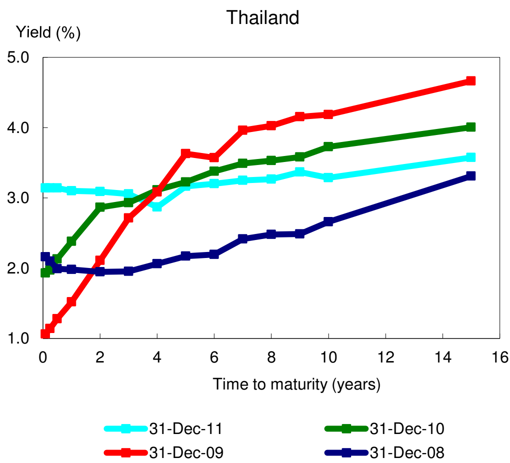
Figure 9: Government Bond Yield Curves for ASEAN Countries, end-2008 – end-2011
(percent)

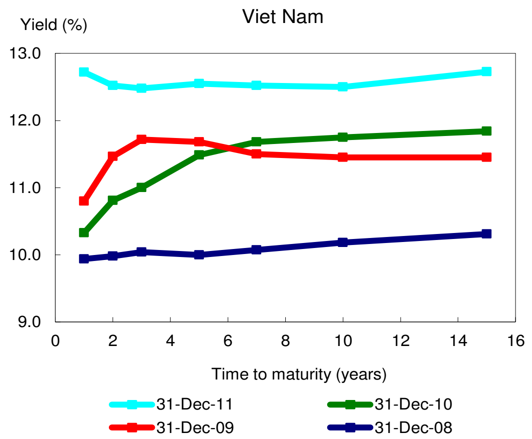












Source of basic data: Bloomberg LP

D. Cross-Border Bond Investment

Cross-border bond investment by ASEAN+3 residents within the ASEAN+3 region remains small. 2.1 presents cross-border debt securities investment from seven ASEAN+3 economies – Indonesia, Japan, Republic of Korea, Malaysia, the Philippines, Singapore, and Thailand – to the ASEAN+3 region, European Union (EU), and the United States (US) covering the year 2010. (The data was based on the International Monetary Fund's (IMF) *Coordinated Portfolio Investment Survey*.) The share of each of the seven ASEAN+3 economies' cross-border debt securities investment to ASEAN+3 varies, from 1% for Japan to 69% for Thailand. Aside from Thailand, only Malaysia has a ASEAN+3 share that is above 50% (i.e., 52%), while the rest are below 50%.

Table 2.1: Cross-Border Debt Securities Investment by ASEAN+3 Economies, 2010
(US$ million)

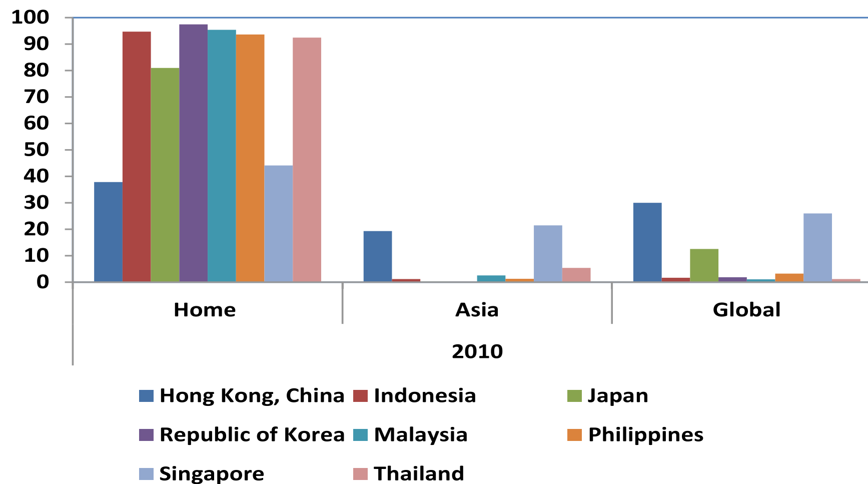
	Debt Securities Investment From:						
Debt Securities Investment To:	**Indonesia**	**Japan**	**Republic of Korea**	**Malaysia**	**Philippines**	**Singapore**	**Thailand**
ASEAN+3	1,167	29,542	2,635	5,890	1,135	78,384	12,750
Rest of the World	4,382	2,637,808	27,354	4,953	4,708	126,252	5,193
of which:							
EU	1,468	874,774	7,871	1,182	1,144	58,852	1,055
United States	212	157,553	2,175	395	506	34,764	282
ASEAN+3 Share (%)	21	1	8	52	19	31	69

Notes:
1. "ASEAN+3" consists of the People's Republic of China, Indonesia, Japan, the Republic of Korea, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam. No data for Brunei Darussalam, Cambodia, Lao PDR, and Myanmar.
2. "EU" consists of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom.

Source: International Monetary Fund's (IMF) Coordinated Portfolio Investment Survey.

The ADB (2012b) reports that the largest proportion of total debt investments by Asian countries is still in domestic debt instruments issued in their home markets, with the portfolio allocation for domestic debt investments ranging from almost 40% for Hong Kong, China to more than 90% for most other ASEAN+3 economies in 2010 (**Figure 10**). Investments by Asian investors into domestic debt instruments offered in Asian markets other than their home country are still small, with the proportion ranging from 0.2% each for Japan and Republic of Korea, to 21% for Singapore. This indicates that ASEAN+3 investors are likely to have a "Home" bias, i.e., a strong preference for domestic debt securities in their respective home markets.

Figure 10: Portfolio Debt Allocation by ASEAN+3 Investors to Home, Asia, and Global, 2010
(percent)



Notes:

1. "Asia" comprises the People's Republic of China (PRC); Hong Kong, China; India; Indonesia; Japan; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei,China; Thailand; and Viet Nam.
2. "Global" comprises the United States (US) and European Union (EU)-15.

Source of basic data: ADB (2012b)

E. General State of LCY Bond Market in ASEAN

Overall, the LCY bond markets in the ASEAN region have had recorded positive and rapid growth in the past decade or so, largely induced by greater investor participation, wider issuer base, developments on the market microstructure—such as establishment of trading platforms, clearing and settlement systems, etc.—and improvements in their legal and regulatory environment. Moving forward, it is expected that ASEAN bond markets will continue to grow strongly, especially as the region is and will still be awash with liquidity, partly encouraged by the on-going accommodative monetary policy, labelled as quantitative easing, of the United States (US), which have led foreign investors to chase for higher yields through investing in emerging market bonds, such as those in ASEAN. In addition, investors are expected to continue to invest in bonds in the Asian region, which is performing relatively better economically than the US or the European Union (EU), which continues to struggle with a recession and uncertainty in the handling of its banking and sovereign debt problems.

Despite these developments in ASEAN bond markets, there still remain numerous obstacles. For one, the ASEAN bond market is still relatively tiny in terms of size. Secondly, there has been progress in the trading activity in government bonds in the region, but trading in corporate bonds is still weak. Third, cross-border bond investment within ASEAN, and even within ASEAN+3, is not buoyant.

Against this backdrop, it is important to address these barriers to hasten the development of ASEAN+3 bond markets, especially encourage more cross-border bond investment. It has been proposed that a regional credit rating facility for ASEAN+3 bonds is needed to achieve this purpose. In this context, the role of DCRAs in the region will be crucial. This is because DCRAs are the ones who are in a better position to relay information to investors as regards the creditworthiness of LCY bond issuers. They also have an advantage in analysing the structure, terms, and conditions of various LCY debt instruments. In this regard, the next section will discuss about the DCRAs in the ASEAN region.

III. Domestic Credit Rating Agencies in ASEAN Region

This section presents a discussion on the characteristics of domestic credit rating agencies (DCRAs) in the ASEAN region. In particular, DCRAs who are members of the Association of Credit Rating Agencies in Asia (ACRAA) will be the focus of this section. Those ASEAN-based DCRAs who are members of ACRAA and who are the focus of this section are: PEFINDO Credit Rating Indonesia, PT ICRA Indonesia, Malaysian Rating Corporation Berhad (MARC), RAM Rating Services Berhad, Philippine Rating Services Corporation (PhilRatings), and TRIS Ratings.

A. Background of DCRAs

There are two DCRAs in Indonesia who are members of ACRAA—PT Pemeringkat Efek Indonesia (PEFINDO) and PT ICRA Indonesia (ICRA Indonesia). PEFINDO was created in 1993 through the joint efforts of BAPEPAM (Capital Market's Supervisory Board) and Bank Indonesia (BI), to become the first DCRA in the country. It obtained its license from BAPEPAM a year later. PEFINDO is an affiliate of Standard and Poor's (S&P). By the end of 2011, PEFINDO has 92 local institutional investors as its shareholders, consisting of banks, insurance companies, pension funds, securities companies, and the Indonesia Stock Exchange. Meanwhile, ICRA Indonesia (ICRA Indonesia) acquired its license from BAPEPAM only in 2010. It is 99% owned by ICRA Limited, a CRA in India.

BAPEMAM is the government agency responsible for supervising and monitoring both PEFINDO and ICRA Indonesia. Among the rules stipulated by BAPEMAM in relation to credit ratings in Indonesia include: i) Rating of Debt Securities; ii) Licensing of Rating Agency; iii) Behavior of Rating Agency Companies; iv) Ranking Agreement Guidelines; v) Company Reports Rating Agency; vi) Document Maintenance Company by Rating Agency; and vii) Publications by Rating Agency Companies. (ADB 2012c)

In Malaysia, there exists two DCRAs who are ACRAA members, and they are Malaysian Rating Corporation Berhad (MARC) and RAM Rating Services Berhad (RAM Ratings). MARC was incorporated in October 1995, and started its operations in 1996. Insurance companies, stockbrokers, and investment banks domiciled in Malaysia are the major shareholders of MARC. It rates asset-backed securities, Islamic debt instruments (*sukuks*), corporate bonds, and corporate bond issuers. In addition, it provides financial strength ratings for financial institutions, including insurance firms. Meanwhile, RAM Ratings was incorporated much earlier than MARC, in November 1990, and is a subsidiary of RAM Holdings, which has as its major shareholders Fitch Ratings and McGraw-Hill Asian Holdings (Singapore). It rates various organizations such as financial institutions—such as banks and insurance companies—, non-financial corporates, government-linked or financed institutions, and investment vehicles. It also rates various types of debt instruments, such as *sukuks* and structured debt instruments.

The regulator of DCRAs in Malaysia is the Securities Commission Malaysia, which was created in March 1993 pursuant to the *Securities Commission Act 1993*. It is a self-funding statutory body that reports to the Ministry of Finance. The Securities Commission first introduced the regulatory framework for the DCRA industry in Malaysia through its release of the "Practice Note on the Guidelines on the Offering of Private Debt Securities and the Guidelines on the Offering of Islamic Securities" in January 2006. It then rationalized its regulatory requirements for DCRAs through the enactment into law of the Capital Markets and Services Act in September 2007. Finally, in March 2011, the Securities Commission released the "Guidelines on Registration of Credit Rating Agencies", which supersedes the Practice Note, which was introduced in January 2006. The 2011 Guidelines stipulate the registration criteria, registration procedure, compliance and reporting requirements, and actions of non-compliance, covering Malaysia's DCRA industry. (Securities Commission Malaysia, 2011)

In the Philippines, a DCRA that is also an ACRAA member is Philippine Rating Services Corporation (PhilRatings). It is accredited by the Philippine government's Securities and Exchange Commission (SEC), which has been using PhilRatings' ratings as bases in approving companies' applications for licenses to issue debt securities since 1985. Meanwhile, the Philippine central bank—Bangko Sentral ng Pilipinas (BSP)—has recognized PhilRatings as a DCRA for bank supervisory

purposes since 2003. Between 1985 and June 2012, PhilRatings has assigned about 418 credit ratings for issuers and debt issues spanning 109 companies.

In Thailand,TRIS Rating, an ACRAA member, has almost 20 years of experience in credit ratings dating back in 1993 when it was part of Thai Rating and Information Services Co. (TRIS), the first DCRA in Thailand, which was later renamed TRIS Corporation in 2007. In 2002, TRIS Rating was created as a separate company. TRIS Rating provides credit ratings for companies and debt issues. It only rates LCY debt instruments—such as secured and unsecured debentures, structured finance issues, guaranteed debentures, and securitized debt instruments.

Credit rating agencies in Thailand are regulated by the Bank of Thailand (BOT), Ministry of Finance, and the Securities and Exchange Commission. Per regulations of the Commission, new debentures issued publicly must have a credit rating from an authorized credit rating agency. Meanwhile, private placements can choose to have either issue or issuer ratings, whereas those with limited distribution (i.e., not exceeding ten investors) are exempted from ratings. (ADB, 2012c)

B. Rating Symbol and Definition

The rating symbols of DCRAs in ASEAN-4 vary in terms of entity or issuer, tenor, and debt instrument. Generally, there are seven (7) to nine (9) long-term rating symbols and definitions for a rated entity or issuer. In addition, some ASEAN-4 DCRAs provide short-term ratings for an entity or issuer. A rating outlook is also given by ASEAN-4 DCRAs, and these are normally of four (4) categories.

For a long-term debt instrument, i.e., a debt instrument with tenor of more than 1 year, its rating symbols and definitions by most ASEAN-4 DCRAs totalled eight (8), while one DCRA has nine (9). For a short-term debt instrument, i.e., those with tenor of 1 year or less, DCRAs in the ASEAN-4 countries have about four (4) to five (5) rating symbols and definitions.

PT ICRA Indonesia has 7 rating symbols for a rated entity or issuer, ranging from [Idr] AAA—which is the highest credit rating, with the rated entity having the lowest credit risk—to [Idr] C, the lowest credit rating with the rated entity having an extremely high credit risk (**2.2a**). For a rated instrument that has a tenor of more than 1 year, there are eight (8) rating symbols, ranging from [Idr] AAA to [Idr] D, which is its lowest credit rating.

Table 2.2a: Rating Symbol and Definition of PT ICRA Indonesia for Entity/Issuer & Long-Term Debt Instrument

Rating	Definition
[Idr]AAA	Highest credit-quality-rating. Rated entity/instrument has the lowest credit risk.
[Idr]AA	High credit-quality-rating. Rated entity/instrument has a low credit risk.
[Idr]A	Adequate credit-quality-rating. Rated entity/instrument carries an average credit risk.
[Idr]BBB	Moderate credit-quality-rating. Rated entity/instrument carries a higher-than-average credit risk.
[Idr]BB	Inadequate credit-quality-rating. Rated entity/instrument has a high credit risk.
[Idr]B	Risk-prone credit-quality-rating. Rated entity/instrument has a very high credit risk.
[Idr]C	Lowest credit-quality-rating for rated entity; poor credit rating for rated instrument.
[Idr]D	Lowest credit-quality-rating for rated instrument. Rated instrument has very low prospects of recovery.

Notes:

1. A plus sign (+) or a minus sign (–) can be appended to all rating symbols except for [Idr] AAA.
2. Rated long-term debt instruments are those with tenors of more than one (1) year.

Source: PT ICRA Indonesia.

Credit ratings for short-term debt instruments are also being provided by PT ICRA Indonesia. These short-term ratings, which range from [Idr]A1 (highest credit rating) to [Idr]A5 (lowest credit rating) are listed in **Table 2.2b**:

Table 2.2b: Rating Symbol and Definition of ICRA Indonesia for Short-Term Debt Instrument

Rating	Definition
[Idr]A1	Highest credit-quality-rating. Rated short-term instrument has the lowest credit risk.
[Idr]A2	Above-average credit-quality-rating. Rated short-term instrument has higher credit risk than those rated [Idr]A1.
[Idr]A3	Moderate credit-quality-rating. Rated short-term instrument has higher credit risk than those rated [Idr] A1 or [Idr] A2.
[Idr]A4	Risk-prone credit-quality-rating. Rated short-term instrument carries high credit risk.
[Idr]A5	Lowest credit-quality-rating. Rated short-term instrument has limited prospects of recovery.

Notes:

1. Ratings can be appended by a plus sign (+) for all rating symbols except for [Idr]A5.
2. A short-term instrument has a maturity of less than one (1) year.

Source: ICRA Indonesia.

MARC has ratings on two (2) types of issuers—corporate and sovereign—and there are four (4) types of entities that it rates, namely, non-financial corporates, financial institutions (ex. banks), insurance companies, and Islamic financial institutions. The rating symbols for each of these issuers and entities are presented in **Table 2.3a**. Generally, the symbols for long-term ratings of entities and issuers have eight (8) categories, ranging from AAA—the highest rating—to D—the lowest rating. Long-term ratings can be appended by either a plus (+) sign or a minus (-) sign. Also, MARC provides four (4) types of short-term entity or issuer ratings, with the highest short-term rating category being MARC-1, and the lowest MARC-4. Furthermore, MARC gives an assessment on the future direction of the rating in the intermediate term, which runs over a 1- to 2-year period, in the form of a rating outlook; and Table 2.2a also presents the 4 types of rating outlooks that MARC provides.

Table 2.3a: Rating Symbol and Definition of Malaysian Rating Corporation Berhad (MARC) for an Entity/Issuer

Rating	Definition
Long-Term	
AAA	Extremely high capacity to meet financial obligations.
AA	Very strong capacity to meet financial obligations.
A	Strong capacity to meet financial obligations.
BBB	Adequate capacity to meet financial obligations.
BB	Likelihood of default is lower than lower-rated issuers.
B	Greater likelihood of default and high degree of uncertainty.
C	High likelihood of default.
D	Default.
Short-Term	
MARC-1	Very strong capacity to meet short-term financial obligations.
MARC-2	Strong capacity to meet short-term financial obligations.
MARC-3	Adequate capacity to meet short-term financial obligations.
MARC-4	Uncertain capacity to meet short-term financial obligations.
Rating Outlook	
Positive	Rating may be raised.
Negative	Rating may be lowered.
Stable	Rating may remain unchanged.
Developing	Rating may be raised, lowered, or remain unchanged.

Note: Long-term ratings from AA to B can be appended by a plus (+) or minus (-) sign.
Source: Malaysian Rating Corporation Berhad (MARC).

MARC also provides credit ratings on debt instruments, specifically corporate debt, Islamic capital market instruments—including *sukuks* and those with non-fixed income obligations—, and structured finance products. Except for Islamic capital market instruments that have non-fixed income obligations, the rest have eight (8) long-term rating symbols or categories, five (5) short-term rating categories, and 4 types of rating outlooks (**Table 2.3b**). Meanwhile, there are seven (7) rating categories for non-fixed income Islamic debt instruments, having all the rating symbols as shown in Table 2.2b, with the exception of the rating symbol "D".

Table 2.3b: Rating Symbol and Definition of Malaysian Rating Corporation Berhad (MARC) for Debt Instrument

Rating	Definition
Long-Term	
AAA	Extremely high ability to meet financial obligations a timely basis.
AA	Very strong ability to meet financial obligations on a timely basis.
A	Strong ability to meet financial obligations on a timely basis.
BBB	Adequate capacity to meet financial obligations on a timely basis.
BB	Likelihood of default is lower than lower-rated issues. Uncertainties exist.
B	Greater likelihood of default and high degree of uncertainty.
C	High likelihood of default.
D	Payment in default.
Short-Term	
MARC-1	Very high likelihood of meeting short-term financial obligations on a timely basis.
MARC-2	Strong capacity to meet short-term financial obligations on a timely basis.
MARC-3	Adequate capacity to meet short-term financial obligations on a timely basis.
MARC-4	Vulnerable to non-payment of short-term financial obligations.
D	Payment in default.
Rating Outlook	
Positive	Rating may be raised.
Negative	Rating may be lowered.
Stable	Rating may remain unchanged.
Developing	Rating may be raised, lowered, or remain unchanged.

Notes:
1. Long-term ratings from AA and B can be appended by a plus sign (+) or a minus (-) sign to show the relative standing within the rating categories.
2. Long- and short-term ratings carry a suffix (*bg)* for bank-guaranteed issues, (*cg)* for corporate-guaranteed issues, (*fg)* for issues guaranteed by a financial guarantee insurer, and (*s)* for all other support, when such support or guarantee provides a favourable effect to the assigned rating.
3. Ratings are appended by a subscript (*id*) for Islamic capital market instruments, (*is*) for *sukuks*, and (*iq*) for non-fixed income Islamic capital market instruments.

In addition, MARC has 5 rating categories on the corporate governance processes and practices of Islamic financial institutions (IFIs) in Malaysia. They are:

a. GR-1 (IFI has very good corporate governance processes and practices);
b. GR-2 (IFI has good corporate governance processes and practices);
c. GR-3 (IFI has satisfactory corporate governance processes and practices);
d. GR-4 (IFI has weak corporate governance processes and practices); and
e. GR-5 (IFI has very weak corporate governance processes and practices)

RAM Ratings has a rating definition for 4 types of issuers, and these ratings are corporate credit ratings, financial institutions ratings, claims-paying ability ratings, and financial enhancement ratings. Entity ratings are either long-term or short-term. The long-term ratings are applied to financial institutions,

non-financial corporates, insurance companies, and financial guarantee insurance companies. Meanwhile, the short-term entity ratings apply to financial institutions, non-financial corporates, and financial guarantee insurance companies. There are eight (8) symbols for long-term ratings, ranging from AAA—with the rated entity having a superior quality to meet its financial obligations—to D, which means that the rated entity is currently in default. On the other hand, there are five (5) symbols for short-term ratings, ranging from P1 (rated entity has a strong capacity to meet its short-term obligations) to D (rated entity is currently in default) (**Table 2.4**).

Table 2.4: Rating Symbol and Definition of RAM Ratings for Entity/Issuer

Rating	Definition
Long-Term	
AAA	Entity has a superior capacity to meet its financial obligations.
AA	Entity has a strong capacity to meet its financial obligations.
A	Entity has an adequate capacity to meet its financial obligations.
BBB	Entity has a moderate capacity to meet its financial obligations.
BB	Entity has a weak capacity to meet its financial obligations.
B	Entity has a very weak capacity to meet its financial obligations.
C	Entity has a high likelihood of defaulting on its financial obligations.
D	Entity is currently in default on either all or a substantial portion of its financial obligations, whether or not formally declared.
Short-Term	
P1	Entity has a strong capacity to meet its short-term financial obligations.
P2	Entity has an adequate capacity to meet its short-term financial obligations.
P3	Entity has a moderate capacity to meet its short-term financial obligations.
NP	Entity has a doubtful capacity to meet its short-term financial obligations.
D	Entity is currently in default on either all or a substantial portion of its financial obligations, whether or not formally declared.

Notes:
1. Long-term ratings apply to non-financial corporates, financial institutions, insurance companies, and financial guarantee insurance companies. Short-term ratings apply to non-financial corporates, financial institutions, and financial guarantee insurance companies.
2. Long-term ratings can be appended by subscripts 1, 2, or 3 in each rating category from AA to C, if the entity ranks at the higher-, mid-, or lower-end, respectively, of its rating category.

Source: RAM Ratings.

The Philippine Rating Services Corporation (PhilRatings) has nine (9) rating symbols and definitions for domestic issuers—specifically, corporates, financial institutions, and local government units (**Table 2.5a**). These ratings range from "PRS Aaa", which is the highest credit rating and signifies a very strong capacity of the issuer to meet financial obligations, to "PRS C", which symbolizes a default by the issuer on its financial commitments. It also has the same set of ratings for long-term debt instruments, whereas for short-term debt instruments, PhilRatings provides six (6) rating symbols ranging from "PRS 1", which indicates strongest capability to meet interest and principal payments, and "PRS 6", which means default (**Table 2.5b**).

Table 2.5a: Rating Symbol and Definition of Philippine Rating Services Corporation (PhilRatings) for Entity/Issuer

Rating	Definition
PRS Aaa	Very strong capacity to meet financial obligations.
PRS Aa	Strong capacity to meet financial obligations.
PRS A	Above average capacity to meet financial obligations.
PRS Baa	Average capacity to meet financial obligations.
PRS Ba	Below average capacity to meet financial obligations.
PRS B	Weak capacity to meet financial obligations.
PRS Caa	Currently vulnerable to defaulting on its financial obligations.
PRS Ca	Currently highly vulnerable to defaulting on its financial obligations.
PRS C	In default.

Note: Rating symbol and definition applies to corporates, financial institutions, and local government units.
Source: Philippine Rating Services Corporation (PhilRatings)

Table 2.5b: Rating Symbol and Definition of Philippine Rating Services Corporation (PhilRatings) for Long- and Short-term Debt Instrument

Rating	Definition
Long-Term	
PRS Aaa	Extremely strong capacity to meet financial obligations.
PRS Aa	Very strong capacity to meet financial obligations.
PRS A	Strong capacity to meet financial obligations.
PRS Baa	Obligation has adequate protection measures, but with certain speculative characteristics.
PRS Ba	Obligation faces major uncertainties that could lead to obligor's inadequate capacity.
PRS B	Weak capacity to meet financial obligations.
PRS Caa	Vulnerable to defaulting on its financial obligations.
PRS Ca	Highly vulnerable to defaulting on its financial obligations.
PRS C	In default.
Short-Term	
PRS 1	Strongest capability for timely payment of both interest and principal.
PRS 2	Above average or strong capability to pay both interest and principal.
PRS 3	Satisfactory capability for payment of both interest and principal.
PRS 4	Minimal assurance for timely payment of both interest and principal.
PRS 5	Very doubtful capability to pay interest or principal.
PRS 6	In default.

Source: Philippine Rating Services Corporation (PhilRatings)

TRIS Ratings has eight (8) rating symbols and definitions for both an entity or issuer and a long-term debt instrument, ranging from “AAA”, the highest credit rating, to “D”, the lowest rating (**Table 2.6)**. In addition, the rating agency has five (5) rating symbols and definitions for short-term debt instruments, the highest being “T1”, and the lowest, being “D”. The identifier “sf” is appended to the rating of a structured finance product, and a plus (+) or minus (-) sign is also appended between rating symbols “AA” and “C” to signify the relative standing within the rating category.

There are also four types of rating outlooks, namely, “Positive”, “Negative”, “Stable”, and “Developing”. TRIS Ratings formulates its rating outlook based on the prospects of the industry where the rated entity is operating, and the business conditions of that entity that could potentially affect its creditworthiness.

Table 2.6: Rating Symbol and Definition of TRIS Ratings for Entity (Issuer), Long- and Short-term Debt Instrument

Rating	Definition
Entity/Long-Term Debt Instrument	
AAA	Extremely strong capacity to meet financial obligations. Smallest degree of credit risk.
AA	Very strong capacity to meet financial obligations. Very low degree of credit risk.
A	Strong capacity to meet financial obligations. Low credit risk.
BBB	Adequate capacity to meet financial obligations. Moderate credit risk.
BB	Less than moderate capacity to meet financial obligations. High credit risk.
B	Low capacity to meet financial obligations. Very high credit risk.
C	Significant inability to meet financial obligations. Highest risk of default.
D	In default.
Short-Term	
T1	Issuer has strong market position, wide margin of financial protection, appropriate liquidity and other measures of superior investor protection.
T2	Issuer has secure market position, sound financial fundamentals, and satisfactory ability to repay short-term obligations.
T3	Issuer has acceptable capacity to meet its short-term financial obligations.
T4	Issuer has weak capacity to meet its short-term financial obligations.
D	In default.
Rating Outlook	
Positive	Rating may be raised.
Negative	Rating may be lowered.
Stable	Rating may remain unchanged.
Developing	Rating may be raised, lowered, or remain unchanged.

Notes:

1. The identifier “sf” is appended to a debt instrument that is a structured finance product, as defined by the Securities and Exchange Commission (SEC) of Thailand.
2. Long-term ratings from AA to C can be appended by a plus (+) or minus (-) sign to determine the relative standing within a rating category.

Source: TRIS Ratings.

C. Rating Methodology

Credit ratings reflect the creditworthiness of an entity or an issuer as regards its ability to meet short- and/or long-term financial obligations, particularly in terms of repaying the interest and principal. For DCRAs based in the ASEAN-4 countries, their rating methodology generally makes use of a combination of business or industry analysis and financial analysis. In business or industry analysis, among the common areas that are being looked at by the ASEAN-4 DCRAs are the rated entity’s competitive position, legal and regulatory environment, management quality, and business diversification. With respect to financial analysis, the DCRAs normally study the entity’s profitability, capital structure, liquidity, and asset quality conditions.

The ratings methodology of PT ICRA Indonesia is akin to a risk analysis framework, i.e., a comprehensive evaluation of the risks on the ability of the entity to generate cash flows. The specific risks

that PT ICRA Indonesia looks at are business risk and financial risk (**Table 2.7)**. In evaluating the business risk of an issuer, PT ICRA Indonesia takes into account industry risk, the entity's competitive position, and management quality. Industry risk—which encompasses the level of competition, regulatory risks, demand-supply conditions—is assessed by the rating agency in order to determine the relative attractiveness of that industry in which the issuer operates in. Meanwhile, the competitive position of the issuer is evaluated based on the issuer's level of technology, locational advantage, market share, operating efficiency, and scale of operations. Management quality is assessed by PT ICRA Indonesia in terms of management's experience and commitment in the line of business, risk tolerance, policies on leveraging and managing currency and interest rate risks, business plans and projects, and the relative strength of the other companies who are affiliated or belong to the same group as the issuer.

Meanwhile, the financial risk of a rated entity or issuer is likewise assessed by PT ICRA Indonesia in order to understand the entity's current financial position and risk profile. The main areas in the rating agency's financial risk analysis include the entity's financial position, profitability, capital structure, and financial flexibility. Among the specific topics that the rating agency considers in assessing the entity's financial position are: accounting quality—such as reviewing accounting policies and auditor's opinions—, contingent liabilities/off-balance sheet exposures, debt service, "gearing"—which looks at the issuer's level of debt relative to its funds—, financial flexibility, operating profitability, and working capital.

Table 2.7: Summary of PT ICRA Indonesia's Rating Methodology

Business Risk	Financial Risk
Industry Risk	Financial Position
Competitive Position	Profitability
Management Quality	Capital Structure
	Financial Flexibility

Source: PT ICRA Indonesia.

MARC's rating methodology varies across types of entities (**Table 2.8**). For a sovereign entity and its debt instrument, the analysis of its credit rating would be based on its debt and contingent liability management, economic strength, financial sector resilience, fiscal sustainability, monetary and exchange rate management, and political, institutional, and social stability (MARC 2012b). For a corporate entity and its debt instrument, a combination of business risk analysis, financial risk analysis, analysis of management and other qualitative factors, together with the issue structure and term will be utilized (MARC 2012a). The weights of business risk analysis, financial risk analysis, and analysis of management and other qualitative factors are 50%, 40%, and 10%, respectively, and these normally hold for most non-structured products. For business risk, the analysis covers the corporate entity's competitive position, operations, and the characteristics of its industry. For financial risk analysis, the areas that would be covered are the corporate entity's cash flow and debt service capacity, profitability, capital structure, and financial flexibility and policies. In assessing the corporate entity's management quality, MARC looks at the management's track record, particularly during different phases of the economic cycle; corporate governance policies; growth plans; and risk appetite, among others. Meanwhile, MARC also considers the nature of the issue structure and terms and conditions in rating a debt instrument. In general, it's issue-specific rating would largely depend on the implications of the debt issue on its maturity profile, debt servicing burden, covenants, and the planned use of the debt proceeds.

Table 2.8: Summary of Malaysian Rating Corporation Berhad's (MARC) Rating Methodology

Entity	Factors		
Sovereign	Debt and contingency liability management		
	Economic strength		
	Financial sector resilience		
	Fiscal sustainability		
	Monetary and exchange rate management		
	Political, institutional, and social stability		
	Business risk	**Financial risk**	**Management quality**
Corporate	Competitive position	Cash flow and debt service capacity	Track record of management
	Operational efficiency	Profitability	Corporate governance
	Industry characteristics	Capital Structure	
		Financial flexibility	

Source: Malaysian Rating Corporation Berhad (MARC).

PhilRatings' rating methodology takes into account both business risk and financial risk facing the entity or issuer (**Table 2.9**). In business risk, the ratings agency takes into account five (5) areas: i) Economic risk, ii) Industry risk, iii) Market position, iv) Business diversification, and v) Management and strategy. In dealing with economic risk, the ratings agency assesses the extent of the risks in the overall economy in which the entity operates in, and how changes in the macroeconomic performance impacts the operations of the entity. Industry risk is dealt with by the ratings agency by looking at the structure of the industry, the degree of competition, the regulatory and legal framework, and the government's role in the industry. Market position is evaluated based on the entity's market share in key business areas, the quality of the entity's business, and pricing power. Business diversification looks at the strengths and weaknesses of the different business lines of the entity, its customer base, and the variety of its products. Management and strategy is assessed based on the company's past performance to ascertain the level of managerial effectiveness and credibility of its management and planning processes. Meanwhile, financial risk facing the entity is assessed by PhilRatings in terms of the entity's asset quality, capital structure and leverage, cash flow and liquidity condition, earnings generating capacity, and financial flexibility.

Table 2.9: Summary of Philippine Rating Services Corporation's (PhilRatings) Rating Methodology

Business Risk	Financial Risk
Business Diversification	Asset Quality
Economic Risk	Capital Structure & Leverage
Industry Risk	Cash Flow & Liquidity
Management & Strategy	Earnings Generation
Market Position	Financial Flexibility

Source: Philippine Rating Services Corporation (PhilRatings)

An assessment of PhilRatings' historical rating record and performance covering the period 1993-2011 reveals that PhilRatings had assigned 636 issuer and issue credit ratings to 98 companies in which 77% of these ratings were for long-term debt issues and 23% for short-term issues. Also, 91% of these credit ratings were for investment-grade debt instruments. Out of the long-term debt issue credit ratings which numbered 492, 101 of these were for new debt issues, as the remainder were for the monitoring of outstanding debt securities. As such, there were a total of 245 credit ratings for new debt issues made by PhilRatings between 1993 and 2011. Out of these ratings for new debt issues, about one-fourth were for companies in the manufacturing sector, which served as that sector that received the largest number of

new debt issue credit ratings from PhilRatings. Moreover, PhilRatings gave issuer ratings to 13 entities from 1993 to 2011, and that there were a total of 5 defaults during this period. Meanwhile, PhilRatings' 1-year transition probability matrices covering debt issues made in the 1993-2011 period indicate that debt issues rated PRS Aaa or PRS 1 are more stable than those with lower ratings as they have a greater probability in remaining in the same rating. In addition, PhilRatings' 5-year cumulative default probability matrix shows that debt issues with a PRS Aaa rating have a less than 1% probability of defaulting in five years whereas those rated PRS Ca have a 20% probability of defaulting in five years.

TRIS Ratings has rating methodologies for various types of entities, such as banks, corporates, local government units, and government-related-entities. The rating methodology for both banks and corporates encompasses three types of analyses: 1) Industry analysis; 2) Business analysis; and 3) Financial analysis (**Table 2.10**).

Table 2.10: Summary of TRIS Ratings' Rating Methodology

Entity	Industry Analysis	Business Analysis	Financial Risk Analysis
Corporate	Industry prospects	Competitive position	Accounting quality
	Degree of competition	Management quality	Financial policy
	Legal/regulatory framework	Organizational structure	Profitability
		Ownership structure	Capital structure
		Business diversification	Liquidity
			Efficiency
Bank	Industry prospects	Competitive position	Profitability
	Degree of competition	Management quality	Capitalization
	Legal/regulatory framework	Organizational structure	Funding and liquidity
		Ownership structure	
		Business diversification	
		Business strategies	
		Franchise value	
		Asset quality	
		Risk management	

Source: TRIS Ratings.

For both a corporate entity and a bank, the areas that are looked at in industry analysis are: 1) Industry prospects; 2) Degree of competition; and 3) Legal and regulatory framework. In business analysis of a corporate entity, the rating agency looks at the entity's management quality, organizational structure, ownership structure—including its relationship with affiliated companies belonging to the same business group—, competitive position, and business diversification. For a bank, business analysis covers all the above-mentioned areas, but at the same time, adds other elements such as the bank's i) Business strategy; ii) Franchise value—which looks at the bank's standards in rendering quality service, operating efficiency of the bank's network, reputation to its customers, utilization of its branch network and alliances, and group synergy; iii) Asset quality, which covers the quality of loan and securities investment portfolios, quality of credit risk management, and allowance for loan losses; and iv) Risk management.

For the financial risk analysis, TRIS Ratings looks at the entity's i) Accounting quality, using consolidated financial statements; ii) Financial policy, covering capital structure and dividend policy, among others; iii) Financial ratios related to capital structure, profitability, liquidity and cash flow, and efficiency. For banks, the rating agency looks at various ratios pertaining to profitability—with emphasis on the bank's revenue base, interest spreads, operating profits, and it's degree of revenue diversification

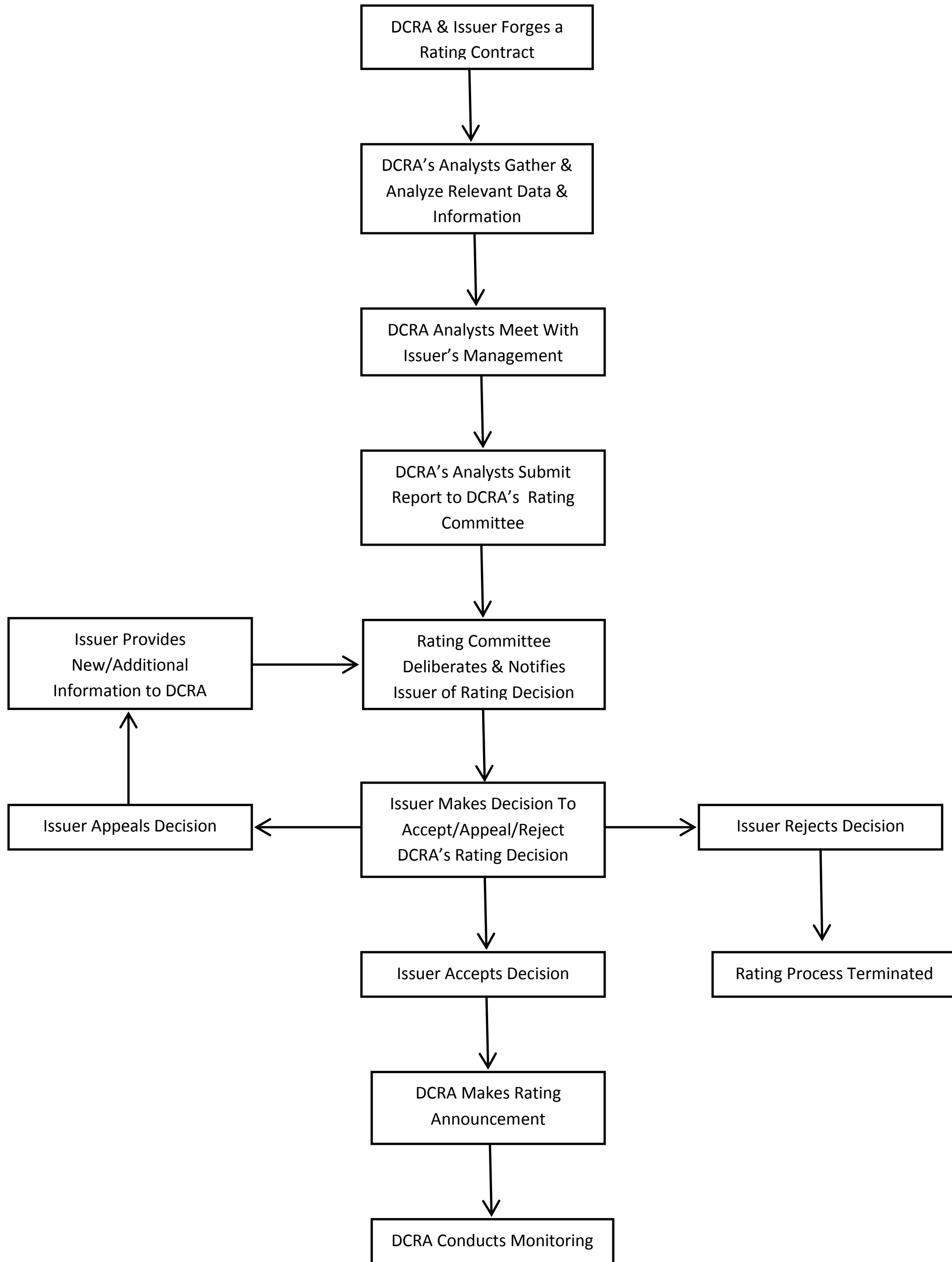
and stability. TRIS Ratings also evaluates bank capitalization, focusing on the composition and quality of bank capital. It likewise assesses a bank's funding and liquidity conditions, magnifying on the bank's ability to service its debt and to maintain liquidity and gain access in funding sources, especially during times of stress. (For more details on TRIS Rating's rating methodologies on banks and corporates, refer to TRIS 2007a and TRIS 2007b, respectively.)

TRIS Ratings evaluates the credit risk profile of local governments in Thailand based on their economic environment, their relationship with the central government, their administrative capability, their budgetary management, and their fiscal performance (TRIS, 2007c). As regards government-related-entities—which include certain government agencies, ministerial departments, and state-owned enterprises (SOEs)—TRIS Ratings assess their industry risk, business risk, and financial risk, and also the degree of government support for them (TRIS 2007d).

D. Rating Process

The rating process for DCRAs in ASEAN-4 countries starts with an entity forging an agreement with the DCRA for the latter to provide a rating on the former's planned issuance of a debt instrument. The DCRA will then form a team of analysts who will then gather pertinent data and other information needed for their analyses of the entity's business and financial performances as well as managerial performance. The information will be sourced by the DCRA from the entity. The structure, terms, and conditions of the proposed debt instrument issue will also be assessed by the DCRA. The DCRA will then meet with key management personnel of the entity to further discuss various areas related to the information provided by the entity, as well as to gather more information. The team of analysts will then submit a report, which includes the recommended rating, to the DCRA's Rating Committee, who will then deliberate and finalize on the proposed rating. Then, the rating agency will notify the rated entity on the rating provided to them. The rated entity can either accept the rating or appeal for reconsideration. The Rating Committee will then reconvene if the rating is on appeal for reconsideration and will again make a decision as regards the rating of the entity. If the rating has been accepted by the rated entity, the rating agency will then disseminate the rating to the public. After which, the rating agency will monitor the performance of the rated entity on an annual basis until the contract ends. On the other hand, if the rating has been rejected, the rating process will then be terminated. A diagram showing the general rating process of ASEAN-4 DCRAs is illustrated in **Figure 11** below:

Figure 11: Rating Process of Domestic Credit Rating Agencies (DCRAs) in ASEAN-4



IV. Association of Credit Rating Agencies in Asia

The Association of Credit Rating Agencies in Asia (ACRAA) was established in September 2001 by 15 DCRAs from 10 Asian countries. At present, it has 28 DCRA members. In the ASEAN+3 region, there are a total 16 DCRA members—5 from the PRC, 4 from the Republic of Korea, 2 from Indonesia, 2 from Malaysia, and 1 each from Japan, the Philippines, and Thailand (**Table 2.11**).

Table 2.11: Domestic Credit Rating Agencies (DCRA) Members of the Association of Credit Rating Agencies in Asia (ACRAA) in the ASEAN+3 Region

Country	Domestic Credit Rating Agency
People's Republic of China	China Chengxin International Credit Rating
	China Lianhe Credit Rating
	Dagong Global Credit Rating
	Shanghai Far East Credit Rating
	Shanghai Brilliance Credit Rating & Investors Service
Indonesia	PEFINDO Credit Rating Indonesia
	PT ICRA Indonesia
Japan	Japan Credit Rating Agency Limited
Republic of Korea	Korea Investors Service
	Korea Ratings Corporation
	NICE Investors Service
	Seoul Credit Rating & Information
Malaysia	Malaysian Rating Corporation Berhad (MARC)
	RAM Rating Services
Philippines	Philippine Rating Services Corporation (PhilRatings)
Thailand	TRIS Rating

Source: Association of Credit Rating Agencies in Asia (ACRAA)

ACRAA consists of six committees, namely, the “Best Practices”, “Communications”, “Membership”, “Regulatory Relations”, “Research and Special Studies”, and “Training” committees. It has a Board of Directors and Officers and is headed by a Secretary-General.

ACRAA had numerous accomplishments since its inception in 2011 (ACRAA 2011). So far, ACRAA had conducted sixteen (16) dialogues, the first held in August 2002 in Kuala Lumpur, Malaysia, and the most recent was in January 2012 in Manila, Philippines. The topics of these dialogues include i) code of conduct, ii) rating of well-secured debts, iii) definition of default, iv) factoring corporate governance into ratings; v) harmonization of rating standards and practices, vi) role of rating agencies under Basel II, vii) steps to accelerate cross-border investment in Asia, viii) role of rating outlook, ix) best practices in withdrawing ratings, and x) enforcement of conflict-of-interest rules, among others.

Between 2002 and 2011, ACRAA had conducted seventeen (17) training workshops on various topics—such as securitization, infrastructure projects, real estate investment trusts, micro-small-and medium-sized enterprises, bank loans, guaranteed bonds, and rating harmonization. (ACRAA 2011a) Furthermore, ACRAA conducted a study for the ADB to help establish measures of ratings comparability across different jurisdictions in ASEAN+3 countries plus a few other Asian countries, through mapping of national scale ratings and derivation of expected default curves.

In April 2011, ACRAA published its “Code of Conduct Fundamentals for Domestic Credit Rating Agencies”, which provides a list of recommended practices for DCRAs per the Code of Conduct of the International Organization of Securities Commissions (IOSCO) released in 2004 and the ADB’s Handbook of International Best Practices for Credit Rating Agencies launched in 2008. The Code stipulates best practices in four areas, in particular, on the quality and integrity of the rating processes; on DCRA independence and avoidance of conflicts of interests; on DCRA responsibilities to investors and issuers; on the disclosure of the Code and communication with market participants. (ACRAA 2011b) Adhering to the provisions of this Code would greatly help the DCRAs in the region to enhance their competence and integrity, and thereby promote better credibility.

V. Conclusion

Local-currency (LCY) bond markets in the ASEAN+3 region have developed impressively in terms of size and liquidity in the past years. This was spurred by the region’s solid economic growth, regulatory changes in capital markets, developments in market microstructures for bond issuance and trading, increased variety of fixed-income products, greater participation of institutional investors, and availability of hedging instruments. Also, the advent of domestic credit rating agencies (DCRAs) has contributed to the development of bond markets in the region.

Despite these positive changes in the ASEAN+3 LCY bond market, certain challenges still exist. One major challenge is that cross-border bond investment within the region remains relatively small. Most ASEAN+3 economies have a relatively large chunk of their debt securities investment being made in their own respective markets or outside ASEAN+3, such as in the EU or in the US. This may suggest that ASEAN+3 bond investors have a “Home” bias. Also, it indicates that ASEAN+3 bond markets are still not fully integrated, i.e., they appear to be segmented.

Against this backdrop, various proposals have been raise to help spur cross-border bond investment in the region. One is establishing a regional credit rating facility. Another is to promote mutual recognition and ratings harmonization across different jurisdictions in the region. In either case, the role of DCRAs is vital. Overall, there appears to be room for ASEAN DCRAs to attain ratings harmonization and mutual recognition of ratings. For one, rating symbols and definitions do not vary substantially across ASEAN DCRAs. In addition, their rating methodologies cover three main elements, namely, business risk, financial risk, and management quality—which also includes corporate governance. Their rating process also has various commonalities.

The accomplishments of ACRAA in the past ten years or so since its establishment have contributed to improving the functions and credibility of DCRAs. Their trainings workshops and dialogues were essential in enhancing the competence and integrity of their member DCRAs. ACRAA’s publication of their Code of Conduct was an important step to enable DCRAs to adhere to best practices in four areas, namely, on the quality and integrity of the rating processes; on independence and avoidance of conflicts of interests; on their responsibilities to investors and issuers, and on the disclosure of the Code and communication with market participants. Engaging in a regional study on mapping national scale ratings was also a good step to find ways to achieve mutual recognition and rating harmonization. Moving forward, ACRAA’s roles in terms of enhancing the credibility of DCRAs, in helping policymakers build an environment conducive for mutual recognition and rating harmonization, and in determining the feasibility of a regional credit rating facility, become very important.

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Paper 3: Feasibility of Mutual Recognition by Domestic CRAs and Regulatory Authorities on Bond Ratings & of an Independent Regional CRA in ASEAN+4

1.0 Introduction

It is widely acknowledged that the flow and quality of information are critical in ensuring the efficient operation of today's financial markets and fostering greater market integration. While many agents, like banks, institutional investors and other financial institutions contribute toward the efficient allocation of financial resources, credit rating agencies (CRAs) continue to play an important role. They are principally viewed as agents that mitigate the degree of information asymmetry, a situation wherein the bond issuer knows more information about the probability of default than the investor or other stakeholders. When unabated, this situation is detrimental for investors as a high degree of informational uncertainty will also penalize worthy debt issuers, thereby resulting in a suboptimal allocation of financial resources.

In theory, credit rating agencies are supposed to gather and process information and impartially interpret data to ascertain the degree of credit worthiness of issuers of debt. Credit ratings are usually interpreted as both qualitative and quantitative opinions on matters concerning the probability of default of a debt issue. When the rating of a particular bond issue is published, secondary users can make sound investment decisions as long as the said rating is generated independently, competently and rigorously. CRAs also compile data on ratings migration which provide useful information for modelling rating transition probabilities. In a way, ratings agencies help in minimizing costs related to information gathering and at the same time may be instrumental in lowering borrowing costs. In this simple relationship, establishing and maintaining reputation is considered vital for continued patronage and operational viability.

Over the years, top Global CRAs (GCRAs) continue to provide corporate and sovereign ratings and other services, an important function given that many of today's financial regulators increasingly prescribe the holding of high quality investment instruments. Within the ASEAN+3 bond markets, for instance, only regulators in Hong Kong, Japan, Singapore and Vietnam do not require bond ratings prior to bond issuance (ADB, 2012). In some jurisdictions, however, bond issuers are required to secure bond ratings prior to issuance.

If CRAs generate timely and quality information, then there is no problem, after all, the ratings that they generate represent quantitative and qualitative opinions on creditworthiness. However, since information gaps realistically exist in the financial sector, some natural barriers to complete information may be present. First, there is incomplete knowledge due to poor market penetration. GCRAs cater to international clients who operate in developed economies that have familiar economic structures. In developing economies marked by heterogeneity, however, differential assessments do exist even for the same corporate entity due to differences in methodologies, economic conditions, etc. This has prompted oligopolistic GCRAs to enter into business partnerships with ratings agencies in domestic markets which are more knowledgeable of domestic matters. Second, the nature of the business which is to ascertain credit risk relies on private information that is restricted by confidentiality agreements and certainly is not shared with other competitors. Regulation often plays a role in solidifying market power.

Recently, GCRAs have been the subject of heightened scrutiny due to major controversies that rocked the financial world. Market participants like investors and regulators expect that when the issued rating is favourable, the rated entity should have the ability to stave off adverse market pressures that may result in bankruptcies and default (e.g. Enron, subprime mess and Lehman Brothers). It was also revealed that rated firms did not share complete information to ratings agencies. According to Alessi and Wolverson's (2012) article in the Council of Foreign Relations, the GCRAs have issued controversially favourable ratings which were negated by outcomes of bankruptcies and irregularities. For instance, some GCRAs assigned investment grade ratings to bond issues that defaulted. This was clearly exemplified by the Enron case. In another notable financial event, they were instrumental in creating a subprime mess which unfortunately played a major role in precipitating a massive slowdown in the US housing market.

Prior to such controversies, GCRAs have operated within an environment with minimal regulations despite their oligopolistic nature. Together, the big three have accounted for almost 100% of rated companies. They also have a sizeable number of technical analysts compared with those whose operations do not go beyond national borders. They have been recognized as Nationally Recognized Statistical Ratings Organizations (NRSROs) by the US Securities Exchange Commission, a designation that has effectively shielded them from government intervention.[21] The high degree of industry concentration has, for many years, prevented the entry of new firms, effectively shielding existing firms from competitive pressures. The lack of competition and favoured status coupled with government regulations on investment holdings have provided no incentive for market users of information or ratings to explore other means to ascertain credit worthiness.

Aside from the environment within which they operate, part of the reason why these GCRAs continue to thrive is due to the model that they follow. According to Duan and van Laere (2012), the prevalent model now is the so called seller model (issuer pays model) wherein the issuer will pay a fee for its bond issuances to be rated. Duan and van Laere noted that this business model has several problems including conflict of interest that may compromise independence. This model is in sharp contrast with another model wherein the user of information pays the credit rating agency in order to estimate the probability of default of an issued debt.

Aside from assigning corporate ratings, the GCRAs were also heavily involved in rating sovereign debts which are nationally backed. Because of the link between public finance and key macroeconomic outcomes, GCRAs have also exerted considerable influence in macroeconomic outcomes especially during the critical period wherein several European countries have been subjected to intense scrutiny over fiscal health. As Kaminsky & Schmukler (2002) noted, CRAs have significant macroeconomic effects through the impact of rating changes on stock market returns and country risk status. Gande and Parsley (2010) also studied the responsiveness of mutual fund flows to changes in sovereign ratings and showed that outflows occur given negative changes in ratings. Rating sovereigns is particularly controversial after some central bankers noted certain discrepancies. Recently, a downgrade of Spain's national credit rating has affected the Philippine stock market index and some downgrades in other European countries have increased bond yields. In a recent roundtable on credit ratings, central bankers questioned the apparent bias against domestic companies which are found to be less leveraged compared with their Western counterparts. The ratings of GCRAs also appear to lag relative to the economic progress of ASEAN countries and appear less related to the probability of default. There are also instances wherein factors that are not related to economic fundamentals get factored in.

The controversies have adversely affected the collective reputation of GCRAs and even resulted in heightened scrutiny of agencies' actions and precipitated several policy initiatives. The typical reply is to introduce more regulation as what was done in the European Union and the United States. On September 29, 2006, the Credit Rating Agency Reform Act was signed into law by President Bush. In response, the European Union created the European Securities and Markets Authority (ESMA) to regulate and oversee the actions of the ratings agencies. Recognizing the importance of credit ratings, regulations are also enforced in several ASEAN countries.

While controversies continue to beset the GCRAs, maintaining credit ratings agencies do not represent zero sum games, especially within the ASEAN +3 region which boasts one of the highest savings rates in the world. The recent performance is very promising. The region's bonds markets have continued to grow since a concerted regional effort was hatched to establish domestic bonds markets through the Asian Bonds Market Initiative (ABMI).

Efforts to help CRAs establish reputation, maintain transparency and embrace accountability are already underway. Aside from integrating ethical codes, a more constructive proposal is to set up an independent regional ratings agency or simply focus on the sustained harmonization of regulatory frameworks and rating methodologies and practices in order to make ratings comparable across markets.

[21] By virtue of the Dodd – Frank Act, a new office was created under the SEC to effectively supervise credit rating agencies with NRSRO status. This effectively diminished the autonomy of such organizations.

The objective of these initiatives is to increase cross – border transactions which are impeded by the high degree of heterogeneity in financial markets. In European and ASEAN markets, there are now associations of credit ratings agencies. The Association of Credit Rating Agencies in Asia (ACRAA) was established in 2001 while the European Association of Credit Ratings Agencies (EACRA) was established in 2009.

With heightened financial integration, there is now an increasing realization that credit ratings should be supported by mutual recognition frameworks. This paper reviews the experiences, benefits and limitations associated with the thrust to establish mutual recognition arrangements involving credit ratings.

The organization of the paper is as follows: section 2 identifies some of the issues associated with collective thrusts in promoting cross – border investments through various initiatives like the creation of regional credit ratings and mutual recognition of credit ratings. Section 3 discusses some issues associated with the establishment of a regional ratings agency. Section 4 briefly highlights the NUS model that interprets credit ratings as a public good. Section 5 clarifies the concept of mutual recognition by discussing some issues, developments and frameworks. Section 6 proposes a system of mutual recognition of credit ratings. Section 7 provides a cursory assessment of the feasibility of setting up mutual recognition within ASEAN4 by highlighting regulatory frameworks, market structures and financial products, and the role of credit rating agencies. The last section concludes.

2.0 Some Issues

There is now a sense of urgency among ASEAN member states to solidify gains in integrating markets as envisioned in the charter establishing the ASEAN Economic Community by 2015. A key component is the establishment of strong links among local currency bond markets. Discussions within the ASEAN +3 Bond Market Forum (ABMF) have already identified key characteristics of bond markets that include legal traditions, role of self regulatory organizations, definitions of professional bond investors, key regulatory practices, restrictions and the role of bond registration and credit ratings, to name a few.

Despite significant market and policy developments, there are performance disparities between domestic and regional bond markets. While local currency (LCY) bond markets continue to exhibit stellar growth, this is not the case for cross – border investments within ASEAN+3 markets. Cross – border investments involve investors who reside in an area or jurisdiction different from the origin or source of investments.

In an assessment, much of funds are invested in international bond issues. Promoting cross border investments is critical for it allows firms to tap financial resources in other areas. Within the context of credit ratings, we expect that naturally, uncertainty arises because of the lack of familiarity with ratings standards, methodologies and interpretation of ratings in domestic bond markets. Unlike international ratings, LCY bond ratings are difficult to interpret because they primarily contain processed information pertaining to domestic factors and appear to suffer from lack of comparability.

As mentioned, a huge proportion of businesses still rely on banks for financing needs despite efforts to further develop domestic bond markets. One reason for this is that the relative cost of borrowing from banks may be lower compared with issuance of debt instruments which are subject to registration and other regulations.

Table 3.1 shows that in domestic bonds markets, governments still represent the biggest borrowers compared with those in the private and corporate sector. The table also shows marked heterogeneity. For instance, Japan's sheer size easily dwarfs South Korea and China. The Philippines has one of the smallest market capitalizations, next only to Vietnam.

Table 3.1 Market Capitalization – Size of Local Currency Bond Market

Jurisdiction	Government	Corporate	Total
PRC	2,369.80	696.4	3,066.20
HK	87.6	78.7	166.3
Indonesia	103.9	13.9	117.8
Japan	10,425.50	1,087.30	11,512.80
South Korea	524.3	687.2	1,211.50
Malaysia	160.6	108.4	269
Philippines	63.6	9.4	73
Singapore	105.7	84.9	190.6
Thailand	180.9	44.1	225
Vietnam	14.2	1.4	15.6

Source: Table 25 of ASEAN+3 Bond Market Guide, ADB (2012)

For some countries, tapping international market is also one option. This time the situation is reversed, with the Philippines topping Japan in terms of government issuances. But still, corporate issuances pale in comparison with government ones.

Table 3.2 Size of Foreign Currency Bond Market (as of March 2011) ($ billion)

Jurisdiction	Government	Corporate	Total
PRC	13	58.7	71.7
HK	1.6	70.8	72.4
Indonesia	18	17.3	35.3
Japan	33.6	78.2	111.8
South Korea	21.7	110.7	132.4
Malaysia	3	22.2	25.2
Philippines	34.1	7.3	41.4
Singapore	0	36.4	36.4
Thailand	1.4	6.7	8.1
Vietnam	2.3	0.1	2.4
Total	128.7	408.4	537.1

Source: Table 26 of ASEAN+3 Bond Market Guide, ADB (2012)

There are some challenges, however. First, in the face of heterogeneous agents, there is a need to harmonize rules and regulations for credit ratings across areas of jurisdiction. This may be achieved through the establishment of a regional ratings agency, a supranational institution or through a system of mutual recognition arrangements between or among states. Second, enhancing cross-border transactions comes with costs, however. Compliance costs may incre ase because of the introduction of layers of additional regulation governing the behaviour of firms from another area of jurisdiction. Of course, it is also the objective to reduce regulatory barriers from being erected. Third, there are regulatory trade – offs that may be precipitated by a cooperation or mutual recognition framework and challenges may arise from the limited maturity or lack of ASEAN institutions that will ensure efficient implementation and effective compliance. Fourth, it is clear that issuances from private entities should be considerable in order to stimulate business activity among DCRAs.

3.0 Regional ratings agency

Achieving regional financial integration remains a key objective within ASEAN +3. One of the important observations concerns the lacklustre performance of cross – border investments. In one roundtable discussion about the prospects of Asian bond markets, it was remarked that close to 10% of bond issues are demanded within the ASEAN +3 region. Policy makers have noted that this lack of regional bias may represent a challenge that can be overcome by improving comparability among ratings and facilitating jurisdictional flexibility in terms of mutual recognition among national regulators.

There are initiatives that attempt to foster greater regulatory coherence and transparency. To address heterogeneity, one strategy is to establish mechanisms that will reduce regulatory barriers and differences. These are harmonization, mutual recognition or establishment of a single ratings agency for the entire region.

To promote cross – border transactions, one of the proposals calls for the establishment of a regional ratings agency. A regional ratings agency provides a way to minimize the effects of heterogeneous regulatory structures, macroeconomic environments and accounting standards and practices on the respective behaviours of DCRAs and firms. Reducing oligopolistic power may also provide a powerful motivation. In a World Bank (2006) study on Asian finance, a regional ratings agency may serve as an important counter-weight to GCRAs who continue to dominate worldwide and have made significant penetrations in local markets.

Largely based on a World Bank (2006) study, the establishment of a ratings agency may be justified on economic grounds. First, while GCRAs provide ratings services to international client companies, some regional clients need finer ratings which can be provided by DCRAs. Of course, DCRAs are presumed to be more knowledgeable of domestic conditions. Second, the creation of a regional ratings agency is expected to spur cross – border investments since a single rating can be recognized in other legal jurisdictions. There is no more need to maintain equivalence or conversion scales that attempt to reconcile interpretational differences between local and international ratings. Third, the creation of a regional ratings agency will most likely improve the quality of ratings since its actions may be easily curtailed by regional players. Moreover, this may also be due to the fact that its creation relies heavily on a harmonized regulatory environment. (World Bank, p. 39)

There are a handful of studies that have provided analyses on how to set –up regional ratings agency and identify some important preconditions. In their analysis, Parrenas and Waller (2005) noted the important requisites of setting up a regional ratings agency. These include addressing the various institutional, technical and reputational hurdles; creating a mechanism that will allow exchange of credit information and; enabling standardization of financial reporting. As noted in the 2006 World Bank study, before a regional rating agency can be established, the condition of viability should be met. This is important because its creation does not preclude other market players from seriously engaging in competition against the agency. For instance, RAM Ratings Services BhD of Malaysia has recently launched global and regional rating scales, clearly an indication that any DCRA can compete against a duly constituted regional ratings agency. Partly to ensure viability, the agency should also be involved in businesses other than the provision of ratings. there is also a realization that robust financial development needs to be achieved. Deep financial development leads to increases in projected transactions as well as the complexity of debt instruments. Second, the agency's staffing requirements are most likely immense considering the scope of operations. Third, there is also a pressing issue on the composition and structure of the board of directors. [22]

Based on a presentation by Satoshi Nakagawa of Japan Credit Rating Agency, there are two important hurdles for setting up a regional ratings agency, namely, structural and internal aspects. The structural aspect encompasses key differences among bond markets, macroeconomic environments,

[22] Largely taken from Box 2.3 in the 2006 World Bank report identifies key factors, namely: adequate business size and high capital levels, high – quality governance, competent staff, support from national governments, buy – in from international and domestic rating agencies and independence (World Bank, p. 41).

legal and accounting frameworks. The internal aspect pertains to the nature, structure and behaviour of domestic CRAs. By now, it is clear that harmonization has already started with the establishment of ACRAA in 2001. Further work on common standards and cooperation is still being undertaken, however.

Despite the intricacies of setting up a regional ratings agency, there are practical modalities that regulators can exploit. There are three known alternatives.[23] First, ACRAA may be allowed to evolve into a regional ratings agency. Based on its mandate, ACRAA is in a position to initiate harmonization and standardization of rating practices. There is no precedent for this. The pros are obvious. ACRAA has already undertaken key steps towards the promotion of convergence towards best practices. At present, ACRAA is considering to prioritize basic training programs that will be made common to rating analysts.

Over the years, the reach of ACRAA has undoubtedly increased which means that familiarity with key domestic CRAs is now present. This is a key advantage in fostering dialogues with member CRAs and definitely provides the necessary platform for future assessments. Second, multilateral agreements need to be forged to form a ratings agency from DCRAs. In this case, several countries can enter into a binding agreement creating a single regional ratings agency. Third, ACRAA will be given the task to constitute a ratings agency.

However, ACRAA and its members and even independent rating agencies do not have the mandate to enable mutual recognition of regulatory structures. Such task falls under the domain of securities markets regulators who until now have focused on the harmonization and regionalization of bond markets.

4.0 An alternative platform: The NUS model

As mentioned earlier, CRAs provide analytical services in exchange for a fee. This renders the rating or the service excludable in character in the sense that it becomes a private good. As explained in Duan and van Laere (2012), the National University of Singapore's (NUS) notion of credit ratings is similar to a public good, an infrastructure issue. What NUS has done so far is to openly provide estimates of companies' probability of default. While CRAs engage in this, the model is quite different in that ratings are not sold to issuers and investors. Using a forecasting model, the idea is to use databases of companies that issue debt and allow the econometric model to predict the probabilities and have them posted in the internet following the Wikipedia model.

The advantages of this endeavour are clear. First, the model escapes the tremendous governance requirements of a regional ratings agency. Board representation is critical in establishing the survival and reputation of a ratings agency. Because of the neutral status of an academic institution, there is no problem. Second, access is maximized and the problem that arises from the issuer-ratings agency is avoided because no credit ratings fee is paid. Exclusivity is accorded because ratings in the current scheme of things are a private good. Only those who paid can use the ratings and others are effectively excluded. Third, there is no problem with this model since the computed probabilities are meant to inform about the state of future prospects which is quite similar to the usual defense offered by GCRA when their ratings do not appear to be realistic. Fourth, because of the interpretation of ratings as a public good, there is no need to usher in new regulations that would govern the behaviour of market players like DCRAs and GCRAs. This appears more desirable considering that the regional ratings agency will necessarily encroach into the business jurisdictions of other ratings agencies. Fifth, staffing problems may be avoided since there is minimal need for credit analysts except for those who are hired by the institution to provide econometric evaluation and assessment of results.

There are some perceived problems, though. First, there is no guarantee that the approach prescribed by the model will promote greater cross border transactions because of the lack of involvement of key regulators and associations. The model, though, may still be subjected to further scrutiny as far as its forecasting properties are concerned. Second, because of the nature of the endeavour, the NUS may not be able to persuade companies to divulge more information than what is

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[23] Based on the presentation by Satoshi Nakagawa which was presented during the 11th OECD – ADBI Roundtable on Capital Market Reform in Tokyo, Japan on February 2010.

provided in databases. It does not provide an in – depth assessment of non – quantitative information that do not show up in international company databases. The access to prvate confidential information is crucial to a comprehensive credit rating analysis.

5.0 Mutual recognition: concepts, developments and some issues

5.1 Concept

Some policymakers do not think that establishing regional ratings agency is as feasible compared with other modalities of cooperation such as mutual recognition and harmonization of ratings practices. As expected, the establishment of regional ratings agency is a long run realization since it depends greatly on the cooperative efforts of players, the establishment of common regulatory standards and the setting up of governance mechanisms and institutions. As a clear example of the uphill quest to establish a regional ratings agency, proposals for creating a single European ratings agency have not progressed despite the enthusiasm of the regulator to introduce the new entity.

Mutual recognition, within the context of ASEAN + 3, is not a new concept. Achieving common standards has already been initiated in some endeavours such as the ASEAN Capital Markets Forum (ACMF) which uses mutual recognition process (Verdier, 2011). There is also the ASEAN Bond Market Forum (2010) that prescribes mutual recognition. As explained in Verdier (2011), for mutual recognition to work, one state enters into an agreement with another state or a group of states in order to recognize the equivalence or adequacy of regulatory systems. In a way, unlike EU style of harmonization, mutual recognition does not prescribe the adoption of a single set of rules by national regulators.

As elucidated by Atty. Dumlao, the secretary general of ACCRA, mutual recognition arrangements are in effect if regulatory authorities in other areas recognize credit ratings assigned by DCRAs in other local jurisdictions. In view of this, we want to understand the various mechanisms that will bring about and strengthen mutual recognition as well as challenges that may derail it.

5.2 Issues

Some of the interesting questions to ponder on are as follows: What are the feasible modalities that will enhance regulatory supervision in the absence of a strong and duly constituted supranational institution tasked to oversee the multilateral mutual recognition arrangements among ASEAN countries? What are the benefits of mutual recognition and how can they be reconciled with existing regulatory systems that pertain to ASEAN bond markets? What are the conditions that will warrant mutual recognition within the context of credit ratings and are they substitutes to more formal regulatory systems that involve entities that have collective power? To what extent will mutual recognition introduce substantial harmonization of rules and regulations?

We can say that a vital component of mutual recognition is harmonization of standards of credit ratings agencies across areas of jurisdiction. As will be established later, there is a big difference between harmonization of evolved regulatory systems or practices and harmonization of basic practices and core principles. As part of its mandate, the ACRAA spearheads efforts towards achieving harmonization of standards and ratings practices among DCRAs but it is not a harmonization of regulatory frameworks. The former is more feasible considering that the choice to adjust practices lies within firms while the latter appears to be more complicated in the sense that it involves the conditional adjustment of regulatory approaches by national governments. In a way, when there is mutual recognition, the primary objective is to arrive at an assessment declaring a regulatory system as either equivalent or adequate relative to a reference system (see Verdier, 2012). Although, the ACRAA is not a pan – Asian government entity, it provides the natural platform for substantiating wider mutual recognition of credit ratings.

With respect to the incentive to harmonize, there are two important levels. At the micro level, there should be recognition on the part of individual DCRAs that convergence is achievable and benefits should be realizable. This is due to the fact that harmonization entails costs and since CRAs are agents that respond to incentives, the pay – offs should be clear. Second, while convergence of ratings practices is important, there should also be a convergence in regulatory stance across national regulators. Mutual

recognition avoids excessive regulatory penalty, a situation wherein different sets of rules are imposed on the same firm. For credit ratings, it means that a DCRA that issues a rating in Indonesia should be recognized by a regulatory enforcer in another country as long as standards are recognized by the said enforcer. It should be known that such cautious attitude is expected given that the regulator's main objective is to protect the interests of domestic investors within its jurisdiction.

While the benefits of a region wide system of mutual recognition are promising, there are issues that may affect the behaviour of individual DCRAs. The first is that as micro units, individual DCRAs have the incentive not to reveal too much information. This is expected in industries with very high concentration and players having considerable market power. Mutual recognition transforms the competition landscape because enhanced comparability and relative transparency reduces the monopolistic power of DCRAs. It should be noted however, that no prescription whatsoever is imposed on the way credit rating systems evolve, only the minimum requirements. Second, accounting systems appear to vary with geographical location. This may offer challenges because accounting systems are only legally enforced within national boundaries. Third, mutual recognition also hinges immensely on legally enforceable contracts throughout the region. Fourth, the presence of multinational firm partnership may naturally provide inertia on the transformation of DCRAs. Fifth, different markets exhibit varying degrees of market development.

Apart from the expected behavioural responses, there are critical institutional responses for mutual recognition. For mutual recognition to work there is a need to determine whether or not regulatory and supervisory practices with respect to CRAs are equivalent. For instance, the regulator should assess whether or not supervisory practices in Indonesia are equivalent to those in Singapore.

5.3 Developments

Some significant developments have started to emerge. Recently, the Asian Development Bank (ADB) published the Handbook of International Best Practices for credit rating agencies which contains vital procedures and protocols, clarifies contractual and behavioural expectations and highlights some desirable best practices. This is important especially within ASEAN countries with relatively young CRAs compared to their international counterparts. Compiling and sharing best practices is expected to reduce the gap among CRAs. Equally important from a regulatory perspective is the International Organization of Securities' Commissions (IOSCO) Code of conduct which covers important provisions on the quality of ratings and the ratings process, ways to promote organizational independence and outline of responsibilities of CRAs to investing public.

As noted in Verdier (2009), IOSCO is an example of a Transnational Regulatory Network (TRN) which helps financial markets standardize practices. But TRNs by their very nature are non – binding but in the case of IOSCO, it is becoming the standard.

Reconciling the code of conduct with the respective codes of CRA is of utmost importance in some regulatory spheres. For instance, the European Commission has recently tasked the Committee of European Securities Regulators (CESR) to conduct an assessment of individual firm's conduct in relation to the provisions of the IOSCO code of conduct in order to ascertain compliance.

The real value of such documents is that they provide platforms on which mutual recognition can be launched. Defined as the convergence of various practices and ratings principles across borders, harmonization of ratings standards remains an important step towards mutual recognition. This is where ACRAA's role is indispensable. Given its central role towards harmonization, it may act as the clearing house for certifying that the practices are comparable and compliant with widely recognized codes of conduct within the Asian region. However, there is also a need for another indispensable regulator that exercises jurisdiction over the conduct of DCRAs.

Currently, ASEAN +3 does not have its own regional regulator of credit rating agencies unlike the European Union (ADB, 2012). While its principal mandate is to oversee credit rating companies, it offers a platform for initiating important engagements that will reduce information barriers related to credit ratings. A good amount of intuition and knowledge can be derived from the European regulatory experience on

the supervision and regulation of CRAs. Following its mandate provided by EU Regulation (EC) No 1060/2009 on Credit Rating Agencies, the European Securities Markets Agency (ESMA) ascertains whether the ratings from non – EU countries which are endorsed by ESMA recognized CRAs meet the stringent requirements. There are also credit ratings from countries that are not allowed to be used for purposes of regulation. Currently, there exist several MOUs between ESMA and other countries like Canada, US, Japan, Singapore, etc.

Within EU, there are two mechanisms, namely, certification and endorsement. These mechanisms are applied to third countries and such may present critical clues as to the proper modality for establishing mutual recognition.

Within ASEAN, certain agreements appear to highlight the state of regulatory sophistication. An international agreement between two credit ratings agencies regulators, namely the ESMA and Singapore has been reached recently. While Singapore does not have its own DCRAs, credit ratings are assigned by GCRAs which provide the incentive for Singapore to improve its regulatory apparatus. This agreement is important for the simple reason that a ratings agency operating within Singapore that has satisfied its requirements will no longer be subjected to the regulatory requirements of ESMA. In short, what ESMA requires is something that has been satisfied in Singapore and this is only possible if the two regulatory systems are considered equivalent.

In another instance of recognition, ESMA has also approved the use, within EU credit ratings from Brazil. ESMA can provide equivalence decisions and endorsement decisions as mechanisms for promoting regulatory convergence. An equivalence decision means that the supervisory and legal frameworks of the non – EU country are congruent to the requirements of the regulation. As a clear example of how sophisticated the Japanese regulatory framework is, the CESR has endorsed the equivalence between the EU and Japanese legal and supervisory framework for credit ratings to the European Commission.

6.0 Towards a system of mutual recognition of credit ratings[24]

6.1 Mutual recognition within ASEAN+3: A backgrounder

It is now clear that the ASEAN approach to foster greater financial market integration resembles the mutual recognition configuration that minimally relies on advanced supranational institutions. As already mentioned, ASEAN leaders have already adopted a Charter that will enable them to establish what is known as the ASEAN Economic Community by 2015.

An integral part of this initiative, the ASEAN Capital Market Forum (ACMF) consists of securities markets regulators who are tasked to formalize mutual recognition arrangements in several areas. One of the more important developments concerns the ASEAN and Plus Standards Scheme. A product of ACMF, it aims to facilitate multi-jurisdictional bond offerings within the ASEAN region. As a scheme, it is composed of two levels of standards, namely, the ASEAN standards and the Plus Standards. The ASEAN standards follow the IOSCO standards on cross – border offerings. The Plus Standards represent additional standards required within each national jurisdiction. To date, only three ASEAN countries have fully implemented the standards. These are Malaysia, Singapore and Thailand.

ASEAN+3 has also immensely benefited and continues to benefit from several initiatives since the establishment of the ABMI. The ASEAN +3 countries have started the project of harmonization of bond rules by organizing the Asian Bond Market forum (ABMF) in 2010. The ABMF is envisioned to be the “common platform to foster standardization of market practices and harmonization of regulations relating to cross-border bond transactions in the region. The ABMF is expected not only to lead the region towards more harmonized and integrated markets, but also to act as the nexus between ASEAN+3 and the rest of the world in international standard setting and rule making.” (ADB, 2012, p. viii). This provides

[24] Establishing a system of mutual recognition for credit ratings is a key initiative by ACRAA’s Secretary General, Atty. Dumlao.

a promising venue to also discuss matters that may contribute towards greater integration like the creation of a regional ratings agency and mutual recognition of credit ratings.

Another feature of the ABMF which proves to be beneficial is its commitment to document intra – regional comparisons which are necessary in order to identify national differences and target market practices that are required for harmonization and standardization; explore issues to promote harmonization of bond standards; and prepare a road map for harmonization of regulations (ADB, 2012, p. 13). The document also outlines and discusses several policy restrictions that may impede greater financial integration.

In developing a system of mutual recognition, it is critical to identify and characterize the regulatory environment and industrial organization, identify relevant actors and quantify parameters. After identifying the important elements that make up the system of mutual recognition we will now map such elements to the frameworks that will be proposed to enable mutual recognition.

It appears that the system of mutual recognition requires the active participation of ACRAA in major ASEAN+3 working subgroups. We observed that in most existing fora, only securities regulators are present. We propose two modalities or structures that support mutual recognition. The first system establishes a mechanism that highlights the role of existing agents of cooperation as well as that of ACRAA. It also integrates the role of TRNs in facilitating standardization of ratings practices. The second involves mutual recognition among regulators themselves. This limited version is usually feasible in case there is marked heterogeneity.

6.2 Mutual recognition: key elements

As mentioned, the initialization of mutual recognition arrangements hinges heavily on the feasibility of undertaking joint commitments between parties in order to sustain cooperation, coordination and monitoring. It is also critical that the mutual recognition agreement is simple and transparent or has well defined parameters of expectations, outcomes and objectives to economize on negotiation costs and speed up the entire process. As a formal agreement, however, one obvious trade – off is the political possibility that parties need to cede certain regulatory powers and ensure that minimum standards are faithfully observed.

Three necessary requirements in any mutual recognition arrangements are: (a) joint commitments to recognize regulatory systems; (b) existence of mechanisms for ascertaining regulatory equivalence and (c) enhanced cooperation in achieving regulatory objectives.[25]

Under joint commitment, it is critical that governments and regulators agree on a common framework and provide timely and effective exchange of information. There should be intent to readily recognize the adequacy of regulatory mechanisms in different areas of jurisdiction. As noted in Verdier (2012) it is also important that to maximize the benefits of mutual recognition, two contracting countries must be at least on the same level of development in terms of the state of financial development and regulatory sophistication. For instance, it would be senseless to negotiate a mutual recognition for credit ratings if the other party does not have a bond market or considerably lags behind in terms of bond market development.

Because mutual recognition seeks to invigorate cross – border investments by developing mutually recognized credit rating systems, regulatory players must seek to achieve the twin aims of regulatory compliance and enforcement, maintain market integrity, and infuse investor confidence. There should be reasonably minimal regulatory requirements and growth of financial markets.[26]

[25] These requirements have been identified in a joint consultation paper by the Australian Securities and Investments Commission Commonwealth of Australia (ASIC).
[26] These constitute common objectives and have appeared as part of the negotiations between New Zealand and Australia. They are embodied in the ASIC consultation paper.

Ensuring compliance depends on the degree of complexity of mutually acceptable regulatory framework. Because mutual recognition depends on common objectives, not approaches, one needs to work on common standards of credit ratings. As will be explained later, this is an area where credit rating associations such as the ACRRA will play a very important role, which is to ensure that there is uniformity in the application of minimum standards, consistency in providing basic training and feasibility of conducting best practices. The simplicity of the mutual recognition agreement will naturally precipitate minimal regulatory requirements for DCRAs.

In relation to promoting investor confidence, it is also expected that organizations need to work on establishing reputations even in jurisdictions that they do not operate physically. In a mutual recognition agreement, the market may have a collective view of all participants indicating that a source of fragility may be judgmental lapses on the part of the participants which may erode market confidence of the other players. In this case, it is just a matter of time for the other participants to be scrutinized which may lead to further reputational losses, something that for instance prompted the ESMA to conduct investigations on the big three and their affiliates.

6.3 The notion of regulatory equivalence

Ascertaining regulatory equivalence requires broad comparability of regulatory regimes. We introduce two mechanisms. Under the first mechanism, the bottom – up and top – down approaches are employed to establish a mutually recognized framework. Under this system, regulatory equivalence should be determined among the regulators themselves. The second system necessitates a sophisticated array of regulatory components that emanates from a single authority.[27]

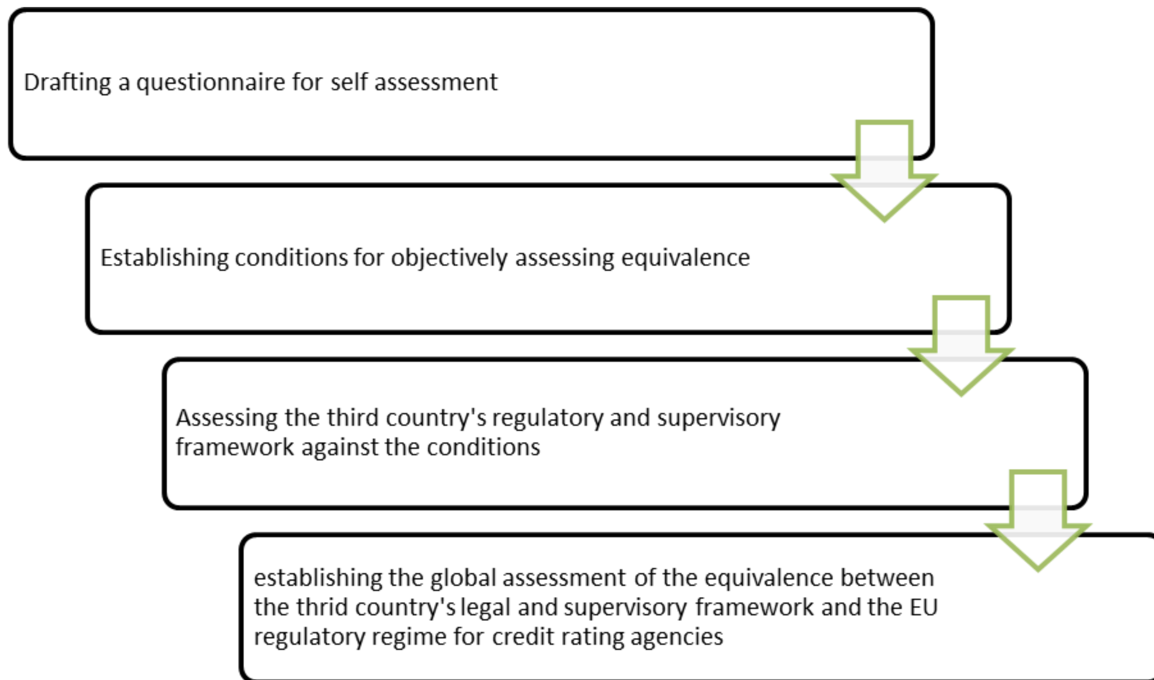
But how does one establish this system? The main obstacle concerns the benchmark on which equivalence must be assessed. A good structure is to involve the ABMF, ACMF and ACRAA together because the first two already have the structure to deal with regulatory harmonization and ACRAA is doing work on harmonization of rating practices among DCRAs. Right now, ACRAA is not a part of the entities formed within ABMF and ACMF. Thus, the existence of a broader body to handle mutual recognition will expedite the process of ascertaining regulatory equivalence.

For this mechanism to work there must be an evaluation of the relative economic states of ASEAN countries. This is expected because differential market development may derail harmonization of regulatory frameworks. Second, one must ensure that reciprocal market access will have adequate demand. Third, one needs a system of enhanced cooperation in terms of supervision and enforcement (Verdier, p. 6). Certain standards need to be met. One international convention that matters is the IOSCO ethics. ACRAA can spearhead efforts to assess the compliance of DCRAs. Within ASEAN +3, there is now a code of ethics and best practices implemented through the efforts of ACCRA.

We can learn from the EU experience in accrediting third country credit rating agencies. The CESR for instance, drafts a detailed questionnaire to gather information about the third party's state of regulatory systems. Such self – assessment questionnaire is vital in the case of the ASEAN.

[27] Because of infeasibility, we only focus on the first mechanism. For the sake of completeness, we have the following pros and cons. First, it mandates the creation of a supranational body that will wield regulatory powers with respect to credit rating agencies. This involves the scrutiny of national systems of regulations vis – a – vis standards. For instance, the only way that this will work is that there is a supranational ASEAN regulator that prescribes a common regulation. There are some drawbacks, however. First, it runs counter to the ASEAN tradition that values mutual recognition and harmonization. Second, it would be difficult to constitute a single authority similar to the EU model due to minimal political experience.

Figure 1 Ascertaining equivalence: The EU Process



Source: Committee of European Securities Regulators (CESR), 2010

Table 3.3 highlights some provisions from ESMA that represent substantive core provisions.[28] This means that if any of them is not satisfied, then the regulatory regime fails the test of equivalence.

Table 3.3 ESMA core provisions on equivalence

Provisions	expectation
Authorization or registration	Credit rating agencies should be authorized or registered in the third country.
Regulatory interference	Regulations should prevent interference of supervising regulatory bodies with the content of credit rating and methodologies
Effective supervision and enforcement	DCRAs should be routinely supervises and regulatory provisions pertaining to their operation be applied on an ongoing basis.

Source: Committee of European Securities Regulators (CESR), 2010

In ascertaining the congruence of regulatory and supervisory mechanisms, CESR looks into seven areas, namely: (1) scope of regulatory and supervisory framework, (2) corporate governance, (3)

[28] The procedure for ascertaining equivalence, as shown in Figure 1, were taken from the CESR document (10-333) that detailed how the equivalence between Japan and EU regulatory structures on credit ratings was determined.

conflicts of interest management , (4) organizational requirements, (5) quality of methodologies and quality of ratings, (6) disclosure and (7) effective supervision and enforcement (CESR, 2010).

To understand how to operationalize mutual recognition arrangements, an extensive discussion of its elements is in order.

6.4 A system of mutual recognition[29]

As noted earlier, a mutual recognition agreement has many variants or configurations which necessitate a clear specification of critical elements. In terms of credit ratings, there are many nontrivial ways through which SMR for credit ratings can be constituted. Due to the dynamism of the financial sector, a system of mutual recognition should be formulated in such a way that one skirts the long process associated with complete harmonization of rules and regulations. As mentioned, we cannot replicate the EU experience since we lack necessary institutions to facilitate negotiations which mean that countries within ASEAN should utilize existing mechanisms that foster cooperation.

In a system of mutual recognition, the critical elements pertain to objectives and aims, provisions on automaticity, mutuality and reciprocity, a built – in system of accreditation and consultation through regulatory equivalence.

A. Objectives

As mentioned before, any SMR requires a mutually agreed upon objective in order to delimit the scope of cooperation and clarify the limits of the basis of recognition. The existence of an objective is necessary because it materially shapes the nature of preconditions for mutual recognition.

We all know it is common in international finance that numerous regulatory prescriptions are imposed on potential firms that seek to operate across national jurisdictions to protect the rights of domestic investors. However, it is ill – advised to insist on the elimination of differences by formulating and adopting a common set of regulations.

In the case of credit ratings, however, the issuer of the ratings need not be physically present in another jurisdiction but still the rating may still be used as long as a legal framework exist to warrant its use. Financial flows depend on how well investors understand the different rules promulgated across different areas of jurisdiction, if any. Based on the paper of Atty. Dumlao, the objective of a system of mutual recognition is for regulatory authorities in one national jurisdiction to recognize credit ratings issues by DCRAs from other national jurisdictions and on the level of DCRAs to recognize as a legitimate, acceptable competition credit ratings. In this case, we can easily see what is being intended for, that is, for regulators to come together and map their respective rules and regulations that pertain to DCRAs. There is recognition that substantive differences may not be bridged and thus the importance of having a mutually agreed upon objective.

B. Outcomes

1. Better and more responsive regulatory regimes

Mutual recognition of ratings is seen as a plausible catalyst for the improvement of existing regulatory arrangements between DCRAs and their respective national regulators since it will expand the information set of investors who previously were not aware of how to treat or characterise bond issues rated by a DCRA in another national jurisdiction.

It is noteworthy to point out that ACRRA is now proceeding to develop a guidebook that will detail how credit rating methodologies are formulated and implemented for industries. This is a very interesting

[29] This section largely borrows from the fundamental ideas contained in a paper presented by Atty. Dumlao to the ASEAN+3 Financial Cooperation Forum last December 7, 2012 in Korea sponsored by the Ministry of Strategy and Finance and organized by the Korea Capital Market Institute (KCMI).

initiative because it will lead to further refinements of ratings methodology by narrowing the basis of analysis, leaving a lot of room for intraregional comparability of industry – based ratings. It is also partly in response to the criticism that global ratings agencies' assessments offer a rating cap even when firms can be assessed favourably based on industry specific criteria rather than macroeconomic factors.

2. More reliable, mature and reputable DCRAs

The forging of mutual recognition agreements brings together parties that have acted independently or minimally interacted thereby enriching the credit rating process. It is critical that reputation status be made a direct function of competence, integrity and soundness of rating processes. Based on ACRAA's framework, the building blocks of credibility are competence and integrity. ACRAA is involved in capacity building through joint training and establishing best practices. These are actions that are left out during regulators' meetings. Competence is partly achieved through the provision of training on rating methodology, criteria, introduction of analytical approaches and new products. Under integrity, there is a code of conduct governing the behaviour of rating agencies and establishing methods or measures of comparability of ratings.

Based on ADB's best practices, there are methods that will ensure comparability of ratings that go beyond the region. For instance, ADB is prescribing techniques for dual ratings and default probabilities.

It is also important to highlight that such efforts are reinforced by the external forces of discipline, namely, market expectations, peer pressure and regulatory oversight.

C. Mutuality and reciprocity

In principle, a system of mutual recognition should always ensure that there is sustainability, robustness and continuity. Compared with the usual unilateral model, mutual recognition is much more demanding in terms of behavioural expectations of regulatory agencies. The design of frameworks should be based on mutual interest and should not bar corrective adjustments at certain points in time. This aspect of fluidity trumps a regime of rigidity in dealing with the dynamics of interaction. Regulators must be ready to engage cooperatively, voluntarily exchanging information and making timely assessments in coordination with their regulatory counterparts. The mutual recognition agreement should also not preclude regulators from exercising ex-post policies that improve regulatory oversight.

D. Based on national accreditation

To speed up the process, regulators need to consult with a regional organization to gather information about the activities of DCRAs. Obviously, relying on one's own regulatory circles has clear drawbacks. Regulators only know best what is happening in their respective areas of jurisdiction. The collective experience of these DCRAs would bridge regulatory gaps and pave the way for understanding the regionalization of domestic regulations on DCRAs.

ACRRA is in a position to act as the clearing house for accreditation. Accreditation of foreign DCRA by a national regulator should be based on minimum qualifications that are also recognized in other jurisdictions. Remember that in a domestic setting, regulations are applied not based on initial points but rather they are applied after considering the evolution of the firm vis – a – vis the current economic environment. This is the reason why harmonization of regulations requires a longer time to finish since it focuses on evolved systems, not their primitives. We can consider the broad aims or objectives of concluding a mutual recognition as part of the primitive attributes of a regulatory system. This leads us to conclude that the basis of regulation is the evolved firm.

E. Based on minimum qualifications

There is a natural ceiling to the level of administrative burden that accompany any mutual recognition agreement but it should not be arbitrary, otherwise, it will be seen as a protective wall or anti – competitive shield against foreign competition.

There is also some natural opposition because national regulations may provide ways through which DCRAs may gain regulatory advantage. This is where ACRAA's role is very important. ACRAA has shifted its training programs to arrive at a common set of competency and standards for its members. This implies that when a rating is issued in another jurisdiction, there is confidence that it can still be used in another because of common standards. This strategy is laudable because it is anchored on the idea that all DCRAs will have or start from a common initial conditions. No matter what or how DCRAs evolve their methodologies and practices there is always a way to trace back the fundamentals of ratings they issue.

F. Accreditation

When two parties enter into a mutual recognition agreement, there is a need to recognize the dynamics of entry and exit of credit rating agencies. Accreditation is important because a regulatory agency's primary function in the domestic environment is to ensure that that the informational basis of ratings is both credible and accurate. For a rating issued outside of the area of jurisdiction, the same regulatory provisions must be applied in ascertaining the credibility and accuracy of ratings.

1. Identify the qualifications and requirements – There are important considerations. First, similar to the EU initiative on CRAs, an assessment of DCRA own codes of conduct relative to TRNs such as IOSCO code of conduct should be undertaken. Second, there is a need to determine the kind of statistics/indicators that will be used to evaluate track record. Third, there is a need to factor in the impact of competition on DCRA business. Fourth, in terms of requirements, common training on credit ratings should be used.

2. Who should make the identification? – The regulator, in consultation with ACRAA and domestic CRAs

3. Not a guarantee of accuracy. – Accreditation is not a guarantee of accuracy However, in the event there are serious breaches of confidence or deviations from minimum standards, the domestic regulator should be empowered to discipline the errant party.

G. Recognition

In this case, recognition means that the DCRA is duly accredited by the regulatory authority and that accreditation continues to be valid on the basis of its compliance with minimum qualifications and observance of rating standards.

H. Categories of qualification

The following constitute key requirements for determining qualification of credit rating agencies.

a. Financial capacity
b. Management probity
c. Acceptable basic rating methodologies
d. Analytical competence
e. Integrity of the rating process
f. Experience and market acceptance

7.0 Feasibility of mutual recognition: the case of ASEAN 4

With the system of mutual recognition for credit ratings as a background, we provide a cursory assessment of establishing key mutual recognition arrangements within ASEAN4. For our purposes, ASEAN4 consists of the Philippines, Thailand, Malaysia and Indonesia. Relying heavily on the ASEAN + 3 Bond Market Guide, we can compare and contrast the local currency bonds markets in these countries.

To ascertain feasibility, we focus on the state of differences in terms of regulatory frameworks and bond market developments.

At this point, it is now a common realization that increasing integration of domestic bond markets is a necessary condition for more vibrant cross border movements of investments. One should also realize that the effectiveness of credit rating arrangements hinges heavily on the state of regulatory convergence among countries.

7.1 Comparative developments

It should be noted early that local currency bond markets within ASEAN4 are different in terms of product diversity, stage of sophistication, and sources of growth. Among the ASEAN4 countries, Malaysia is considered to have the largest and most sophisticated domestic bond market for it caters to domestic and international investors. In contrast to the Philippines, Malaysia has more robust corporate and sukkuk (Islamic bonds) issuances while the Philippines continues to depend on external sources and bond issuances continue to be dominated by government issued bonds. Malaysian bonds are relatively well subscribed to by international investors. Moreover, there are support mechanisms for deepening the bond market like the existence of financial guarantee institutions.

In terms of products diversity, Indonesia and Malaysia have sukkuk bonds (Islamic bonds) but not in the Philippines and Thailand. This may introduce concerns because sukkuk bonds are instrumental in deepening the Malaysian bond market. To take advantage of this, the Philippines and Thailand should consider offering sukkuk bonds.

Structures that provide ample information also exist and play an important role for domestic bond demand and beefing up market reputation. In Malaysia, for instance, the Bond Info Hub provides information for international investors about the Malaysian bond market.

7.2 Market regulators and credit rating agencies

Table 3.4 shows the main regulators of bond markets within the ASEAN4. It is clear that all markets have their respective government regulators. Across areas of jurisdiction, registration of bond issuances is a common regulation. In international assessments and accreditation, registration of CRAs is an essential consideration. Within ASEAN4 countries, securing credit ratings may or may not be mandatory as such requirement depends on the type of debt instrument that is being issued. In Malaysia, all sukkuk bonds are required to be accompanied with credit ratings from recognized agencies.

We can see that in relatively robust bond markets such as Malaysia, there is a considerable effort to internationalize practices. As a matter of fact, convergence to international standards is being promoted as a way to widen access of the bond market. As noted earlier, one way to eliminate errant behaviour of GCRAs is to determine the degree of alignment between GCRA's code of conduct with that of the IOSCO code of conduct. In Malaysia, for instance, DCRAs are required to report why there are misalignments among code provisions.

Similar to the ASEAN and Plus standards, it may be a good strategy to include the IOSCO code of conduct for credit ratings as one of the non-negotiable core standards that all credit rating agencies, irrespective of affiliation and size should have. It is also shown that other entities like financial guarantee corporations may enhance the value of credit ratings and vice versa.

As noted in the ASEAN+3 Bond market guide, it is also important to be familiar with the process of issuing bonds. In the report, there is an aversion to the requirement that bond issues should be first rated prior to public offering. In a recent roundtable, in a recent roundtable discussion, Dr Bandid Nijathaworn from the Thai Bond Market Association seems to favor not requiring ratings to accompany debt issues because such will result in better resource mobilization. Of course, he acknowledged that ratings provide a sense of security for regulators who believe that investors need more information in order to recognize investment risks.

Table 3.4 Regulators and DCRAs

Jurisdiction	**Main regulator**	**Related regulator**	**Credit rating agencies**
Indonesia	Indonesia Capital Market and Non-Bank Financial Service Supervisory Agency	Bank Indonesia	PT ICRA Indonesia, PT Pemeringkat Efek Indonesia, and PT Fitch Ratings Indonesia
Malaysia	Securities Commission Malaysia	Bank Negara Malaysia	Rating Agency Malaysia (1990), Malaysian Rating Corporation (1995)
Philippines	Securities and Exchange Commission	Bangko Sentral ng Pilipinas	Philippine Rating Service Corporation, Credit Rating and Investors Services Philippines
Thailand	Ministry of Finance, Securities and Exchange Commission	Bank of Thailand	TRIS Rating and Fitch Ratings (Thailand)

Note: Taken from ASEAN Bond Market Guide, Table 3, p. 37

Table 3.5 ASEAN4 Scorecard

ASEAN Bond market Development Scorecard	Indonesia	Malaysia	Philippines	Thailand
Transparency				
Disclosure standards-adoption of ASEAN and Plus Standards	x	y	x	y
accounting standards- adoption of IFRS for cross border offerings	x	y	y	y
Auditing standards-adoption of ISA for cross border offerings	x	y	y	y

Source: ASEAN Bond Market Guide

In facilitating cross – border bond issuances, ASEAN has put in place a mechanism known as the ASEAN and Plus Standards Scheme. As shown in Table 3.5, there are major standards that some countries in ASEAN4 have not addressed yet. Clearly, Indonesia based on the Guide, will still need to align its disclosure policies, accounting standards and auditing standards. Philippines need to implement disclosure standards.

7.3 Some important developments

The existence of standards illustrates a key motivation for the establishment of mutual recognition of credit ratings in ASEAN4. As noted by Mr. Chalee Chantanayingyong of SEC Thailand, it also shows that there are significant and innovative initiatives aimed at increasing the scope of jurisdictional acceptance of bond issues. The ASEAN Debt Disclosure Standard is now in place in Singapore, Thailand and Malaysia which is expected to drive down disclosure related costs associated with multi – jurisdictional bond issues. There are now other schemes such as the collective investment schemes which mean that bonds can be sold in other member countries without seeking authorisation. Passporting of financial services, according to Mr. Diwa Guinigundo of the Philippines' BSP, allows firms to operate in another jurisdiction without being authorised in the said jurisdiction.

7.0 Concluding remarks

ASEAN +3 countries continue to sharpen initiatives that will further integrate financial markets in order to encourage cross – border investments. However, promoting cross – border investments is not a costless activity since different actors subscribe to different regulations.

Recent discussions clearly highlighted bold moves on the part of ASEAN countries by creating innovative investment schemes that have a regional appeal. It is now becoming widely acknowledged that credit rating agencies have an important role to play in establishing mechanisms that will foster mutual recognition of regulatory systems for credit ratings.

Based on the paper's review, mechanisms are now in place to integrate the region's local currency bonds markets. The Asian Bond Market Forum (ABMF) and the Asian Capital Markets Forum (ACMF) are critical to understanding existing bond market infrastructures, regulatory frameworks and key challenges. A key ADB publication, the Asian Bond Market Guide provides a definitive review that is useful for undertaking comparative assessments. Another key player is the ACRAA which has proved to be useful in fostering harmonization of rating practices among member CRAs. Interestingly, ACRAA's strategy is to ensure that all credit rating agencies must subscribe not only to best practices but should be able to trace evolved methodologies and systems to common basic methodologies. This strategy is laudable because it is anchored on the idea that all DCRAs will have to start from a common initial conditions. No matter what or how DCRAs evolve their methodologies and practices there is always a way to trace back the fundamentals of the ratings they issue.

To facilitate cross – border investments, mutual recognition is critical and should be promoted because it is much in line with the preferences of ASEAN member countries. Moreover, initiatives like the ASEAN and Plus standards provide avenues, through which ASEAN member countries can harmonize core regulations and standards and at the same time, determine their own set of regulations. While the adoption of core standards appears to be non – optional, it is the Plus standards that appear to be consistent with mutual recognition agreements. Apparently, there is a need to develop agreements in other areas and such should involve mutual recognition on credit ratings. While mutual recognition is the favoured mode, it appears that the establishment of a regional credit ratings agency may not be feasible considering that ASEAN lacks the institutional set – up needed to effect regional harmonization.

Finally, this paper has highlighted several alternatives but the one that stands out involves the ABMF, ACRAA and national regulators. Through mutual recognition, DCRAs can expand their scope of operation without worrying about multiple regulatory hurdles that exist in other countries. A key component also is establishing the equivalence of regulatory frameworks. However, as the paper has noted, participating countries need to conduct self assessments in order to determine how a system of mutual recognition can be implemented.

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Paper 4: Integrative Report on the International Discussions on the Credit Rating Agencies and Enhancing Infrastructure to Strengthen Regional Credit Rating Capacity in the ASEAN+3 Region

I. Introduction

The integration of the region in terms of enhanced flows of goods, services, human resources and capital has been a primarily objective of the ASEAN+3. In the area of capital flows, aside from encouraging the regional flows of foreign direct investments (FDI), cross-border financial flows are targeted because of the high savings rate of the major economies of the region on the one hand, and the investment appetite of the rapidly growing economies on the other hand. However, in spite of the presence of this complementation that can usher regional capital flows, excess funds are channelled to the US and Europe while sovereigns and corporates sourced their funds outside the region. This has been attributed primarily to an underdeveloped bond market in the region that does not encourage cross-border flows. Part of this inadequacy is the non-recognition of the credit ratings given by domestic credit rating agencies (DCRAs) beyond the domicile of the issuer. In this light, a proposal has been suggested by governments, financing institutions and fund managers towards the establishment of an Asian Regional Credit Rating Agency (RCRA) separate from the existing domestic credit rating agencies (DCRAs) which operate nationally. The topic has been resurfacing a little more frequently in Asian Bond Market Initiative (ABMI) forums. In this presentation, we will attempt to bring the issues behind the establishment of a RCRA in the region to the closer attention of the key stakeholders of ACRAA and start a deeper debate on the significance of such a regional initiative.

Credit Rating Agencies (CRAs) have played a central role in the financial system. Their credit ratings have served as a gauge for investors to choose the right financial instruments and for issuers to borrow capital funds. In most bond markets, bond issuers naturally have more information regarding the probability of default than investors. Credit ratings mitigate the degree of this information asymmetry (Dacuycuy, 2012). CRAs are responsible for gathering information on issuers of debt and giving accurate and unbiased interpretations on their credit worthiness.

Furthermore, credit ratings issued by CRAs are used as benchmarks by market participants in their decision-making process. Not only do they look at the probability of default and credit risk, but also consider other risks that give an investor a better perspective about companies that issue securities. These other non-credit risks include transactions linked with the company's liability structure, risks with its pool of assets that may affect payment of obligations, exogenous factors that are associated with third parties' performance, and other legal and documentation risks (Cousseran, n.d.).

Ratings also influence market prices. Information about issuers available to investors will most likely influence the interest to be paid by the issuer for fixed income securities and structured finance products, as well as the market value of the instrument (Khanzada, 2011). Many investors have relied on CRAs because the ratings they give are considered to be "certification" of good creditworthiness and hence, investment-worthy.

CRAs have used two business models: the Issuer-Pays Model and the Subscriber-pays model (Castell, 2012). From the name of issuer-pays model, it implies directly that the issuer or the borrower will pay to be rated. The credit rating serves as a marketing tool that conveys to potential investors that their security is a good, credit-worthy investment. However, rating agencies may charge higher fees depending on the complexity of the transaction and the type of the instrument. Under the subscriber-pays model, investors pay for the ratings of financial securities or for the access to information about issuers' securities. The subscription of investors to these ratings enabled them to make better-informed investment decisions based on publicly-available information processed using various quantitative analysis about the issuer.

This study serves as an integrative report for the ASEAN+3 project: *The International Discussions on the Credit Rating Agencies and Enhancing Infrastructure to Stengthen the Regional Credit Rating Capacity in the ASEAN+3 Region*. The outputs of the research project consist of four papers, three of which were prepared by Castell (2012), Taningco (2012) and Dacuycuy (2012). Paper 1 (Castell, 2012) entitled *International Discussions on Global CRAs and Current Conditions of Domestic CRAs in Europe* discusses the issues related to Global CRAs (GCRAs) raised in international forums and specifically by the Financial Stability Board (FSB), G-20 and the International Organization of Securities Commissions (IOSCO), and discusses the current conditions of domestic and regional CRAs (DCRAs and RCRAs) in Europe. Paper 2 (Taningco, 2012) entitled *Domestic Credit Rating Agencies & Local Bond Markets in the ASEAN Region* gives a profile of domestic CRAs in the four ASEAN economies with local CRAs (Indonesia, Malaysia, Philippines and Thailand), and characterizes their ratings practices and methodologies. It also summarizes in brief the role of the Association of Credit Rating Agencies in Asia (ACRAA) and measures it has taken to support the development of the DCRA industry and the Local Currency (LCY) bond market Paper 3 (Dacuycuy, 2012) entitled *Feasibility of Mutual Recognition by Domestic CRAs and Regulatory Authorities on Bond Ratings and of an Independent Regional CRA in ASEAN+4* identifies the strengths, weaknesses, and feasibility of establishing of having mutual recognition among DCRAs and that of an independent RCRA for the ASEAN-4 region. This fourth paper seeks to integrate the findings of the three papers and give policy recommendations to enhance cross-border bond investment in the ASEAN+3 region.

Section 2 of this study summarizes the findings of Paper 1 focusing on the issues regarding GCRAs and those raised by the IOSCO. It also summarizes the European experience on DCRAs and RCRAs. Section 3 depends heavily on Paper 2, briefly characterizing LCY bond markets and the ratings practices of Indonesia, Malaysia, the Philippines, and Thailand, the regulatory bodies and their implications on CRAs and the measures of ACRAA in developing DCRAs and the LCY bond market. Section 4 summarizes the findings of Paper 3 on the feasibility of an MRA among DCRAs and regulatory authorities as well as that of the establishment of an independent RCRA. Lastly, Section 5 gives policy recommendations and initiatives for both the national and regional level.

II. Issues Regarding Global Credit Rating Agencies

a. Main Issues regarding CRAs on the National and Regional Scale

i. On the Independence of CRAs (or on conflicts of interest)

The IOSCO (2011) encourages CRAs to have independent rating decisions. Independent rating decisions are those “free from political or economic pressures and from conflicts of interest arising due to the CRA’s ownership structure, business or financial activities, or the financial interests of the CRA’s employees.” CRAs should avoid activities that may compromise their independence, especially the objectivity of their rating procedures.

Independence is crucial to the rating process of CRAs although this is sometimes compromised. The case of Enron mentioned in Paper 1 showed that it threatened Merrill Lynch to raise its ratings or else it will withhold investment banking businesses. Analyst behaviour creates conflicts as well especially if the rating is tied to their compensation. The issuer-pays model creates a larger conflict of interest as compared to the subscriber-pays model. The impression comes off that issuers are inclined to pay more to receive higher ratings. Ideally, CRAs must provide credit ratings in a timely manner and their dealings with issuers should not compromise the quality of the ratings, but there are reasons for changes in the business model. First, a free-rider problem may arise when the ratings have been published. Issuers may have paid for the issuance of the rating, but the dissemination of the information may be unrestricted. The income of CRAs from subscribers would be undermined if the ratings are freely-disseminated. Second, issuers pay for their ratings because they believe that paid ratings are better than unsolicited ratings as it translates to low risk associated with their debt issuances. Third, there are increasing rating-based regulations and wide acceptance of ratings by reputable rating organizations. The introduction of the

Nationally Recognized Statistical Rating Organizations (NRSRO) had benefitted GCRAs although this undermines the independence of CRAs. As previously mentioned, pressure to inflate ratings is great because the compensation received the CRA comes in the form of fees from issuers. Ancillary services such as financial advisory also undermine independence.

ii. On the Quality and Integrity of the Rating Process

The IOSCO (2011) encourages CRAs to have quality and integrity in the rating process. "CRAs should endeavour to issue opinions that help reduce the asymmetry of information among borrowers, lenders and other market participants."

The disclosure of information of issuers to investors is seen to be biased because there is great information asymmetry. Issuers will selectively disclose information that is favourable to them. In the case of Asia, reports and data do not follow the same format as those in developed markets. In this case, CRAs cannot perform the roles that are expected of them. The integrity of the rating process must be ensured to reflect the creditworthiness of the issuer, but GCRAs have claimed that it is not their responsibility to identify any fraudulent information supplied by the issuer. With the corporate scandals that occurred over the past years, CRAs were accused to have compromised ratings for renewed business with issuers, pushing decisions towards favourable ratings for the issuers. This raises the question on whether the methodologies used by the CRAs are of good calibre and meet the minimum standard for ratings. Under the issuer-pays model, profit may prevail over quality, and this will compromise the quality and the integrity of the rating process.

iii. On Transparency

IOSCO (2011) encourages the transparency and timeliness of the disclosure of ratings. They should also maintain all non-public information in confidence. This should be under the terms of a confidentiality agreement or mutual understanding that the information between CRAs and issuers are shared confidentially.

There are issues on the lack of full disclosure of information on the key assumptions and methodologies used by CRAs. CRAs are responsible for imparting not only the ratings to investors, but also the information used in the process (those that may be publicly disclosed) as well as the actual rating methodologies.

b. The European Experience on domestic/regional CRAs

As appointed by the European Parliament and Council, the European Securities and Markets Authority (ESMA) supervise the operations of all European CRAs. ESMA has the authority to request relevant information from CRAs, to conduct hearings, to examine records, and to conduct on-site inspections. This is unlike in the US where the supervision of CRA activities is undertaken by their Securities and Exchange Commission. The role of ESMA is already a move for simplifying administrative oversight. EU CRAs are therefore required to pay annual supervisory fees depending on the reported turnover generated from the rating activities and the provision of ancillary activities.

According to the findings of Paper 1, with regard to the scope of operations, it was seen that 9 out of the 16 CRAs (not including the big three GCRAs) are operating locally. Most of the CRAs make use of the issuer-pays business models. Most of the CRAs provide corporate credit rating assessments, although some of them specialize in certain markets and industries. Furthermore, more than half of the CRAs in the EU give unsolicited ratings (10 of 18) as well as ancillary services (10 of 18). Most of them make use of teams or analysts coming from their respective ratings committees. The rating process is relatively standard for most of the EU CRAs: initial contact with the issuer, collection of data, meeting with the issuer, draft report, presentation with the ratings committee, discussion with the client, and the final

report. For most of the CRAs, the final report and the final rating is published in their respective websites, and most review their ratings annually. With regard to internal control mechanisms, almost all have a code of conduct,, a couple have business and employee code of conduct, and few have an employee code of ethics. For most of the CRAs, their compliance function is taken care of by compliance officers.

III. CRAs in the ASEAN-4

a. Characteristics of LCY Bond Markets

Since the 1990's, emerging East Asia's LCY domestic bond market has expanded in terms of size, standing at US$ 5.7 trillion by the end of 2011 from US$ 466 billion in 1996 (Taningco, 2012). Including Japan, this figure increases further to US$ 18.4 trillion in 2011 from US$ 4.9 trillion 1996. For ASEAN countries with existing bond market statistics including Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam, the combined domestic bond market totalled US$882 billion at the end of 2011, from US$149 billion at the end of 1996. 71% of this is in LCY government bonds while the rest is in corporate bonds.

In terms of liquidity, the ASEAN bond markets seemed to have tightened during the 2008 global financial crisis, although it has improved since then. The bid-ask spread widened in 2008 for most ASEAN markets, although they drastically narrowed in 2009, and widened a little, once again, from 2010 to 2011.

In terms of yield movements and yield curve trends, yields of LCY government bonds were on a downward trend for several ASEAN countries from 2006 to 2011. This was true for Indonesia, Malaysia, the Philippines, Singapore, and Thailand. Viet Nam, on the other hand, registered an increase in the 10-year government bond yield.

Cross-border bond investment by Asian residents within Asia remained small. Domestic debt instruments issued in their respective home markets still account for the largest proportion of total debt investments in Asia. There is still what is called a "home bias" for most ASEAN+3 investors, a strong preference for domestic debt securities in their respective home markets.

Overall, the LCY bond markets in the ASEAN have had positive and rapid growth in previous years. Among the key factors that have contributed to the growth in the ASEAN+3 LCY bond market include economic growth; formulation of legal and regulatory frameworks; improvements in the market microstructure; regional cooperation and initiatives; wider investor participation; greater product variety; and also, the participation of DCRAs.

b. DCRAs and their Ratings Methodologies

i. Indonesia

In Indonesia, there are two ACRAA-member DCRAs: *PT Pemeringkat Efek Indonesia* (PEFINDO) and PT ICRA Indonesia (ICRA Indonesia). PEFINDO is an affiliate of Standard and Poor's and has 92 local institutional investors by the end of 2011. ICRA Indonesia acquired its license from BAPEPAM (Capital Market's Supervisory Board) and is 99% owned by ICRA Limited, which is a CRA in Indonesia.

With regard to its methodology, ICRA Indonesia makes use of a comprehensive evaluation of the risks on the ability of the entity to generate cash flows. In evaluating business risk, it looks at industry risk (level of competition, regulatory risks, demand-supply conditions), competitive position (level of technology, locational advantages, market share, operating efficiency, and scale of operations), and management quality (experience and commitment of management, risk tolerance, policies on leveraging and managing currency and interest rate risks, business plans, projects, and relative strength of affiliated companies). Financial risk is assessed through understanding the companies' financial position, profitability, capital structure, and financial flexibility.

ii. Malaysia

Malaysia has two DCRAs that are ACRAA members: Malaysian Rating Corporation Berhad (MARC) and RAM Rating Services Berhad (RAM Ratings). MARC's shareholders are comprised mainly of Malaysian insurance companies, stockbrokers, and investment banks. RAM Ratings is a subsidiary of RAM Holdings with Fitch Ratings and McGraw-Hill Asian Holdings (Singapore) as its major shareholders. RAM Ratings rates financial institutions and non-financial corporates, government-linked and investment vehicles.

MARC's rating methodology varies with the type of entity. Rating for a sovereign entity and its debt instrument depends on its debt and contingent liability management, economic strength, financial sector resilience, fiscal sustainability, monetary and exchange rate management, political, institutional and social stability. For a corporate entity, ratings are composed of 50% business risk analysis (competitive position, operations, industry characteristics), 40% financial risk analysis (cash flow and debt service capacity, profitability, capital structure, financial flexibility and policies), and 10% analysis of management and qualitative factors (management's track record, corporate governance policies, growth plans, and risk appetite).

iii. Philippines

The Philippines has the Philippine Rating Service Corporation (PhilRatings) which is also a member of the ACRAA. It is accredited by the *Bangko Sentral ng Pilipinas* (BSP) and the Philippine government's Securities and Exchange Commission (SEC).

PhilRatings' methodology is similar to that of PEFINDO since the analysis is divided into that of business risk and financial risk. Business risk entails economic risks (risks in the overall economy of operation, macroeconomic performance), industry risk (industry structure, competition, regulatory and legal framework, and governance), market position (market share of the entity, quality of business, and pricing power), business diversification (strengths and weaknesses of the business line, customer base, and product variety), and management and strategy (past performance). Financial risk analysis looks at asset quality, capital structure and leverage, cash flow and liquidity, earnings generation, and financial flexibility.

iv. Thailand

Thailand has TRIS Rating, which is also an ACRAA member. It was part of Thai Rating and Information Services Co. (TRIS) in 1993, the first DCRA in Thailand which was renamed TRIS Corporation in 2007. It provides credit ratings for companies and debt issues, but only rates LCY debt instruments.

TRIS Ratings provides a more meticulous rating methodology. It uses an industry, business and financial risk analysis for both corporate entities and banks. Industry analysis is the same for both types of entities, looking at industry prospects, degree of competition and legal and regulatory framework intact. For corporate entities, business analysis entails the understanding of the corporation's competitive position, management quality, organizational structure, ownership structure and business diversification. Financial risk analysis entails the evaluation of accounting quality, financial policy, profitability, capital structure, liquidity and efficiency. For banks, business analysis entails the understanding of competitive position, management quality, organizational structure, ownership structure, business diversification, business strategies, franchise value, asset quality and risk management. Financial risk analysis entails the evaluation of profitability, capitalization and funding and liquidity.

c. Ratings Symbols and the Ratings Process

As regards to symbols, the ratings practices of each of the ASEAN-4 DCRAs are varied not only in terms of the actual symbols, but also the definitions and the number of definitions of each rating scales. These symbols are enumerated in Paper 2.

The rating process for the DCRAs in the ASEAN-4 economies entail the forging of a contract between the DCRA and the issuer, gathering of data by the DCRA's analysts, meeting with the issuers management, DCRA analyst's report to the DCRA's rating committee, deliberation and decision of the rating committee which if the issuer may choose to accept, then the DCRA will announce the rating and conducts monitoring. Should the issuer appeal the decision, the issuer must provide additional information to the DCRA for further evaluation. Should the issuer reject the decision, the rating process is terminated.

d. Regulatory Bodies and their Implications on CRAs

A regulatory framework is important in addressing the issues of independence, conflict of interest, quality and integrity of the credit rating and transparency that are usually hurled at credit rating agencies in the conduct of their business. Most DCRAs are under the supervision of regulatory agencies of government within their territories. However, there are variations in the manner of licensing and supervision DCRAs in the region. In the light of these diverges there is a need for harmonization of regulatory frameworks in order to enhance harmonization of credit ratings of various DCRAs in various jurisdictions as well as to contribute in facilitating greater capital flows within the region.

e. ACRAA measures in developing domestic CRAs and the LCY bond market

The efforts of ACRAA have made significant effects in the LCY bond market of the ASEAN+3 region. It presently has 28 members with 16 coming from the ASEAN+3. ACRAA has conducted several dialogues with DCRAs on codes of conduct, rating of well-secured debts, default definitions, factoring corporate governance into ratings, harmonization of rating standards and practices, role of DCRAs under Basel II, accelerating cross-border investments in Asia, roles of rating outlooks, best practices, and enforcement of rules of conflicts of interest, among others. It published its Code of Conduct (ACRAA Code Fundamentals for Domestic Credit Rating Agencies) in 2011, providing a list of recommended practices for DCRAs that comply to the code of conduct of IOSCO and the ADB's handbook of International Best Practices for CRAs.

The contribution of ACRAA in the development of the bond market in the region is made through the establishment of a framework of cooperation for addressing information asymmetry in the capital market and specifically in enforcing the highest standards of credit rating among its members. Over the years, the association has embarked on several initiatives including training programs that enhance the competence of the member DCRAs, on the one hand, and best practices dialogues that contribute in strengthen the integrity of the member DCRAS, on the other hand. These programs have contributed in building the credibility of the DCRAs.

IV. The Feasibility of an SMR among Domestic CRAs and Regulatory Authorities on Bond Ratings and an Independent of an Independent Regional CRA in ASEAN-4

a. Inadequacies in the ASEAN Region's Financial Markets

From the findings of Paper 1 and Paper 2, the rationale for establishing either a System of Mutual Recognition of Credit Ratings (SMR) among DCRAs and Regulatory Authorities or an independent RCRA in ASEAN-4 may be summarized in three distinct points (Tullao, Cabuay, and Hofilena, 2012).

The promotion of cross-border transactions involving local currency bonds is of utmost concern to facilitate the expansion of the market for the domestic currency bonds within the region. The economies of the ASEAN are characterized to have very high savings, but in the absence of regional cross-border financial transactions, excess funds in the region are channelled to Western capital

markets. These funds are then returned to the region to finance investments at higher spreads because of the lower ratings made by international credit rating agencies

International credit ratings agencies tend to underrate bonds issued by domestic banks and corporations because of caps on sovereign bond ratings. The true creditworthiness of these institutions are understated because of the sovereign ratings. These ratings create a bottleneck for cross-border investment. In effect, LCY bonds may become very expensive because of higher interest rates.

Domestic credit ratings are quite adequate in evaluating the credit worthiness of domestic banks and corporations, but these ratings are not recognized outside the domicile of the issuer. Ratings by DCRAs are not recognized by institutional and large scale buyers of bonds, even if their ratings are adequate given their knowledge of the market and other idiosyncratic risks pertaining to the domestic issuer of bonds. This hinders cross-border investments as well.

b. Responding to the Inadequacies

Given these inadequacies, a number of proposals have been put forward in the past including the removing of the sovereign cap required by GCRA in rating domestic currency instruments by banks and corporations, provision of special ratings for the region by GCRAs, the granting of international recognition of the ratings of DCRAs, the affiliation of DCRAs with GCRAs, and the establishment of an independent regional credit rating agency. (Tullao, Cabuay, and Hofilena, 2012)

c. Establishing an Independent Regional CRA

The proposed establishment of an RCRA is premised on addressing the inadequacies of current DCRAs to develop the regional bond market (Tullao, Cabuay and Hofilena, 2012). The development of the bond market will facilitate cross-border transactions and strengthen integration within the ASEAN+3.

This, however, is confronted with several constraints needed to be overcome (Tullao, Cabuay, and Hofilena, 2012). First there is the existence of significant institutional, technical and reputational constraints. Independence, credibility and viability is necessary for an RCRA to perform its role. The success of an RCRA will require adequate business size, high capital levels, high-quality governance, staff with adequate expertise, support of respective sovereigns in the region, buy-in from GCRAs and DCRAs, and independence from political pressures.

A mechanism that will allow the free, unrestricted exchange of credit information is required because reliable and adequate information is critical to the success of any CRA given the information asymmetry in the financial sector. Clear legal and regulatory frameworks need to be established. Credit bureaus need to be promoted to gather information on a regular basis, and issuers should freely disclose all necessary information. Both positive and negative information must be collected, and since disclosure is not mandated, this may serve as a problem. The sharing of the information should be free but at the same time, legal rights and privacy of issuers must be protected. Ghosh (2006) suggests the formation of a credit registry.

The quality and comparability of financial information depend on the quality and standards of financial reporting/accounting system utilized. A problem stands: the ASEAN+3 economies follow different accounting standards, and although they are converging with international standards, it is still ways off. The disclosure of information on the probability of default is essential, but issuers may not disclose this as it may adversely affect their ratings.

DCRAs may tie up with GCRAs, ending up with either GCRAs fully owning the DCRAs, or the tie-up remaining only at the technical assistance phase. If the first scenario occurs, then a global rating standard will be established immediately, along with an instant transfer of technology. This may, however, lead to the monopolization of GCRAs or an oligopolistic set up of the big three GCRAs. This may overlap the functions of DCRAs and will eventually have implications on sovereignty. Should the second scenario occur, DCRAs are free to adopt whichever policies and standards set by the GCRAs, but this will lead to slower convergence of practices.

Lastly, a sound regulatory framework is essential in addressing issues of independence, conflict of interest, quality and integrity of ratings, and transparency. Most DCRAs are supervised by regulatory agencies set by their respective governments. With the lack of a supranational regulatory authority, the establishment of an RCRA will be problematic. If the RCRA be subject to the rules and regulations of all national regulatory agencies in the region, it may be very difficult to bring the RCRA into fruition given the variability in not only regulatory requirements, but also that of standards and practices in ratings and financial reporting, as well as heterogeneities in the degree of market development.

Other options may then seem to be attractive, such as the formation of a System of Mutual Recognition of Credit Ratings (SMR) that includes the harmonization of ratings procedures and regulatory frameworks.

d. On Establishing an SMR regarding Bond Ratings

In responding to the above-mentioned inadequacies, the ASEAN+3 may explore the establishment of an SMR among DCRAs and regulatory bodies rather than establishing an RCRA. The SMR will serve as an intermediate step that will allow for the harmonization of ratings practices and regulatory procedures, and could make the establishment of an RCRA more feasible. For this option to be feasible, majority of Asian CRAs must support the initiative, and a regional coordinating body must lead the way. ACRAA may be this coordinating body (Tullao, Cabuay and Hofilena, 2012). It will need to initiate the identification of common standards for practices of all CRAs and the establishment of a plan on developing common standards and practices. It will also need to draw up cooperative programmes to encourage harmonization and publish such standards for transparency and to serve as a self-regulatory tool. Forming an SMR will require that each member of the region be compelled to acknowledge the ratings of other members of the region. This will pave the way to developing ASEAN capital markets (Tullao, Cabuay and Hofilena, 2012).

Given this light, Paper 3 considers three systems that may provide the framework for establishing an SMR and the harmonization of standards.

The first system entails the joint efforts of ACRAA and the ASEAN+3 member countries in harmonizing ratings practices and regulatory frameworks. This requires the enforcement of cooperative arrangements. However, the main obstacle is the benchmark against which equivalence must be assessed. The equivalence of regulatory frameworks should be undertaken by a regulator in another area of jurisdiction, which may be one or two countries with advanced regulatory states.

The second system favours the creation of a supranational ASEAN body tasked to harmonize the differences across national regulations, much like ESMA of the EU. However, this may run against ASEAN tradition that values mutual recognition and harmonization as this might come off as a surrender of sovereignty. The constitution of this authority will be difficult because of minimal political experience, cost considerations and the incompatibility of existing institutions to coexist with a single supranational body. The process of establishing this body may be time consuming as it will require the harmonization of all regulatory frameworks in order to facilitate cross-border regulatory consistency.

The third system entails that regulators will initiate and finalize the SMR. This requires a dialogue among regulatory agencies tasked to directly supervise DCRAs. The framework of cooperation may be attractive to countries with comparable regulatory systems and mechanism. A supranational body need not be established because the cooperation need only to strengthen cooperation. However, because of the non-reliance on a collective body of cooperation and harmonization, regional arrangements may take time considering differences that are not easily settled.

There are issues to establishing SMR, however. Individual DCRAs do not have the incentive for full disclosure of information. An SMR will reduce the monopolistic power of DCRAs. Furthermore, accounting systems vary greatly across countries, and this will slow down the process of establishing an SMR completely because of the differences in reports and standards. The SMR is hinged on legally-

enforceable contracts throughout the region, which may be difficult to establish. The commitment of DCRAs may fluctuate over time as well. The presence of multinational partnerships may delay the transformation of DCRAs. Lastly, different markets have different degrees of market development.

Even then, the establishment of an SMR is the democratic option. It allows for member CRAs to agree upon their degree of convergence. The SMR will improve the credibility of these DCRA ratings, and will eventually promote cross-border investments. But as suggested, ACRAA will not only need to establish dialogue towards convergence, but also make sure the compliance of each participant.

V. Conclusion and Policy Recommendations

There are a number of domestic credit rating agencies (DCRAs) operating in the region. The competitive edge of these DCRAs is anchored on its ability to assess the creditworthiness of domestic entities. This can contribute in the development of the local-currency bond market through their potentials of rating small and medium-sized enterprises and local government units. In addition, they can also contribute to this goal as well as in cross-border financial investments by expanding the issuer base, enhancing product variety and attracting domestic and foreign bond investors for the issuance of government and corporate bonds.

Although DCRAs have some advantages they are also faced with a number of creditability challenges in promoting cross-border bond investments including the quality and integrity of rating process, independence and avoidance of conflict of interest, and their responsibilities to investors and issuers.

The proposed establishment of a regional credit rating agency (RCRA) in Asia is premised on addressing the inadequacies of the current domestic credit rating agencies (DCRA) in exploiting its potential contributions in the development of the bond market in the region. As envisioned, a developed bond market will ultimately enhance greater cross-border transactions and ultimately contribute in strengthening the goals of the integration of the ASEAN+3 region.

The proposed RCRA, however well-intentioned, is confronted with difficult challenges including major institutional, technical and reputational constraints, inadequate mechanisms in the exchange of credit information, variability of standards used in financial reporting, thinness of the market for the viability of the enterprise, the question on governance structure as well the regulatory framework that will oversee the regional entity. The intensity of these difficulties is making the proposed establishment of a RCRA in Asia almost an impossible dream.

Despite these limitations on the practicability of establishing a RCRA there are however, several avenues that may be pursued sans some of the constraints. The option of establishing a System of Mutual Recognition of Credit Ratings (SMR) among regulatory agencies has some prospects. To wit, regulatory bodies that supervise DCRAs may establish bilateral or multilateral agreements recognizing the DCRAs in other jurisdictions. Although this option may tackle the questions on regulatory framework and governance structure it may not, however, readily address the reputational, technical and institutional constraints of DCRAs as well as the inadequate mechanisms for sharing comparable financial information for risk analysis.

Given the limitations of this option, what may be pursued as an intermediate step is the route of accreditation of DCRAs in various jurisdictions given by a regional accrediting body. This may require that regional bodies like Association of Credit Rating Agencies in Asia (ACRAA) and ASEAN Bond Marker Forum (ABMF) be given an active role in the accreditation process, including overcoming some of the limitations mentioned earlier. The accreditation of DCRAs may be given by ACRAA based on set criteria accepted globally and applicable regionally. The association can also address the institutional, technical, reputational constraints of DCRAs through its programs that harmonize standards, procedures, methodologies, quality of human resources, and code of ethics of various DCRAs in the region. In addition, ACRAA can devise a system of accreditation and degree of accreditation similar to the one

given by the National Recognized Statistical Rating Organization (NRSRO) in the US and some global standards set by the International Organization of Securities Companies (IOSCO). At the same time, ABMF can work towards the harmonization on regulatory frameworks including the standardization of financial reporting and mandatory disclosure of information by issuers of debt instruments. Moreover, the regulatory bodies may allow credit ratings on debt instruments done by DCRAs outside their jurisdiction based on the level and degree of accreditation made by ACRAA.

a. Policy Implications

Because of ACRAA's central role in facilitating the harmonization of standards and ratings practices, it is difficult to envision a system of mutual recognition without its involvement. Given that there are material gains in ensuring that minimal standards are met, along with conventions formulated by transnational regulatory networks (TRNs), ACRAA can institute best practices better by evolving into an accrediting institution that scrutinizes current and prospective credit rating agencies. This is something that will surely complement efforts to harmonize regulations that may be instrumental in promoting cross – border investments.

While ASEAN +3 does not enjoy the presence of advanced institutions that continue to influence and shape the regulatory environment of the European Union, Asian values and tradition are clearly embodied in the preferred method of advancing mutual interests. However, what is evident within the ASEAN +3 is the existence of for a designed for facilitating harmonization and mutual recognition. As demonstrated in ACRAA's approach toward harmonization as well as in the ASEAN +3 Bond Market Forum's (ABMF) collaboration process, mutual recognition is still the dominant framework for continued cooperation and engagement. The effectiveness of credit ratings in promoting fund movements also depends on the harmonization efforts of the ABMF in terms of bond market regulations and infrastructure development. This provides a justification to efforts that strengthen multilateral arrangements rather than focusing on bilateral mutual recognition arrangements.

In a mutual recognition agreement, there is a need to strengthen provisions on investor protection, creation of independent institutions, and enforcement of expected code of conduct for parties involved in cross – border investment. These are already discussed in the ABMF but such discussions should also include credit ratings agencies.

ASEAN + 3 member countries should re-examine some of the region's regulatory frameworks that have been recognized by the European Securities and Markets Authority as equivalent to the EU regulatory framework on credit rating agencies. A study that assesses the compliance of individual regulatory frameworks to Transnational Regulatory Networks' conventions may be a good preliminary step. Countries like Japan and Singapore should engage in productive consultations with ACRAA in order to share experiences which are vital to arrive at a concrete understanding of how accreditation works among national regulators.

In ascertaining the congruence and robustness of regulatory and supervisory mechanisms, there is a need to focus on seven areas, namely: (1) scope of regulatory and supervisory framework; (2) corporate governance; (3) conflicts of interest management; (4) organizational requirements; (5) quality of methodologies and quality of ratings; (6) disclosure; and (7) effective supervision and enforcement. These are areas that the Committee of European Securities Regulators (CESR) focuses on. (CESR, 2010).

To address the issues of credibility of DCRAs in enhancing cross-border investments in the region the role of ACRAA is likewise crucial. The association has formulated a *Code of Conduct Fundamentals for Domestic Credit Rating Agencies* that cover quality and integrity of the rating process, independence and avoidance of conflicts of interest, and responsibilities to the investing public and issuers. The DCRAs should be regularly monitored and evaluated in terms of their compliance on their quality of the rating process, integrity of rating process, independence of the DCRAs analysts and employees, transparency and timeliness of ratings disclosure and treatment of confidential information. Beyond compliance the development of DCRAs should focus on performance above the minimum

requirements set by the Code of Conduct. Hopefully, high performing DCRAs in terms of the elements of the Code of Conduct can attain international recognition and acceptability.

b. Specific recommendations:

1. Recognize the potential of ACRAA as a major instrument in promoting cross border investments and in enhancing the Asian bond market

2. For governments, regulators, and regional financial institutions to encourage and support the Ratings Harmonization Programs of ACRAA, specifically,
    a. Capacity building through Training Programs re-oriented to rating harmonization
    b. The production of a Guidebook on Basic Rating Methodologies and Basic Rating Criteria, and its common application by DCRAs in the region
    c. The continuing conducts of the ACRAA Default Data Study to map DCRA ratings across different jurisdictions
    d. The constant monitoring and enforcement of the ACRAA Code of Conduct Fundamentals and its periodic review and updating to align to common international best practices for CRAs

3. To establish a System of Mutual Recognition of Credit Rating in ASEAN+3. To defer any move to create a regional credit rating agency, as being too difficult, complicated to organize, and dysfunctional at this time.

4. To more closely coordinate the work of ABMF, ABMI, ACMF, and ACRAA in harmonizing standards and practices in credit ratings.

5. To pursue parallel efforts of harmonizing regulatory frameworks in aid of enforcing an effective system of oversight over regional financial markets and in particular, the system of mutual recognition of credit ratings.

6. To promote the establishment of at least one DCRA in every ASEAN country and towards this end, to enlist the participation of ACRAA.

7. Restore the ABMI Task Force on Working Group on Credit Ratings and include ACRAA as member.

8. Fund and conduct a study on a Final Concept and Implementations Plan for a Systems of Mutual Recognition of Credit Ratings for ASEAN +3

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