Research Paper and Policy Recommendations

on

The International Discussions on the Credit Rating Agencies and Enhancing Infrastructure to Strengthen the Regional Credit Rating Capacity

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Executive Summary

1. International Discussion on Credit Rating Agencies

After Enron's collapse in 2001, international discussions on credit rating agencies (CRAs) focused on (1) independence of the CRA and conflicts of interest and (2) oligopoly. As a result of these discussions, in 2003 the International Organization of Securities Commissions (IOSCO) set up the following four principles:

- Quality and integrity of the rating process,
- Independence and conflicts of interest,
- Transparency and timeliness of ratings disclosure, and
- Confidential information.

The subprime problem and the Lehman Shock (2007–2008) added two major issues: (3) the credibility of the rating method and data on structured finance and (4) overdependence on CRAs. Overdependence on CRAs was considered to amplify market pro-cyclicality. In 2010, the Financial Stability Board published the principles for reducing reliance on CRA ratings.

The argument of overdependence on ratings is based on the experience of inappropriate practices in the United States and European financial markets before the subprime crisis. This argument should be carefully interpreted in Asia, where financial markets are still immature and the major challenge is how to develop CRAs.

2. Development and Role of Credit Rating Agencies in Asia

Strengthening the credit rating system is essential for the development of sound bond markets in Asia. So far, however, the rating system in Asia has not contributed greatly to the development of Asian bond markets, mainly due to low credibility, weak comparability and insufficient information.

International investors consider that in Asia (1) ratings are not timely even though DCRAs have better knowledge of local credit information, (2) DCRA ratings of local companies are frequently inflated, and (3) local ratings are measured on individual national scales, which are relative in segregated local markets and are not comparable to each other. Although the problems of unfair rating by GCRAs and pro-cyclicality, which is often exacerbated by GCRAs, have also been pointed out in the discussion of credit rating capabilities in Asia, in this paper we focus on the issue of credibility and comparability of DCRA activities.

3. Credit Rating in Asia: Methodologies, Practices and Challenges

Recent regulatory reforms of CRAs in Japan are in line with international discussions. A new registration system was introduced in April 2010, with the objective of ensuring the independence of

CRAs from issuers and improving the quality and fairness of the rating process.

As for methodologies, CRAs first evaluate the default risk and then evaluate the recovery risk for individual obligations. Analysis of the issuer's default risk provides the basis of the assessment and determines the issuer's general ability to fulfill all of its financial obligations.

The credit rating process in Japan starts with a request for credit rating and then proceeds to a request for submission of data to be analyzed, interviews and interacting with the management of the issuers, rating committee, informing issuers of ratings decisions, and a review of the credit rating.

Remaining issues to be addressed in Japan are how to deal with the low profitability of CRAs and how to strengthen credit rating capabilities to vitalize the bond markets.

The DCRAs in Asia are not well recognized in the global market because of their short history, limited track record, insufficient human resources, and so forth. This may be one reason why cross-border investment in Asia has not developed satisfactorily.

The Association of Credit Rating Agencies in Asia (ACRAA) has made much effort to enhance the DCRA's credibility and has made some progress in standardizing the code of conduct, harmonizing the ratings, training analysts and so on. Nevertheless, more efforts are needed in these areas to encourage cross-border investment in the ASEAN+3 region.

4. Efforts to Create a Comparable Credit Rating System

4-1. Introduction of national-scale ratings by global credit rating agencies

In emerging countries, the bond markets are a closed universe, where market activities are conducted mainly by local entities. In these ring-fenced markets, global-scale ratings do not interest investors because they are often reduced to very low levels.

However, as the economies of emerging countries develop, their sovereign credit improves and leading local issuers are becoming qualified as issuers in international bond markets. At this stage, GCRAs attempt to enter those markets, and national-scale ratings (NSRs) are rating products strategically designed by GCRAs to penetrate domestic markets.

While global-scale ratings of GCRAs are comparable across countries, NSRs are defined as the relative scale of creditworthiness within the credit universe of each individual market. GCRAs officially explain that NSRs are comparable with neither global-scale ratings nor with NSRs of other countries.

However, because NSRs are assigned based on the same rating criteria and methodologies as global-scale ratings, they are considered by many investors to function as credit references linking domestic credit universes and the global credit universe. Although there is not yet sufficient trust in NSRs, it is important to note that a number of high credit local companies are forming a credit universe within the Asian regional market and GCRAs have started providing NSRs, which has the potential to evolve into a comparable measure.

4-2. Commercial banks' capacity to perform horizontal comparisons of risk assessment

Bank finance is still a major financial intermediary in Asia and region-wide commercial banks have their own internal rating system that is regionally comparable. They analyze the quality of their loan assets by combining the information on macro economies and each individual and corporate client that they are privileged to access.

Although the details of the methodology are not disclosed, two points should be noted. One is that region-wide comparison of corporate credit is possible through close scrutiny of the information on each individual company. The other is the number of potential rating targets, as discussed in the previous section (4-1). They may be known among local lenders in each individual universe, but they are not recognized as a group that is ready to form a region-wide credit universe. They are gradually composing a universe of potential bond issuers who should be targets of "regional-scale ratings." The commercial banks make the best use of the credit data on such companies rated by their internal uniform measure. They use the internal rating data in their regional portfolio management and credit policies. This group of companies would be of value in creating new schemes that could improve the comparability of local credit ratings in Asia.

5. Regional Credit Rating Agencies in Europe and Latin America

In Europe there are no region-wide credit rating agencies; however, region-wide regulations are being discussed as a result of the global financial crisis in 2008. The European Securities and Market Authority now has full authority to supervise credit rating agencies.

In Latin America, there is one regional credit rating agency in the Caribbean region: Caribbean Information & Credit Rating Services, Ltd. (CariCRIS). This regional credit rating agency was founded primarily because establishing separate credit rating agencies in individual countries would not be efficient since each Caribbean country is so small.

Stakeholders in CariCRIS are local financial institutions, central banks, and the regional development bank. The Rating Committee, an independent body within the company, assigns ratings. The Committee comprises accountants, scholars, former central bank officials, and former executives of foreign banks. The Committee is independent of both shareholders and management.

It should be noted, however, that the high degree of economic and systematic integration in this region enabled the founding of CariCRIS. The Caribbean Free Trade Association (CARIFTA) was formed in 1968 in order to increase regional trade. Later, it developed into the Caribbean Community, or CARICOM. The region's market integration has been as strong as in the EU after 1992. The region's strong uniformity lies behind CariCRIS. Harmonization of corporate legal systems and accounting standards would be an important precondition to assigning region-wide credit ratings in Asia as well.

6. Policy Recommendations

Policy measures to promote robust credit rating systems should be designed to allow a natural evolution based on market principles. Such an approach could be attained by focusing on the development of building blocks, for which the following recommendations are proposed:

6-1. Development of a guidebook for basic rating methodologies and basic rating criteria for selected industries and business sectors

To help DCRAs across the region develop methodologies and criteria to make their ratings more comparable, it is proposed that a project be undertaken to develop a guidebook on common basic rating methodologies and basic rating criteria that can be voluntarily adopted by a large number of Asian DCRAs. The guidebook could establish minimum standards for the credit rating process and for transparency in this process. Given that rating methodologies and criteria differ with the characteristics of each particular industry or business sector, the guidebook should address these different industries and sectors in separate chapters. The project would best be carried out in cooperation with the Association of Credit Rating Agencies in Asia (ACRAA), which has already achieved progress in publishing the Code of Conduct and Best Practice, and with a consultant, preferably with the support of a multilateral institution.

6-2. Promoting convergence of accreditation criteria for CRAs across Asian markets

Significant work on regulatory issues related to CRAs has been done by various international bodies. Building on this foundation, ASEAN+3 could convene a forum for regulators to look at best practices and develop a set of minimum standards in the region for the accreditation of CRAs, which can be adopted by member economies on a voluntary basis.

6-3. Promoting convergence of financial standards and regulations to facilitate comparable credit ratings across markets

Comparability of credit ratings across markets will not be promoted without the convergence of financial reporting standards and disclosure rules, in conjunction with a high level of transparent information flow from governments and firms and legal frameworks for investor protection. Such measures would best be undertaken within a broader regional framework in order to benefit from the engagement of investors and financial institutions both within and outside the ASEAN+3 member economies.

6-4. Creating an official information website with credit information on leading issuers representing each domestic market

Our core policy recommendation is to create a common credit information website to which (a) bond issuers, initiated by local credit agencies or securities houses, can upload their corporate information for the purpose of their IR, (b) investors can access information on ratings in NSRs and credit information on such issuers and (c) CRAs (both domestic and global) can provide their ratings to the issuers. All of this would take place on the same site so that all parties can visually recognize the regional credit universe. The information on this website would be accepted, processed and provided on standardized templates and thus be comparable across borders.

This site would also be open to rating agencies to upload not only the current ratings of issuers but other rating information, i.e., rating rationale and record of rating actions, so that investors could compare not only the rating levels of the issuers but also the quality of rating services of the rating agencies. For the rating service industry, this website would become an important stage of business promotion and competition to expand their coverage from the home market to the regional market.

One of the major problems in measuring cross-border credit has been a lack of comparability between national scale ratings. A clue to solving this incomparability is default data. However, we need a historical record of the bond market to collect reliable default data, but we cannot establish this history because we do not have enough default data. Thus, instead of historical default data, this scheme uses corporate information. Financial statements of the latest three years would be suitable. By using such information on issuers, investors can examine for themselves the level of national scales by comparing issuers' ratings and corporate information. This scheme requires this type of proactive but very basic engagement by investors.

This issuer-information website (tentative naming) should be jointly sponsored by regional governments or multinational organizations.

Abbreviations

ASEAN: Association of Southeast Asian Nations

ACRAA: Association of Credit Rating Agencies in Asia

CRA: Credit Rating Agency

GCRA: Global Credit Rating Agency

DCRA: Domestic Credit Rating Agency

NSR: National Scale Rating

ADB: Asian Development Bank

BOJ: Bank of Japan

FRB: Board of the Governors of the Federal Reserve System

IOSCO: International Organization of Securities Commissions

FSF: Financial Stability Forum

FSB: Financial Stability Board

FSA: Financial Services Agency

JSDA: Japan Security Dealers Association

JCR: Japan Credit Rating Agency, Ltd.

R&I: Rating and Investment Information, Inc

NRSRO: Nationally Recognized Statistical Rating Organization

ECAI: External Credit Assessment Institution

AKI: De La Salle University-Angelo King Institute for Business and Economic Studies

KIF: Korea Institute of Finance

IIMA: Institute for International Monetary Affairs

Chapter 1: Introduction—International discussions on Credit Rating Agencies[1]

Credit ratings born in the United States in the early 20th century have developed to be widely recognized as important reference information of investors' credit risk evaluation. Credit ratings are indispensable financial infrastructure for bond issuers, investors and financial regulators. Today not only in the advanced economies but also in the emerging economies the rating industries have developed to show some presences in their financial markets.

Although rating business had not been regulated by authorities for a long time, after entering in the 21st century, mainly in the U.S., the problems involving credit rating agencies (CRAs) come to be pointed out, and international discussions about CRAs' practices and regulations were actively made.

Issues after the U.S. Business Accounting Corruptions

After the Enron's collapse in the early 21st century the main topics of international discussions on CRAs were concentrated on "Independence of the CRA and Conflicts of interest" and "Oligopoly". In 2002 the Financial Stability Forum raised problems of quality of CRAs' practices and the timing of the disclosure.

Table 1-1：International Discussions on Credit Rating Agencies

2002	Financial Stability Forum（FSF) High-level roundtable: Raised problems of quality of CRAs' practices and the timing of disclosure
2003	IOSCO: Statement of Principles Regarding the Activities of Credit Rating Agencies
2004	IOSCO: Code of Conduct Fundamentals for Credit Rating Agencies
2008	FSF: Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience
2008	IOSCO: The Role of Credit Rating Agencies in Structured Finance Market （revised Code of Conduct）
2008	G20 Summit: Washington Action Plan
2010	Financial Stability Board: Principles for Reducing Reliance on CRA Ratings
2011	IOSCO: Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies

(Source) Compiled by the IIMA from various sources

As a result of these discussions, International Organization of Securities Commissions (IOSCO) published in 2003 "Statement of Principles Regarding the Activities of Credit Rating Agencies". This statement included the following four principles;

1. Quality and Integrity of the Rating Process,

[1] Before starting our research project, we discussed with other Research Institutes on division of labor for efficiency purpose and we agreed that this part (international discussions on CRAs) would be covered by Korea Institute of Finance (KIF). We treat this topic in this section briefly, however, for the convenience of readers. For more details, see the report of KIF.

2. Independence and Conflicts of Interest,
3. Transparency and Timeliness of Ratings Disclosure,
4. Confidential Information.

These four principles were further developed into "Code of Conduct Fundamentals for Credit Rating Agencies" which IOSCO published in 2004 and includes the following four discussions:

1. Quality and Integrity of the Rating Process
   (1) Quality of the Rating Process,
   (2) Monitoring and Upgrading,
   (3) Integrity of the Rating Process,
2. Independence and Avoidance of Conflicts of Interest,
   (1)Procedures and Policies,
   (2)Analyst and Employee Independence,
3. Responsibilities to the Investing Public and Issuers,
   (1)Transparency and Timeliness of Ratings Disclosure,
   (2)Treatment of Confidential Information,
4. Disclosure of the Code of Conduct and Communication with Market Participant.

This Code of Conduct was revised in 2008 adding items related to structured finance.

Issues after the global financial crisis in 2007-2008

After the global financial crisis caused by the collapse of subprime mortgage market in 2007 and Lehman Shock in 2008, two big issues were added. They were "Credibility of the rating method and data on structured finance" and "Over-dependence on CRAs". For structured finance under the OTD (Originate to Distribute) model, CRAs did the rating and consulting business simultaneously by advising how to make higher rated securitized products. That was the issue of Conflict of interests. Over-dependence on CRAs was considered to amplify pro-cyclicality in the market. Over-dependence both by regulators and by investors was the issue to be dealt with. Serious discussions have been made to solve these issues. The Financial Stability Board published the principles for reducing reliance on CRA rating in 2010 (Table 1-2).

The argument of over-dependence on rating is rooted on the experience of inappropriate practices in the United States and European financial markets before the sub-prime crisis. This argument should be carefully interpreted in Asia, however, where the financial markets are still premature and the major challenge is how to develop CRAs rather than how to avoid over-dependence on them. In order to avoid the similar mistakes Asian nations should not follow the United States and Europe but find other ways to develop their DCRAs.

Table1-2 : Principles for Reducing Reliance on CRA Ratings

Principle I. Reducing reliance on CRA ratings in standard, laws and regulations Standard setters and authorities should assess references to CRA ratings in standards, laws and regulations and wherever possible, remove them or replace them by suitable alternative standards of creditworthiness.
Principle II. Reducing market reliance on CRA ratings Banks, market participants and institutional investors should be expected to make their own credit assessments, and not rely solely or mechanistically on CRA ratings. Firms should ensure that they have appropriate expertise and sufficient resources to manage the credit risk that they are exposed to. They may use CRA ratings s an input to their risk managements, but should not mechanistically rely on CRA ratings. Firms should publicly disclose information about their credit assessment approach and processes, including the extent to which they place any reliance on, or otherwise use, CRA ratings. Supervisors and regulators should closely check the adequacy of firms' own credit assessment process.
Principle III.1. Central bank operations Central banks should reach their own credit judgments on the financial instruments that they will accept in market operations, both as collateral and as outright purchases. Central bank policies should avoid mechanistic approaches that could lead to unnecessarily abrupt and large change in the eligibility of financial instruments and the level of haircuts that may exacerbate cliff effects.
Principle III.2.Prudential supervision of banks Banks must not mechanistically rely on CRA ratings for assessing the creditworthiness of assets. This implies that banks should have the capability to conduct their own assessment of the creditworthiness of, as well as other risks relating to, the financial instruments they are exposed to and should satisfy supervisors of that capability. (a) Larger, more sophisticated banks should be expected to assess the credit risk of everything they hold, whether it is for investment or for trading purposes. (b) Smaller, less sophisticated banks may not have the resources to conduct internal credit assessments for all their investments, but still should not mechanistically rely on CRA ratings and should publicly disclose their credit assessment approach.
Principle III.3. Internal limits and investment policies of investment managers and institutional investors Investment managers and institutional investors must not mechanistically rely on CRA ratings for assessing the creditworthiness of assets.
Principle III.4. Private sector margin agreements Market participants and central counterparties should not use changes in CRA ratings of counterparties or collateral assets as automatic triggers for large, discrete collateral calls in margin agreements on derivatives and securities financing transactions.
Principle III.5. Disclosures by issuers of securities Issuers of securities should disclose comprehensive, timely information that will enable investors to make their own independent investment judgments and credit risk assessments for those securities. In the case of publicly-traded securities, this should be a public disclosure.

(Source) Extracted from the Press release of Financial Stability Board on 2010/10/14

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IOSCO, "Code of Conduct Fundamentals for Credit Rating Agencies," December 2004

Chapter 2 : Development of the Asian bond market and the role of credit rating agencies – Outstanding issues and challenges

2-1. Regional Cooperation on the Development of Asian Bond Markets

After the Asian currency crisis in 1997-98, the priority for Asian countries was to reduce the use of short-term foreign currency borrowings and to correct the excessive reliance of financial systems on the banking sector. To reduce external borrowing, it is necessary to channel Asian savings into Asian investment. The development of bond market would mobilize Asian savings for the Asian investment.

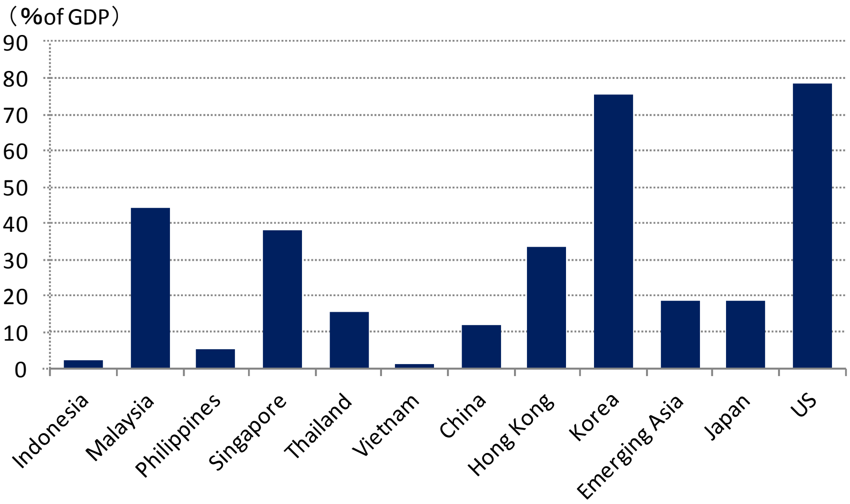
Accordingly, government authorities in Asia have been supportive of bond market development since the currency crisis. For example, at the ASEAN+3 Finance Ministers Meeting in August 2003, the Finance Ministers agreed to promote the Asian Bond markets Initiative (ABMI) to develop the bond market in the region. The objective of the ABMI was to develop efficient and liquid bond markets in the region so that savings in the region can be better utilized to the investment in the region. At present, the idea of promoting development of the regional bond market is widely shared in Asia.

2-2. The Present Conditions of the Asian Bond Markets

However, the development of Asian corporate bond market, has thus far achieved limited progress.

In terms of size of corporate bond market vis-à-vis the size of national economies, the scale in emerging East Asian economies is small compared to advanced economies such as Japan, the US and even South Korea (Figure2-1).

Figure2-1: Size of the Corporate Bond Markets in East Asia (2012, vs. GDP)

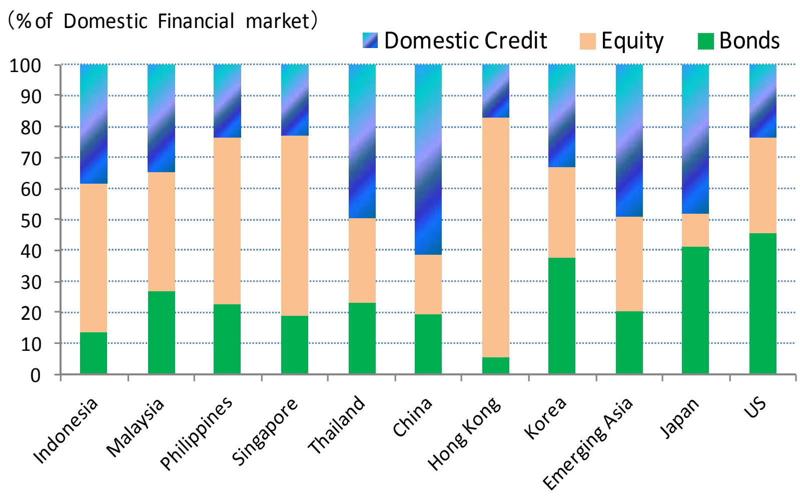


(Note) The data for the US is at the end of 2011 and for others are at the end of Q3 in 2012.

(Source) Asia Bonds Online, Flow of Funds Accounts of the US

The corporate finance of the ASEAN countries are characterized by strong reliance on bank loans like Japan (Figure2-2). Under the circumstances of strong reliance of finance on banking systems, negative shocks of macro economies tend to concentrate on banks. This bank dominant financial system has pros and cons. The positive side is, so long as such a macroeconomic shock remains in a limited degree, the shock is absorbed in the banking system and neither borrowers nor depositors can be affected seriously. But when the shock exceeds a certain extent so that banks cannot absorb it within their capitals, the situation will escalate into a systemic risk. It could cause a credit crunch and hurt real economies very seriously for a long time. That is what we experiences in Japan in late 1990s and what we have observed again in the Euro area right now. On the other hand, bond finance has pros and cons, too. Financial stress can be exposed more easily in bond finance than in bank finance due to its more liquid feature. This very feature is the pros of bond finance as well as cons. The adjustment of financial stress can come out suddenly because mass investors tend to conduct in a herding way, which is the negative side. But as the losses of these adjustments come out early, the recovery after such a burst would start early, too, which is the positive side. The difference of such pros and cons between bond and bank finances have been observed in the development of financial markets in the US and Europe after the Lehman shock. The loss of the US banks was realized in a short time and unemployment rate jumped up very quickly in real economy。 But the economic and financial doldrums did not last long in the U.S. while many things have been happening in the opposite way in Europe..

Figure 2-2: Domestic Financing Profile in East Asia (2012)



(Note) The data for the US is at the end of 2011 and for others are at the end of Q3 in 2012.

Because of the difference in the statistical availability, data series are composed of all sectors.

(Source) Asia Bonds Online, Flow of Funds Accounts of the US

With the support of ABMI, bond markets in East Asia have continued to develop and expand, but the degree of development have varied considerably among the economies. The bond markets in ASEAN member countries Malaysia, Singapore, and Thailand, in addition, those of Hong Kong and Korea have reached considerable size.

The bond markets in Indonesia, the Philippine, and Thailand have shrunk somewhat in 2008 caused by the global financial crisis, however the impact was not large and thereafter the markets have continued to expand.

Although all economies except for Thailand have succeeded in developing corporate bond markets to a certain degree, among the economies whose bond markets have expanded to considerable size (Figure2-1),more outstanding and common reason of the development of bond markets in this region attributes more or less to the increasing issuance of sovereign bonds. Behind this general trend of underdevelopment of corporate bond markets, almost all markets face two problems: 1) the number of companies that could issue bonds is limited; and 2) the financial infrastructure, including credit rating agencies and trading exchange, is inadequate.

2-3. Weak Rating Infrastructure Ranks High among the Factors Accounting for the Underdevelopment of the Asian Bond Market

Strengthening of the credit rating system would be essential for the development of sound bond markets in Asia. In the Joint Ministerial Statement of the ASEAN + 3 Finance Ministers

Meeting of August 2003, credit rating was described as one of key issues crucial to further development of the domestic and regional bond markets.

So far, however, the rating system in Asia has not necessarily contributed to the development of the Asian bond markets. The major factors are as below.

(1) Low credibility

According to the survey carried out by RAM Consultancy Services Sdn Bhd of Malaysia in 2000, many international investors had the opinion that domestic credit rating agencies (DCRAs) in Asia are less credible relative to global credit rating agencies (GCRAs). The followings were investors' views of DCRAs' performance. The situation has not changed much since then.

i) Timeliness of rating actions

Many investors admit that DCRAs have a better understanding of local companies and better access to local information. However, they don't capitalize on this advantage. Their rating actions are not timely. Investors complain that DCRAs do not follow their rated issues closely and that a downgrade often comes too late to be of any use. There is much more room for forward looking analysis that is ahead of the market sentiment.

ii) Quality of analysts and reports

The quality of analysts and reports are not satisfactory. Investors' criticism is that reports are more descriptive than analytical. Investors are skeptical about the accuracy of ratings assigned by the DCRAs. They complain that ratings from DCRAs are frequently inflated and that the default rates for 'investment grade' securities may be significantly higher than 'investment grade' implies.

iii) Independence and transparency

Investors perceive that DCRAs bow to pressure from regulators and/or government when assigning ratings because DCRAs are often owned by a consortium of financial institutions and/or government bodies. Investors are skeptical about independence from the ownership and the client. There is always the possibility of a shareholder, an affiliated company, and a client applying pressure on the rating agency to inflate the assigned rating.

(2) Weak Comparability

In general, the rating processes among DCRAs in Asia are not very different but their scopes and standard of rating still do have gaps. In addition, while the rating processes which DCRAs adopt are the same as GCRAs, their scale of rating so-called “National Scale Ratings” are completely different from those of GCRAs’ Global Scale ratings. Because of those, it is difficult for investors to plan and accomplish cross-border investments in Asian bond markets.

DCRAs focus only on corporations and government agencies within a specific country or region. They concentrate on smaller universe of securities and rank credits within certain domestic markets. In national scale ratings, DCRAs don’t consider national economic and political risks which surround them. Therefore national scale ratings may be helpful only in comparing the relative risk of credits issued in a single country.

On the other hand, GCRAs such as Moody’s and Standard & Poor’s provide investors with a global perspective. They conduct research and analysis on creditworthiness of issuers and the credit quality of debt issuers around the world by adopting standardizing rating criteria on a global basis. These GCRAs are useful for institutional investors to seek geographic diversification of their bond investment.

Facing the differences in the scale of rating between DCRAs and GCRAs, and the large gaps in the methodologies and standard among DCRAs in Asia, institutional investors have difficulties in the cross-border investments in the Asian bond markets. It impedes the smooth capital movement in the region.

(3) Insufficient information

Most international investors do not use DCRA ratings directly. They have their own in-house research departments which conduct their own credit ratings assessment. DCRA rationales are purchased primarily as information sources and used as a counter check to see if any important points are missed by the investors’ own in-house research. Nevertheless, information disclosed by DCRAs is insufficient.

In order to improve credibility and enhance comparability, a necessary action by DCRAs is the publication of basis of rating, in particular a study of default history – whereby disclosing rating methodologies, rating symbols, and historical default rates. Default studies are a complementary tool for rating users to understand the extent to which ratings are reliable. The rating history of DCRAs, however, is still short to date and accumulation of past financial data seems to be insufficient to conduct reliable study on default history.

2-4. Investor's views of Asian CRA's performance

Based on IIMA's interviews with investors, many appear to have poor views of DCRAs overall, with some investors reporting that they do not use DCRAs at all.

However, usage of DCRAs varies significantly among investors. Global investors who make cross-border investments either do not use DCRAs at all or use them only for reference information. This is because these investors have in-house research departments and determine their own ratings. Because the rating agencies of a given country should know the companies of that country best, investors use DCRA information for reference, but ultimately make investment decisions based on in-house rating assignments.

On the other hand, investors without in-house research departments or adequate research staff capacity must rely on DCRA ratings. But even these investors do not communicate with the DCRAs and merely use the credit ratings or report comments for reference. DCRAs do not appear to be used actively.

Usage of DCRAs is low primarily because of the difficulty in making cross-regional comparisons. As noted above, DCRA ratings are national scale ratings that do not address sovereign risk, and comparing the credit risk of companies across countries is difficult. Although this may not be a major issue for investors investing only in their own countries, it is a crucial obstacle for investors making cross-border investments.

Some investors have taken to converting DCRA's national scale ratings to global scale ratings on their own in order to compare the DCRA ratings. For example, investors substitute a global scale rating (for example, A+) reflecting sovereign risk for the highest DCRA's national scale rating of AAA, then aligning the ratings on downward. However, this method may result in lower ratings than actual conditions warrant and would mean that most companies of countries with low sovereign ratings would be non-investment grade.

Addressing sovereign risk is a major issue especially in Asia, which has a high proportion of state-owned enterprises. In interviews, investors reported that investment decisions are facilitated with credit ratings that show individual company risk and sovereign risk as a matrix, and when they can visualize the impact of sovereign risk on a credit rating. Investors have thus voiced a strong desire for details of risk to be disclosed more clearly. Note that even GCRAs are not able to adequately analyze how much companies with cross-border operations in multiple countries are impacted by respective country risk.

We asked investors how they compensate for DCRAs' shortfall—difficulty in making cross-regional comparisons. Investors responded that they can only judge the adequacy of ratings by using peer comparisons with other companies in the same industry in the region. In this case, adjustments could be made in comparisons of companies not only within the same industry, but also of the same size and financial position. For example, companies with a big market share in countries with strong demand could be assigned a higher rating.

A number of investors interviewed noted the importance of converging rules and systems in order to enhance the comparability of ratings. This is because it is very difficult to analyze the differences in countries' varying regulations, accounting standards, bankruptcy laws, and disclosure rules and reflect these in ratings. Efforts by national governments and a wide range of market participants are critical in this regard.

Also, although unrelated to ratings, investors all note the poor liquidity of Asia's corporate bond market as an impediment to the development of the region's corporate bond market. Many investors are buy-and-hold investors because of the market's low liquidity, and this has been a factor in limiting investment. However, investors are optimistic about the outlook for Asia's corporate bond market. This is because 1) voracious demand for funds is anticipated because of high economic growth; and 2) Basel III will result in companies relying increasingly on capital markets for financing. Therefore, as long as foreign investors like European and American investors, who buy and sell more frequently, increase at a faster rate than local investors, the market will grow increasingly deep and the liquidity issue will be resolved. Then, if investing in corporate bonds grows increasingly appealing, companies would have more incentive to obtain credit ratings and more ratings data would be compiled. As rating data accumulates, governments and market participants could work to strengthen the regional credit rating capacity, and confidence in DCRAs would increase. The expansion of Asia's corporate bond market could be expected to gain momentum.

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Chapter 3: Credit Ratings in Asia: its methodologies, practices and challenges

This chapter reviews the situation and activity of the Asian Domestic Credit Rating Agencies (DCRAs), mainly concentrating on Japan[2].

3-1. Japan

3-1-1. Japanese bond market and credit rating agency: history

Corporate finance in Japan

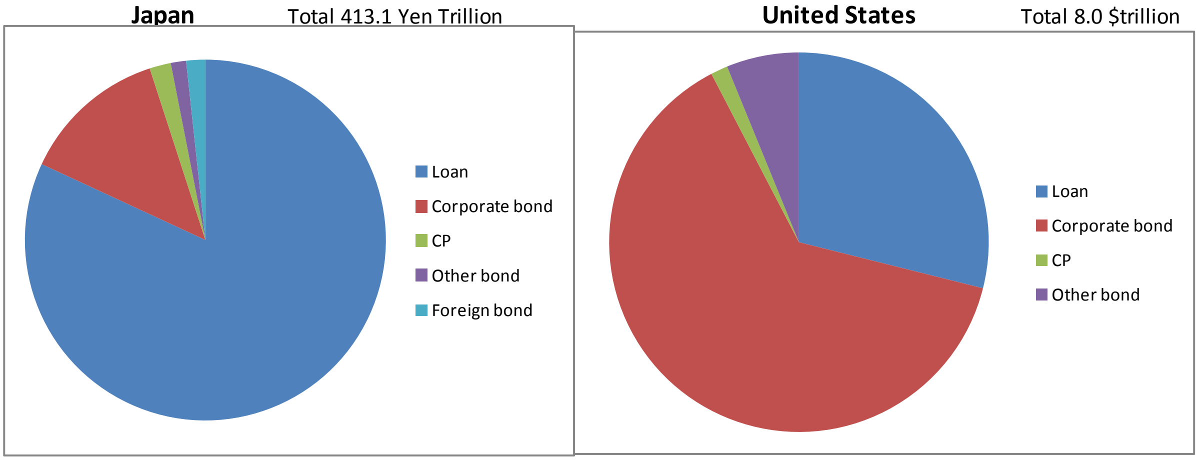
Japanese firms have traditionally relied on bank loans for their financing both short-term and medium-term. Bank loans accounts for more than three quarters of the Japanese corporate business's credit market debt while corporate bond's share is only 13 percent. On the other hand, in the United States, bank loans are less than one third and corporate bonds have the largest share of the credit market debt of the corporate liabilities, approximately constituting two third of the total credit market debt (See figure 3-1).

Figure 3-1: Outstanding of the Credit Market Debt of the Nonfinancial Corporate Business

at the end of December 2011

Japan Total 413.1 Yen Trillion

United States Total 8.0 $trillion



(Source) BOJ,"Flow of Funds", FRB, "Flow of Funds Account of the United States"

Why does the Japanese corporate finance rely so heavily on bank loans rather than corporate bonds issuance? One of the reasons is that the risk premium of bank loans is lower than that of

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[2] For Korea, see the report of the Korea Institute of Finance and for ASEAN countries, see the report of the De La Salle University-Angelo King Institute for Business and Economic Studies

corporate bonds. Therefore the funding cost of bank borrowing is cheaper than the bond issuances. The reasons why the bank loan is a cheaper means of financing than corporate bond are as follows;

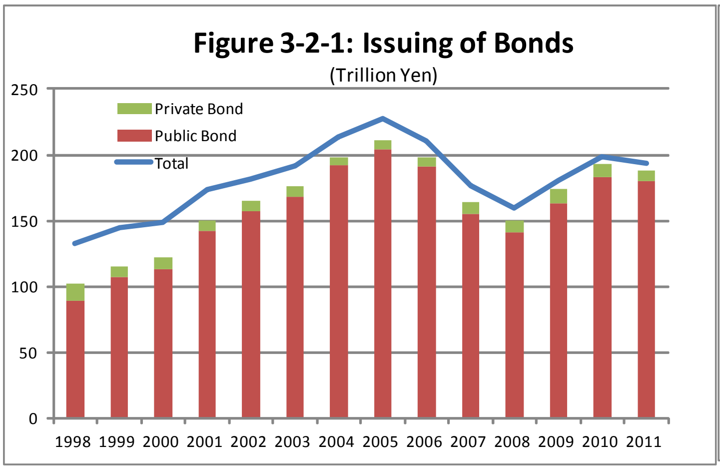
(a) the fierce competition in terms of loan rate, among banks in extending loans to corporation

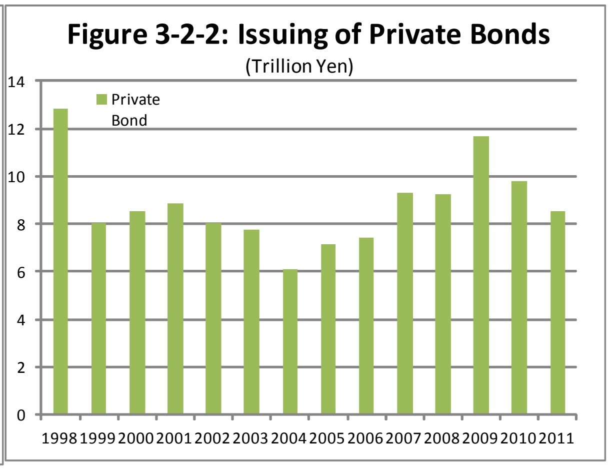
(b) banks are considering of making profit on their total business with clients, which is called a relationship banking

(c) because of the long stagnated Japanese economy corporate businesses do not have much need for funds for their capital investment

(d) Although the regulations on corporate bond issues have been lifted, the legacy of strict regulation until the late 1980s might still hinder the development of the market.

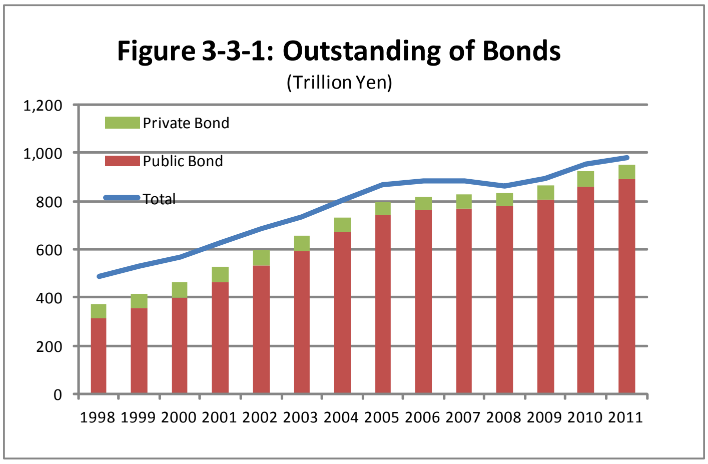
Therefore, in the Japanese bond market, the volume of corporate bond issues is very low, accounting for less than 10 % of bond issued in Japan in a year.[3] Because of the strong needs from the government, the Japanese bond market is dominated mainly by government bonds.

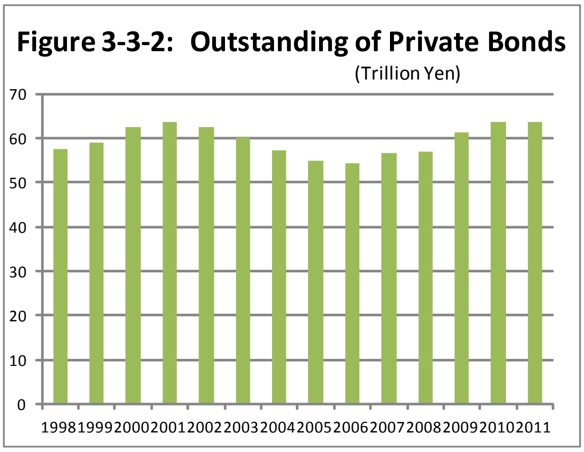




(Note) Both Private bonds and Public bonds are publicly offered bonds. Private bonds include corporate straight bonds, asset backed bonds, convertible bonds.
(Source) Japan Securities Dealers Association (Source) Japan Securities Dealers Association

[3] In the corporate bond market, the electric power companies, one of the biggest bond issuing sectors in Japan, which had about 20 % of the corporate bond outstanding, has stopped issuing bonds after the Great East Japan Earthquake and Fukushima nuclear power plant accident in March 2011. That might be one of the reasons why the issuance of the corporate bonds in 2011 decreased from the level of 2010. Electric power companies except Tokyo Electric Power Company has restarted issuing bonds in 2012 after pausing for a year.





(Note) Both Private bonds and Public bonds are publicly offered bonds. Private bonds include corporate straight bonds, asset backed bonds, convertible bonds.

(Source) Japan Securities Dealers Association

(Source) Japan Securities Dealers Association

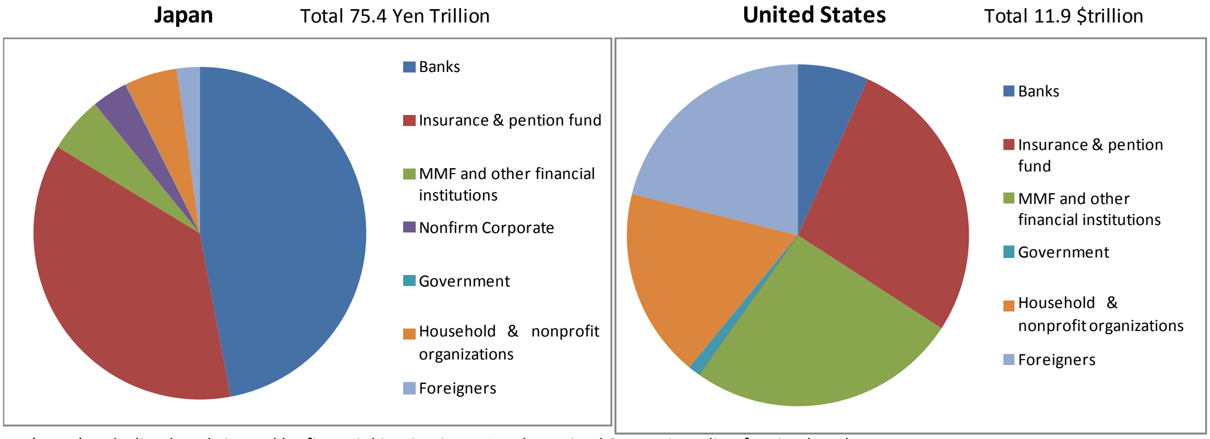
No strong demand for rating historically

In the early 1930s the Great Depression of Showa brought about lots of bank runs and defaults of corporate bonds occurred. In 1938 the Commercial Code was revised to define that no corporate bond should be issued without collateral. Since then until middle of the 1980s it was only financially strong companies that could issue a corporate bond and their bond issuing was managed by a group of commissioned banks and security firms. In the case of financial difficulty of the obligors the commissioned banks gave them a hand of financial rescue and managed to avoid their default. The commissioned banks took the credit risk against covered collateral. Therefore the default risk has been very low in Japan compared to the United States. This is one of the reasons why the rating demand has not been strong in Japan.

Banks used to be the biggest bond holders in Japan under the commissioned bank system. Meanwhile major Japanese banks had strong relationships with their client companies and had much undisclosed information about the issuer companies. They have their own in-house grading system to evaluate the debtors. Therefore the need for CRAs' rating was not strong among the Japanese major banks. They used the CRAs' rating only as a reference. Therefore the need for CRAs' rating was not strong among the Japanese major banks. They used the CRAs' rating only as a reference before the capital ratio regulation was introduced in accordance with the proposal of Basel Committee, which encouraged external credit ratings.

Figure 3-4: Holders of the corporate bonds

at the end of December 2011



(Note) Including bonds issued by financial institutions. For the United States, incuding foreign bonds.
(Source) BOJ,"Flow of Funds", FRB, "Flow of Funds Account of the United States"

Today banks, including small local banks, still have major shares in bond holding. Almost half of the bonds are held by banks. The institutional investors such as insurance companies and pension funds are next to the banks. Household (=individual investors) has only a minor share. In the case of the United States, on the other hand, banks have only marginal share and institutional investors such as insurance companies, pension funds and MMFs have a larger share while household also have a relatively large share.

Furthermore the capital market in Japan is big and deep enough for Japanese companies to finance their needed funds. They do not need to finance those funds by issuing foreign bonds. In the case of emerging Asia, companies need to finance in foreign markets and therefore have a strong need for them to be rated by GCRAs. Thus the presence of deep capital market is the third reason for Japanese companies' low need for rating.

Liberalization of bond issuing and the birth of the Japanese Credit Rating Agencies

As is the case with other Asian CRAs, Japanese CRAs do not have a long history in rating. They started the rating business only in 1980s. As explained earlier, rating need was not strong in Japan historically because only collateralized bonds could be issued and companies that are allowed to issue corporate bonds were limited only to financially strong companies, and commissioned banks had risk taking role in bond issuing. Therefore, investors did not strongly need the rating to choose the bonds to invest in.

Table 3-1: History of the Japanese Credit Rating Agencies

1938	Commercial Code was revised to define that no corporate bond should be issued without collateral.
1975	Mikuni Office published its first rating (Its rating business started in 1983)
1977	Security Trading Council Report: proposed liberalization of corporate bond issuing, use of rating, removal of the ban on non-collateral bond
1979	The first rating was published by Nikkei Japan Bond Research Institute
1984	Joint Japan-US Ad Hoc Group on Yen-Dollar Exchange Rate: Proposed the use of rating as a standard for issuing yen denominated bonds in overseas market
1985	Japan Bond Research Institute (JBRI), Nippon Investors Service (NIS), Japan Credit Rating Agency (JCR) were established
1985	Moody's opened its Tokyo Office
1986	Standard & Poor's opened its Tokyo Office
1987	Rating was Introduced as a eligibility standard for issuing non-collateralised bond
1990	Rating was designated as the only criteria for issuing Straight bond, Convertible bond
1992	Ministry of Finance introduced designated rating organizations system
1993	Commissioned bank system was changed to Bond Managing Company system
1996	Eligibility standards for corporate bond issuing were abolished
1997	Ratings are used as criteria for calculating banking capital ratio to weight risk assets
1998	JBRI and NIS merged into Rating and Investment Information Inc. (R&I)
2006	External Credit Assessment Institution (ECAI) system was introduced for Basel II
2007	Ratings are used as Banking regulation for Basel II
2008	Financial Council Report proposed the introduction of register system to regulate and supervise CRAs
2010	Financial Services Agency published Guideline for Supervision of Credit Rating Agencies
2010	New Registration System started

(Source) Compiled by the IIMA from various sources

In the middle of the 1980s qualification of corporations for issuing bonds has been gradually liberalized, and three rating agencies, namely, Japan Bond Research Institute (merged with NIS to form R&I in 1998), Nippon Investors Service (NIS) and Japan Credit Rating Agency (JCR) were established in 1985. Global rating agencies such as Moody's and Standard and Poor's also opened their Tokyo offices in 1985 and 1986 respectively. After the middle of the 1980s ratings began to be increasingly used in regulations. In 1990 regulators decided rating should be the only criteria for issuing Straight bond and Convertible bond. In 1992 the Ministry of Finance introduced designated rating organization system. Under this system only the ratings by the designated rating organizations were to be used for regulatory purposes. The Japanese three CRAs (JBRI, NIS and JCR) and the Big 3 GCRAs were designated in July 1992 and Duff & Phelps Credit Rating Co, Thomson Bank Watch and IBCA were also designated in September 1992. In 1996 the corporate bond issuing was totally liberalized in that eligibility standard for corporate bond issuing was completely abolished. It can be viewed as the beginning of the true competition in rating business in Japan. Today the rating industry has developed to an indispensable part of financial infrastructure for bond issuers, investors and regulators.

3-1-2. International discussions on CRAs and Japanese new Registration system

After the Enron's collapse in the early twenty first century the main topics of international discussions on CRAs were concentrated on "Conflicts of interest" and "Oligopoly". And after the global financial crisis caused by the collapse of subprime mortgage market in 2007 and Lehman Shock in 2008, two big issues were added. They were "Credibility of the rating method and data on structured finance" and "Over-dependence on CRAs". Over-dependence both by regulators and by investors was the issue to be dealt with. Serious discussions took place to tackle these issues.

Table 3-2: International Discussions on Credit Rating Agencies

2003	IOSCO: Statement of Principles Regarding the Activities of Credit Rating Agencies
2004	IOSCO: Code of Conduct Fundamentals for Credit Rating Agencies
2008	Financial Stability Forum: Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience
2008	IOSCO: The Role of Credit Rating Agencies in Structured Finance Market （revised Code of Conduct）
2008	G20 Summit: Washington Action Plan
2010	Financial Stability Board: Principles for Reducing Reliance on CRA Ratings
2011	IOSCO: Regulatory Implementation of the Statement of Principles Regarding the Activities of Credit Rating Agencies

(Source) Compiled by the IIMA from various sources

In November 2008, the G20 heads of the states agreed that for all CRAs whose ratings are used for regulatory purposes, should be subject to a regulatory oversight regime, including registration, consistent with the IOSCO Code of Conduct Fundamentals.

In Japan, the regulatory system was restructured in line with these international discussion trends. During the global financial crisis in 2007 to 2008, Japan could not escape the damage although the extent of damage was much smaller than in the United States or Europe. In response to the international discussions, the regulatory reform started in Japan in coordination with the United States and Europe. Accordingly the new registration system was introduced in April 2010.

The New registration system's Purposes are provided as follows,

To ensure:

（1） Independence of CRAs from issuers, independence of the financial instruments that CRAs rate and prevention of conflicts of interests,

（2） Quality and fairness in the rating process,

（3） Transparency for the market participants such as investors.

And the Regulations are:

（1） Duty of good faith: Conduct operations with fairness and integrity as independent entities,

(2) Information disclosure:
   (i) Timely disclosure, publish rating policies, etc.,
   (ii) Periodic disclosure: public disclosure of explanation documents,

(3) Establishment of control system: Quality control and fairness of the rating process, prevention of conflicts of interest, etc.,

(4) Prohibited Acts: Prohibit the ratings in the case where CRAs have a close relationship with the issuers of the financial instruments to be rated, etc.

Under the new system anyone can do the rating business without registration to the Japanese Financial Services Agency (FSA). From the viewpoint of investor protection, however, the financial service provider which uses the ratings of the non-registered company should clarify that the ratings are made by non-registered company. And the ratings to be used for regulatory purposes should be made by the registered CRAs. The Japanese CRA registration system was made to avoid the oligopoly by lowering the entering hurdle under the effect of the international discussions after the financial crisis.

The FSA has supervisory power about whether the registered CRAs observe these regulations stated above. The FSA does not regulate the rating activity itself, but rather regulate the rating system of the rating institution and their procedures etc.

3-1-3. CRAs in Japan

3-1-3-1. Registered companies

Under the new regulatory system of the CRA based on the Financial Instruments and Exchange Act, five companies are now registered, namely global Big3 (Moody’s, Standard and Poor’s and Fitch) and two Japanese companies (Japan Credit Rating Agency and Rating and Investment Information Inc.) . Global CRAs established their branches in Japan in the middle of 1980s and now they have Japanese entities. Both Moody’s and Standard & Poor’s have two registered affiliates respectively, one of which is specified to structured finances.

Table 3-3 : Registered Credit Rating Agencies in Japan

Firm's name	Registration date	Parent Company
Japan Credit Rating Agency, Ltd.	2010/9/30	Japan
Moody's Japan K.K.	2010/9/30	US
Moody's SF Japan K.K.	2010/9/30	US
Standard and Poor's Rating Japan K.K.	2010/9/30	US
Rating and Investment Information, Inc	2010/9/30	Japan
Fitch Rating Japan Limited	2010/12/17	US/FR
Nippon Standard and Poor's K.K.	2012/1/31	US

Source: Japanese Financial Stability Agency, Each company's website

3-1-3-2. Rating symbols and Definition

The Japanese CRAs' rating symbols and definition are similar to those of Global CRAs. The characteristics are stated in Table 3-4.

Table 3-4 : Japanese CRAs' Rating Symbols and Definitions

Rating and Investment Information, Inc		Japan Credit Rating Agency, Ltd.	
Long-term Issue Rating ○A Long-term Issue Rating is R&I's opinion on the certainty of the fulfillment of an issuer's individual financial obligations as promised. In addition to the probability of default, a Long-term Issue Rating also assesses the probability of recovery (probability of losses in the event of default). Therefore, it may be lower or higher than the Issuer Rating. ○The definitions of a Long-term Issue Rating are also applicable to MTN programs and Shelf Registrations. ○For structured finance products, "default" in the definitions of CCC, CC and C categories includes "payment shortfall."		**Long-term Issue Rating Scale** (a) A Long-term Issue Rating Scale enables comparison of certainty that the obligations of more than a year will be honored. (b) In light of attempting to call investors' attention to this matter, JCR may make notch differences between a Long-term Issue Rating and Long-term Issuer Rating when it considers there is a difference in terms of probability of recovery between the two as a result of assessing the degree of certainty that the obligation will be honored s agreed. (c) A Long-term Issue Rating includes an issuer's specific obligations it owes such as bonds and issue programs (e.g., medium-term note program). (d) The same Definitions of Rating Symbols and Scales shall be applied to ratings for hybrid securities such as preferred stock.	
AAA	Highest creditworthiness supported by many excellent factors.	**AAA**	The highest level of certainty of an obligor to honor its financial obligations
AA	Very high creditworthiness supported by some excellent factors.	**AA**	A very high level of certainty to honor the financial obligations
A	High creditworthiness supported by a few excellent factors.	**A**	A high level of certainty to honor the financial obligations
BBB	Creditworthiness is sufficient, though some factors require attention in times of major environmental changes.	**BBB**	An adequate level of certainty to honor the financial obligations. However, this certainty is more likely to diminish in the future than with the higher rating categories.
BB	Creditworthiness is sufficient for the time being, though some factors require due attention in times of environmental changes.	**BB**	Although the level of certainty to honor the financial obligations is not currently considered problematic, this certainty may not persist in the future.
B	Creditworthiness is questionable and some factors require constant attention.	**B**	A low level of certainty to honor the financial obligations, giving cause for concern
CCC	An obligation is in default or is likely to default. The obligation in default may not be recovered in full.	**CCC**	There are factors of uncertainty that the financial obligations will be honored, and there is a possibility of default.
CC	An obligation is in default or is highly likely to default. The obligation in default may only be partially recovered.	**CC**	A high default risk
C	An obligation is in default and may hardly be recovered.	**C**	A very high default risk
		D	JCR judges that all the obligation is in default.

* A plus (+) or minus (-) sign may be appended to the categories from AA to CCC to indicate relative standing within each rating category. The signs may also be appended to the CC category if the Long-term Issue Rating differs from the Issuer Rating, reflecting the terms and recoverability of the obligation. The plus and minus signs are part of the rating symbols.

A plus(+) or minus (-) sign may be affixed to the rating symbols from AA to B to indicate relative standing within each of those rating scales.

Sources: Each company's Website

Table 3-5: Global CRAs' Rating symbols and definitions

S& P		Moody's		Fitch	
AAA	An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.	**Aaa**	Obligations rated Aaa are judged to be of the highest quality , subject to the lowest level of credit risk.	**AAA**	**Highest credit quality.** 'AAA' ratings denote the lowest expectation of credit risk. They are assigned only in cases of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.
AA	An obligation rated 'AA' differs from the highest-rated obligations only to a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.	**Aa**	Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.	**AA**	**Very high credit quality.** 'AA' ratings denote expectations of very low credit risk. They indicate very strong capacity for payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.
A	An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.	**A**	Obligations rated A are judged to be upper-medium grade and are subject to low credit risk.	**A**	**High credit quality** .'A' ratings denote expectations of low credit risk. The capacity for payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to adverse business or economic conditions than is the case for higher ratings.
BBB	An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.	**Baa**	Obligations rated Baa are judged to be medium-grade and subject to moderate credit risk and as such may possess certain speculative characteristics.	**BBB**	**Good credit quality**. 'BBB' ratings indicate that expectations of credit risk are currently low. The capacity for payment of financial commitments is considered adequate but adverse business or economic conditions are more likely to impair this capacity.

.

Table 3-5: Global CRAs' Rating symbols and definitions (continued)

S& P		Moody's		Fitch	
BB; B; CCC; CC; and C	Obligations rated 'BB', 'B', 'CCC', 'CC', and 'C' are regarded as having significant speculative characteristics. 'BB' indicates the least degree of speculation and 'C' the highest. While such obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions.				
BB	An obligation rated 'BB' is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.	**Ba**	Obligations rated Ba are judged to be speculative and are subject to substantial credit risk.	**BB**	**Speculative.** 'BB' ratings indicate an elevated vulnerability to credit risk, particularly in the event of adverse changes in business or economic conditions over time; however, business or financial alternatives may be available to allow financial commitments to be met.
B	An obligation rated 'B' is more vulnerable to nonpayment than obligations rated 'BB', but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.	**B**	Obligations rated B are considered speculative and are subject to high credit risk.	**B**	**Highly speculative** 'B' ratings indicate that material credit risk is present
CCC	An obligation rated 'CCC' is currently vulnerable to nonpayment, and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.	**Caa**	Obligations rated Caa are judged to be speculative and are subject to very high credit risk.	**CCC**	**Substantial credit risk** 'CCC' ratings indicate that substantial credit risk is present

.

Table 3-5: Global CRAs' Rating symbols and definitions (continued)

S& P		Moody's		Fitch	
CC	An obligation rated 'CC' is currently highly vulnerable to nonpayment.	**Ca**	Obligations rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest.	**CC**	**Very high levels of credit risk**
C	A 'C' rating is assigned to obligations that are currently highly vulnerable to nonpayment, obligations that have payment arrearages allowed by the terms of the documents, or obligations of an issuer that is the subject of a bankruptcy petition or similar action which have not experienced a payment default. Among others, the 'C' rating may be assigned to subordinated debt, preferred stock or other obligations on which cash payments have been suspended in accordance with the instrument's terms or when preferred stock is the subject of a distressed exchange offer, whereby some or all of the issue is either repurchased for an amount of cash or replaced by other instruments having a total value that is less than par.	**C**	Obligations rated C are the lowest rated and are typically in default, with little prospect fro recovery of principal or interest.	**C**	**Exceptionally high levels of credit risk.**
D	An obligation rated 'D' is in payment default. The 'D' rating category is used when payments on an obligation are not made on the date due, unless Standard & Poor's believes that such payments will be made within five business days, irrespective of any grace period. The 'D' rating also will be used upon the filing of a bankruptcy petition or the taking of similar action if payments on an obligation are jeopardized. An obligation's rating is lowered to 'D' upon completion of a distressed exchange offer, whereby some or all of the issue is either repurchased for an amount of cash or replaced by other instruments having a total value that is less than par.				Defaulted obligations typically are not assigned 'D' ratings, but are instead rated in the 'B' to 'C' rating categories, depending upon their recovery prospects and other relevant characteristics. This approach better aligns obligations that have comparable overall expected loss but varying vulnerability to default and loss.

Table 3-5: Global CRAs' Rating symbols and definitions (continued)

S& P		Moody's		Fitch	
NR	This indicates that no rating has been requested, that there is insufficient information on which to base a rating, or that Standard & Poor's does not rate a particular obligation as a matter of policy.				
*The ratings from 'AA' to 'CCC' may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.		Note: Moody's appends numerical modifiers 1,2, and 3 to each generic rating classification from Aa through Caa. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category: the modifier 2 indicates a mid-range ranking, and the modifier 3 indicates a ranking in the lower end of that generic rating category. Additionally, a "(hyb)" indicator is appended to all rating of hybrid securities issued by banks, insurers, finance companies, and securities firms. By their terms, hybrid securities allow for the omission of scheduled dividends, interest, or principal payments, which can potentially result in the impairment if such an omission occurs. Hybrid securities may also be subject to contractually allowable write-downs of principal that could result in impairment. Together with the hybrid indicator, the long-term obligation rating assigned to a hybrid security is an expression of the relative credit risk associated with that security.		**Notes:** The modifiers "+" or "-" may be appended to a rating to denote relative status within major rating categories. Such suffixes are not added to the 'AAA' obligation rating category, or to corporate finance obligation ratings in the categories below 'CCC'.	

(Source) Each Company's website

Global CRAs' affiliates in Japan use the same rating definitions for the Japanese companies as they use in their global rating. However, S&P separately publishes Japanese local standard for the Japanese small and medium-sized enterprises (SMEs). S&P's "Japan SME National Scale Rating" serves Japanese SMEs, lenders, suppliers, and other parties that have an interest in SME creditworthiness by providing credit ratings for Japanese SMEs. The Standard & Poor's Japan SME rating is an indicator of creditworthiness quantitatively derived from the model. Calculations differ significantly from Standard & Poor's rating criteria and do not include subjective assessments or judgments of individual SMEs by their analysts. Japan SME ratings are expressed by using Standard & Poor's traditional credit rating symbols, but they are shown in lower case (e.g., 'bbb') to highlight that they are quantitatively derived.

3-1-3-3. Rating Methodology

Framework for evaluating an issuer

When assigning a credit rating to individual obligation, a CRA first evaluates the default risk, i.e., the default probability of the bond issuer, and then, evaluates the recovery risk for individual obligations, i.e., the probability of losses in the event of default. The analysis of the issuer's default risk forms the base of the assessment and determines the issuer's general capacity to fulfill all of its financial obligations. This credit rating is called an issuer rating. In a default risk analysis, the CRA analyzes both business risk and financial risk.

Business risk (mainly qualitative assessment)

Ratings reflect a CRA's opinion regarding the outlook over three to five years in the future. The CRA incorporates foreseeable economic fluctuations into its ratings based on its outlooks of macroeconomic environment and individual industry. These premises are reflected in the assessment of business risk.

Business risk is made up of (1) industry risk and (2) individual firm risk. Industry risk refers to the risk inherent to the industry the issuer belongs to. It is assessed from these aspects stated in the table 3-6. The degree of industry risk importantly affects such assessment factors as a company's earning capacity and debt-equity structure.

Table 3-6 : Main factors for assessment of industry risk

1 Size, growth potential and volatility of the market The market size indicates the size of the field in which the company conducts business activities and is judged using sales, total value or size of the assets..
2 Industry structure (competitive environment) The competitive environment among peers is assessed from the viewpoint of the competitive factors such as the height of barrier to entry, the number of players, intensity of price competition, and the degree of differences in marketing and sales capabilities.
3 Customer continuity and stability The risk of the company losing customers in the future is assessed. Consideration is given to factors such as the ease in switching vendors after taking into account economic cost or whether loyalty can be maintained through tangible and intangible incentives, including tactics and brand strength.
4 Capital and inventory investment cycle "Frequency of capital investment" and "certainty of investment recovery" are assessed.
5 Protection, regulation and public aspects Factors such as barriers to entry or institutionalized system of protection for firms in financial difficulty are considered to mitigate industry risk. Regulations can work either to mitigate industry risk, or to increase the risk.
6 Other risks

(Source) Compiled by the IIMA from the R&I website

Individual firm risk is the risk unique to each firm. It is assessed by those factors stated in the table 3-7.

Table 3-7 : Main factors for assessment of individual firm risk

1	Size and characteristics of the market
2	Position in the market
3	Business portfolio composition and characteristics
4	Customer base
5	Competitiveness of products and services
6	Technical skills and R&D capabilities
7	Production capacity and production system
8	Marketing strength, sales ability/organization and service (maintenance) system
9	Stability and adequacy of procurement base
10	Flexibility of cost structure
11	Risk profile/ risk appetite and risk management structure
12	Corporate governance

(Source) Compiled by the IIMA from the R&I website

Financial risk (mainly quantitative assessment)

A CRA assesses the level of a firm’s financial resilience against business risk, as well as strategic investment capacity. In addition to studying various financial indicators obtained by analyzing financial statements, the CRA also qualitatively evaluates factors such as a firm’s financial management policy, funds procurement base and policy controlling liquidity risk.

A CRA's main evaluation factors are described in the table 3- 8.

Table 3-8 : Main evaluation factors for financial risk

1 Earning capacity EBITDA(earnings before interest, taxes, depreciation and amortization), operating income margin, ROA, etc.
2 Scale and investment capacity EBITDA, equity capital, the amount of R&D, etc.
3 Debt redemption period Gross/net debt to EBITDA, gross/net debt to operating cash flow
4 Financial profile Gross/net debt to equity ratio, equity ratio, the extent to which a firm relies on debt, etc.
5 Risk resilience Specially important for financial industry. Comparison of risk buffer with credit risk and market risk.
6 Asset quality Specially important for financial industry. Quantitative measures such as non-performing loan ratio, credit costs. Asset type, stringency of the firms asset assessments and reserve and coverage ratio.
7 Liquidity The asset and debt structure, fund procurement stability, level of the liquidity buffer under stress conditions, the access to alternative sources of liquidity.
8 Financial management policy Financial management policy as a qualitative parameter. Maintaining financial discipline is critical for ensuring high degree of creditworthiness.

(Source) Compiled by the IIMA from the R&I website

A CRA determines a rating by combining the evaluation of adequacy of financial indicators relative to financial reference values with industry risk and individual firm risk taken into account. Thus business risk analysis and financial risk analysis are mutually related and their weights differ from industry to industry. A rating is an overall judgment of these analyses.

3-1-3-4. Rating Process

A brief summary of the credit rating process is stated below based on the case of Japanese CRA[4]. When a credit rating is to be obtained for the first time, the credit rating process will normally take approximately two or three months to complete.

(1) Request for Credit Rating

The credit rating process typically begins with a request by an issuer of a bond that needs to be assigned a credit rating.

[4] This process is the case of JCR. But other CRAs' processes are almost similar to JCR's.

(2) Selection of Responsible Rating Analysts

Following the receipt of the request for a credit rating, analysts are selected, taking into account the industry and the type of the debt to be rated, among other factors. More than two analysts (basically two) are chosen as a Responsible Rating Analyst so as to maintain the objectivity of the analysis under-taken for a credit rating.

(3) Determining Whether to Initiate a Credit Rating

Upon receiving a request for or inquiries about credit ratings, the Responsible General Manager of the Rating Department shall determine whether the cases associated with the relevant requests or inquiries can be processed or not from the perspective of, among others, assuring (1) appropriate quality in assigning credit ratings, (2) compliance with laws and regulations and (3) protection of investor benefits.

(4) Request for Submission of Data

Responsible Rating Analysts ask the issuer to be rated to submit data necessary for the analysis, including nonpublic information. Although the types of data requested differ depending on the industry and the particular features of the company, they are typically wide-ranging, including a corporate profile, management organization, production, sales, financial statement, business plans, information on subsidiaries and affiliates, and other important information such as legal actions, and the past bond issues.

(5) Sources of Information used in Determining Credit Ratings

Responsible Rating Analysts use only the information which meets the requirements of the quality standard. Information sources used for corporate credit ratings typically includes financial statements and business records provided by issuers, documents and explanations regarding the management policy, documents for products to be rated provided by issuers and statistics and reports about economic and industrial trends published by a neutral institution.

(6) Analysis of Data, etc. and Transmission of Questionnaires

Responsible Rating Analysts perform both quantitative and qualitative analyses of the credit strength of the issuer based on the data submitted by the issuer, as well as financial data, industry data and other relevant information. Based on the results of the analysis, the Responsible Rating Analysts hold discussions to identify questions and issues, and compile these questions and issues into a questionnaire that is sent to the issuer to be rated or those they inquired during the interviews.

(7) Interviews and Interacting with the Management of the Issuers

There are two kinds of interviews with executives and employees of the issuer. One is staff interview and another is management interview. A CRA, in principle, conducts these two kinds of interviews when assigning an initial credit rating to an issuer. A staff interview is conducted when reviewing the credit ratings periodically. In addition to a periodical credit rating review, a

CRA conducts a management interview in many cases where Responsible Rating Analysts consider it necessary to have an interview, especially after the issuer's top management undergoes a big replacement. The purpose of the interviews and the inspections of plants and other facilities is to obtain first-hand information specific to the issuer that will help confirm and support their financial analysis. In particular, interviews with senior management is a critical source of information in better understanding of the future prospects of the issuer being rated, because they provide opportunities to learn more accurate vision of the entity being rated and confirm first hand management's policies, strategies, and other important activities.

(8) Rating Committee

Based on the analysis of the data and interviews, the Responsible Rating Analysts discuss the credit strength of the issuer being rated and then prepare materials for convening a Rating Committee, where the analysts propose a credit rating and give an explanation of the rationale. The Rating Committee consists of at least four Rating Committee members and its primary purpose is to discuss whether the recommended credit rating arrived at through the various methods of analysis is consistent with the credit rating structure of the CRA and whether it is accurate and valid, before a final credit rating decision is made. If the analyses presented by the Responsible Rating Analysts are considered inadequate or if the analysts' recommendations are considered inappropriate, the Responsible Rating Analysts may be required to undertake a reexamination and reconvene another Rating Committee later. Each Rating Committee member has a voting right. Resolutions at the Committee shall be made, in principle, by agreement of all members attending Rating Committee. If the agreement is not reached, the items on the agenda shall be discussed in a collegial body consisting of senior Rating Committee Members. Resolution s at such collegial body shall be decided in principle by majority.

(9) Informing Issuers of Rated Securities about Credit Ratings Decisions and for Appeals against them

After a credit rating has been determined, it is promptly notified to the issuer being rated before its publication to the public. This provides the entity being rated with an opportunity to raise an objection against factual errors, etc. so that a more accurate credit rating can be assigned. Once credit ratings are determined, the Responsible Rating Analysts shall explain to the issuers the determining factors and background of the credit ratings, such as primary information emphasized or major topics discussed, by issuing such documents as draft press releases and other draft public notices. In cases where the issuers raise a complaint against the misrepresentation of the facts or other information used for justifying the proposed credit ratings, other rating analysts shall be appointed, only when judged necessary, to reinvestigate and the Rating Committee shall be convened to reexamine the credit ratings in question. In this case, new information and data that support the objection will be requested from the entity being rated.

In cases where the issuers simply express their oppositional views against the rating results, no reinvestigation or reexamination shall be conducted.

(10)Publication

A credit rating that has been decided will be made public without any delay. In addition, if any material change is to be made in the rating criteria, the fact that the change will be made, and an outline of the change will be announced before it is applied to individual credit ratings. The publication will be made through one or more ways, including a news release, distribution to the electric media such as Bloomberg and Reuters, and posting on the CRA's website.

(11)Review of the Credit Rating

As long as there is an outstanding of the rated debt, the performance of the rated entity and the events and developments of the industry it belongs are monitored, and if there is a need to review the credit rating, a review will be made. CRA normally undertakes a regular review of rated debt once a year. When conducting the review of the credit ratings, CRA refers the same rating policies and methodologies used for assigning an initial credit rating. If as a result of the review, it is deemed that there is a likelihood of a change in the credit rating, an announcement will be made that the credit rating has been placed under "Credit Monitor" to call attention of investors. Once it is placed under "Credit Monitor", the credit rating may be changed.

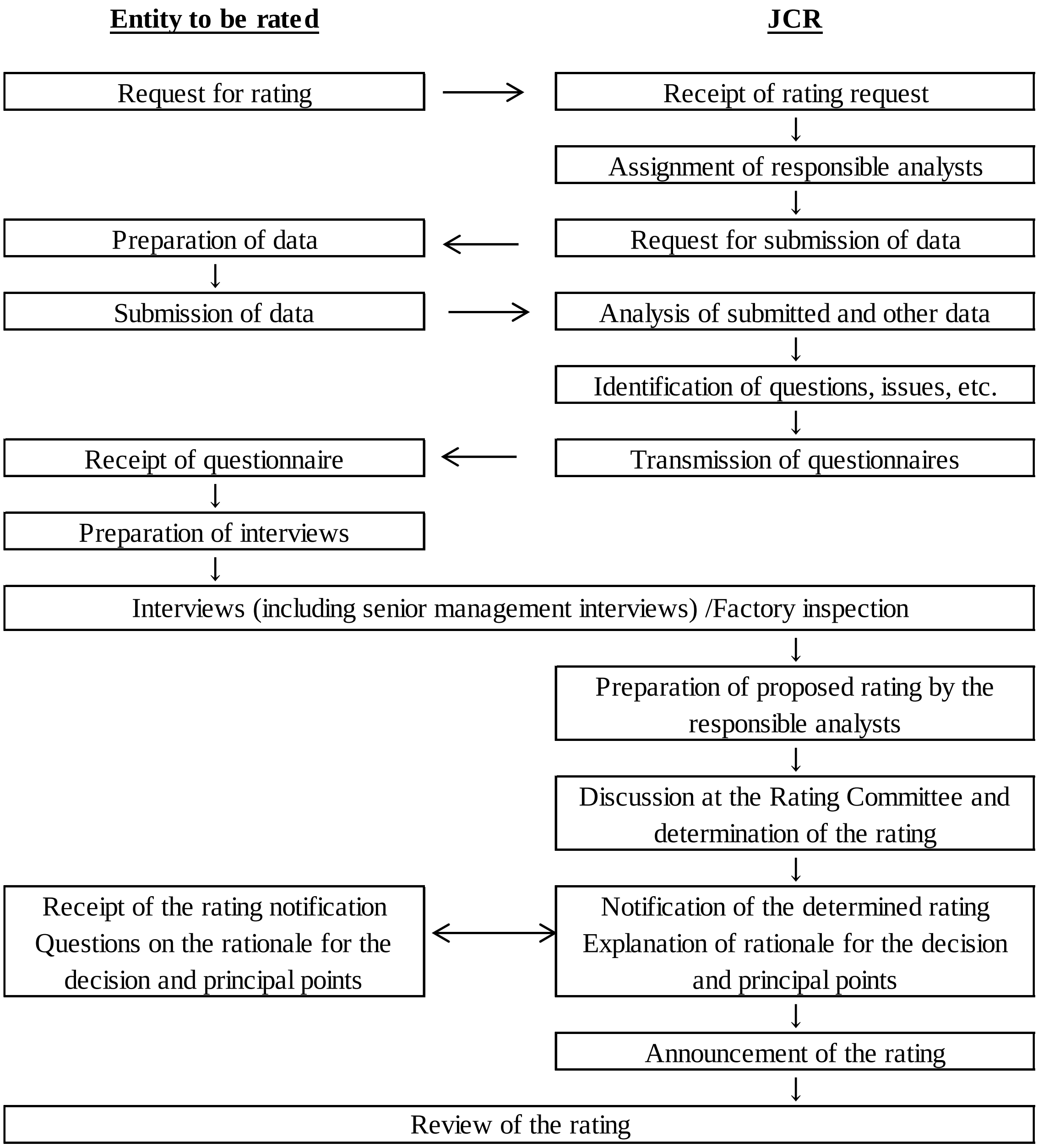
(12)Suspension and Withdrawal

A CRA may suspend or withdraw a rating when relevant information is lacking or if there develop significantly unfavorable circumstances. A credit rating may also be withdrawn by other reasons such as extinction of the rated securities or entities, defaults of the rated entities, request for withdrawing the solicitation of the credit rating from the issuers, etc. The CRA promptly publicizes the fact of Suspension or Withdrawal except in the case of the extinction of the rated securities or entities. When withdrawing credit rating s by the request form the rated issuers and it is because that the CRA determines to downgrade the credit rating of the issuers or securities concerned, the CRA will publicize the fact that the CRA downgrades the credit ratings concerned together with the publication of "Withdrawal".

(13)Unsolicited Credit Ratings

If a publication of a credit rating on an issuer is perceived to contribute to the enhancement of its accuracy because the issuer's market share, for example, is high, a CRA will be willing to assign and publicize the unsolicited credit rating without delay with the consent of the issuer. In this case, the CRA will disclose the credit rating not assigned at the request of the issuer by indicating affix, "p" (in the case of JCR) or some others, to the rating symbol to identify it as such. Even in the cases where credit ratings are not solicited by the Stakeholders, the CRA will assign credit ratings based on the same credit rating process, methodologies and information as for a solicited credit rating. Even in the cases when an interview with Stakeholders can be conducted only partially or no such interview can be conducted or when only partial non-public information can be obtained or no such information can be obtained, the CRA may assign credit ratings not solicited by the Stakeholders, if it can insure the quality of information used for such unsolicited credit ratings.

Figure 3-5: Process of Corporate Credit Rating



(Note) If an objection against the decision is made by the entity being rated, the details of the objection will be examined, and if deemed necessary , the rating will be reexamined by other analysts and discussed again at the Rating Committee.
(Source) JCR

3-1-3-5. Official Use of Ratings

In response to international discussions for over-dependence on rating for the purpose of regulation, Japanese authorities try to lessen the dependence on rating as a regulatory standard based on the principles which Financial Stability Board has published in 2010[5]. Japanese authorities, however, still use ratings for regulatory purposes, for example for calculating required capital ratio for Financial Instruments Business Operators, calculating solvency margin for insurance companies, bond issuing criteria for Special Purpose Companies and so on.

Shelf Registration system

The shelf registration system was established in 1988 in Japan. The system is to register the needed documents which include the total amount to be financed, security type and so on before issuing. The system allows the issuer more flexibility of the amount or timing in issuing bond. In 1992 the rating standard for shelf registration was introduced. The security to be under shelf registration system should be rated Single A or above by two credit rating agencies one of which should be a designated rating organization. In 2009 this rating standard for eligibility was completely abolished.

Basel II Capital Ratio

Ratings are still used by the Japanese authority as a standard for credit risk for banks. Banks calculate their capital ratio by multiplying risk weight corresponding to rating on their risk assets under the Basel II system. The rating institutions registered under the Financial Instruments and Exchange Act are also considered as Extended Credit Assessment Institutions (ECAIs) for the Basel II purpose.

Table 3-9 : Risk weight for calculating risk assets by standardised approach under Basel II

Credit assessment by ECAI (External Credit Assessment Institution)	AAA～AA$^-$	A$^+$～A$^-$	BBB$^+$～BBB$^-$	BB$^+$～BB$^-$	B$^+$～B$^-$	Below B$^-$
Claims on						
Sovereign	0%	20%	50%	100%	100%	150%
Multilateral Development Banks	20%	50%	50%	100%	100%	150%
Banks and Securities Firms	20%	50%	100%	100%	100%	150%
Corporates	20%	50%	100%	100%	150%	150%

(Source) Japanese Financial Services Agency and Basel Committee on Banking supervision

Eligibility Standard to be Listed in Tokyo Pro-Bond Market

In issuing corporate bonds, there is no obligation for the issuer to be rated in Japan. Eligibility standard for bond issuing was abolished in 1996. To be listed in Tokyo Pro-Bond Market, however, issuer is required to be rated by registered credit rating institutions or foreign registered CRAs

5 See Chapter 1 table 1-1.

(registered under the foreign regulations similar to Japanese system).

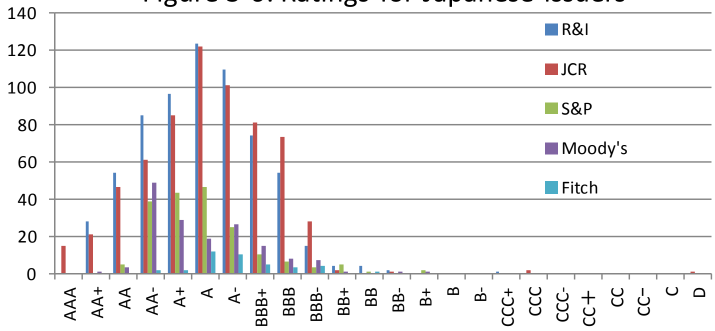
3-1-4. Issues for the Japanese CRAs

3-1-4-1. Characteristics of the Japanese Rating Industry

Concentration on investment grade

The ratings in Japan are concentrated on higher grade. As the issuing of corporate bonds was virtuously limited to financially strong companies until 1996, rated companies tend to be concentrated to higher grade companies. As the figure 3-6 shows the ratings for Japanese issuers generally concentrate on investment grade (BBB- or higher). Ratings of speculative grade are very rare because there are few investors to invest in junk bonds in Japan.

Figure 3-6: Ratings for Japanese issuers



(Note) As of October 2012. In the case of Moody's, ratings are substituted by comparable symbols. (Source) each company's website data

Small number of ratings relative to corporate numbers

JCR and R&I publish ratings only for 600-700 issuers including public sector such as municipal government compared to 3,647companies listed in Japan (including multiple listing to plural exchanges, 2,280 companies in Tokyo Security Exchange only). This means only 1/6 of the listed companies are rated by the CRAs. On the other hand, in the case of the United States, almost all of the listed companies are rated and many companies are rated by two or more CRAs. As Japanese investors tend to use the ratings only as mere guidelines for their investment, there is no need for issuers to be rated by 2 or more CRAs. On the other hand, US investors tend to use the rating as a standard for judging investment decision and ratings by 2 or more CRAs are popular in the United States. Furthermore in the United States one company often issues many different kinds of corporate bonds which have various conditions for payment. So there is real need for rating of each bond. But in Japan, one company issues the same type of corporate bonds. Every bond issued by one company has the similar credit risk. Therefore Japanese companies tend to request "issuer rating" instead of rating for each bond. That is also the reason why the number of Japanese ratings is so small compared to the United States.

Rating split between global CRAs and Japanese CRAs

In Japan the split between the global CRAs and Japanese CRAs used to be a big problem in 1990s. Global CRAs often published unsolicited ratings which were lower than those of Japanese rating companies such as JCR and R&I. It could cause confusion among the investors. The Japanese Financial Services Agency decided unsolicited rating could not be used for computing capital ratio of financial institutions for Basel II. Then the global CRAs ceased to publish unsolicited ratings. Today there still exists some rating split between the global CRAs and the Japanese CRAs and even between Japanese CRAs. However as a rating is an expression of each institute's opinion for the creditworthiness of a company, it is natural that ratings for one company differ among the rating agencies. Every CRA has its own method, model and know-how of data collecting and processing. Diversity in rating is a sound situation. Institutional investors know characteristics of each CRA and use these ratings according to various purposes.

3-1-4-2. Issues to be addressed

Because of the specific history of the Japanese corporate bond, where only financially strong companies have issued bonds, there exists no strong need for rating. Therefore, Japanese Rating Agencies have difficulties for challenge as follows.

How to deal with low profitability

Japanese rating industry is under harsh competition. Japanese CRA's business is mainly "issuer-pays" business model. The harsh competition from this practice leads to a very low rating fee of the CRAs and "rating shopping" occurs from time to time. Rating shopping means an issuer tries to choose a CRA which offers the most favorable rating for the lowest rating fee. In the United States one corporate has plural ratings from 2 or more rating agencies, to confirm the investors to be a credible issuer. For the Japanese CRAs, therefore, how to change the present environment toward more profitable business opportunity is a difficult challenge.

Expanding corporate bond market

The issuance of corporate bonds in Japan is still limited to fairly high-rated companies in specific sectors. As the corporate bonds market is relatively small, corporate bonds are not popular investment instruments especially for individual investors. The main holders of the corporate bonds in Japan are banks (depository institutions) and institutional investors while individual investors and foreign investors are still minor players. Furthermore, as many investors tend to hold corporate bonds until redemption in Japan (="buy and hold behavior"), the liquidity of the corporate bonds is very low. Therefore not only the primary market but also the secondary market is small. That is one of the reasons why the rating need is relatively small compared to the United States. Although this issue is also a difficult challenge, as it might be the effect of the investment culture such as investors' financial literacy, risk appetite and so on, more deregulation and development of financial infrastructure to enhance the market transparency will be a some help to facilitate the money to flow to the bond market.

Conflict of interest

Conflict of interest is not unique to the Japanese CRAs. It is somehow built in the rating system structure itself. The issuer-pay model may result in rating inflation and subscriber-pay model may lead to more severe rating and be costly for issuers. Rating institutions in Japan try to prevent the conflict of interests by various efforts, such as (1) avoiding a reputation risk, (2) separation between analyst and business promotion, (3) using more transparent and objective methodology and model, (4) diversification of the revenue and fixed rating fee, (5) independent shareholders and so on. Nobody can, however, escape from conflict of interests completely. They should try to balance between the interests of each stakeholder.

3-2. DCRAs in the ASEAN+3 region

In the ASEAN+3 region, there exist around 30 domestic CRAs. Most of the major countries have two or more DCRAs (Table 3-10). Many of these DCRAs have some capital or technical relationship with Global CRAs.

Among the major countries, Singapore, whose bond market has developed considerably, does not have any home-grown CRAs, but instead relies on international rating services. The global Big 3 CRAs developed their business in Singapore. In Vietnam, there is no domestic CRA, but the global Big 3 and Japanese R&I have business there.

Authorities in the countries of this region except Japan oblige CRAs to acquire permission or license to do rating business in their countries, though the accreditation criteria is different among the authorities.

In the ASEAN+3 region, against the background of the bond market development, domestic CRAs have grown to show somewhat reasonable presence in the local markets in the last 20 years. For example, according to the "ASEAN+3 Bond Market Guide" by Asian Development Bank, in countries such as China, Indonesia, Korea, Malaysia, Philippines and Thailand, bond issuers have been obliged to acquire ratings at the issuance of bonds.

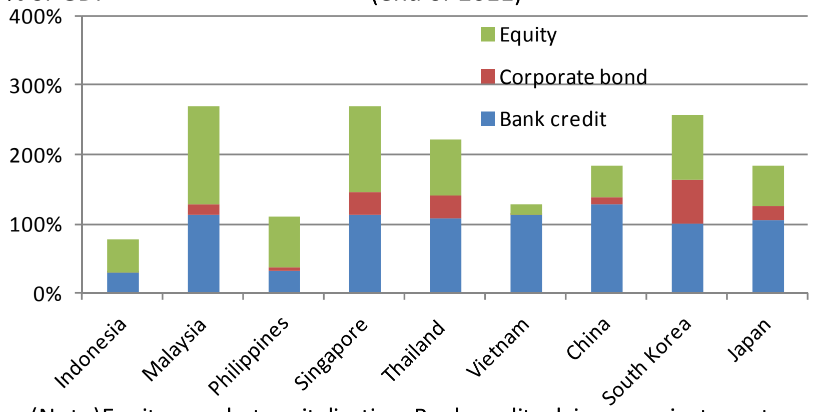
Table 3-10 : List of DCRAs and Affiliates of GCRAs in the ASEAN+3 countries

Country	Company name	Capital relationship with GCRAs	ACRAA[1] membership
Indonesia	Pefindo Credit Rating Indonesia	no but technical assistance from S&P	○
	PT ICRA Indonesia	no but parent company ICRA India is Moody's affiliate	○
	PT. Fitch Rating Indonesia	*Fitch	
Malaysia	Malaysian Rating Corporation Berhad (MARC)	no	○
	RAM Rating Services Bhd	Fitch 4.9%, McGraw-Hill Asia Hldg(Singapore)4.9%	○
Philippines	Philippine Rating Services Corporation (PhilRatings) Credit Rating and Investors Services Philippines, Inc.	no	○
Singapore	Moody's Singapore PTE Ltd.	*Moody's	
	Standard and Poors International L.L.C.	*S&P	
	Fitch Ratings Singapore Private Ltd.	*Fitch	
Thailand	TRIS Rating Co. Ltd. Fitch Thailand	no *Fitch	○
China, with the licence approved by the PBC[2]	Shanghai Brilliance Credit Rating & Investors Service Co., Ltd.	no	○
	Dagong Global Credit Rating Co., Ltd.	partnership with Moody's	○
	China Chengxin International Credit Rating Co., Ltd.	Joint-venture with Fitch,IFC	○
	China Lianhe Credit Rating Co., Ltd.	Fitch 49%	○
	Golden Credit Rating International Co., Ltd.		
	Shanghai Far East Credit Rating Co., Ltd.		○
China, with the licence approved by the CSRC[3]	Shanghai Brilliance Credit Rating & Investors Service Co., Ltd.	no	○
	Dagong Global Credit Rating Co., Ltd.	partnership with Moody's	○
	China Chengxin Credit Rating Co., Ltd.		
	China Lianhe Credit Rating Co., Ltd.	Fitch 49%	
	Golden Credit Rating International Co., Ltd.		
	Pengyuan Credit Rating Co., Ltd.		
Japan	Japan Credit Rating Agency,Ltd.	no	○
	Moody's Japan K.K.	Moody's	
	Moody's SF Japan K.K.	Moody's	
	Standard and Poor's Rating Japan K.K.	S&P	
	Rating and Investment Information, Inc	no	
	Fitch Rating Japan Limited	Fitch	
	Nippon Standard and Poor's K.K.	S&P	
Korea	Korea Investors Service, Inc. (KIS)	Moody's	○
	Korea Ratings Corporation (Korea Ratings)	Fitch 73.5%	○
	Nice Investors Service Co. Ltd. (NICE)	no	○
	Seoul Credit Rating & Information, Inc. (SCRI)	no	○

Notes: 1.ACRAA: the Association of Credit Rating Agencies in Asia
2.PBC: the People's Bank of China
3.CSRC: the China Securities Regulatory Commission
4.*: GCRA's sublidiary defined by Japanese Financial Services Agency
(Source) Compiled by IIMA from company website, AsianBondsOnline and hearing from ACRAA members

The rating industries in this area, however, have some common issues. Some of the challenges which Japanese CRAs face might be common to other Asian nations. For example small bond market compared to bank credit is more or less common to Asian economies (see Figure 3-7).

Figure3-7 : Domestic Finance of Private Sector in East and southeast Asia
% of GDP (end of 2011)



(Note)Equity= market capitalization, Bank credit=claims on private sector.
(Source) Asian Bonds OnlLine, IMF, IBRD

The DCRAs in Asia are not sufficiently recognized in the global market because of their short history, small track record, and insufficient human resources, etc. This might be one of the reasons why the cross-border investment in Asia has not developed satisfactorily. In the case of Japan, for example, although JCR is registered as a Nationally Recognized Statistical Rating Organization (NRSRO) with U.S. Securities and Exchange Commission[6] and also received the certificate of rating agency under the EU regulation[7], its business is concentrated in Japan.[8] Even the Japanese firms which want to finance in foreign market tend to go for ratings by global CRAs. They do not ask CRAs of Japanese origin for their own rating.

Many efforts have been made to enhance the DCRA's credibility both by DCRAs themselves and the ACRAA (Association of Credit Rating Agencies in Asia). ACRAA has made some progress in the areas such as standardized code of conduct, harmonization of the ratings, mapping of national scale ratings by default data study, education of analysts and so on[9]. But they are not enough. Some more efforts to enhance the DCRAs' credibility would be needed to promote the cross-border investment in the ASEAN+3 region. We will discuss in more details how to enhance the credibility of the DCRAs or regional credit rating capacities in chapter 6.

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[6] JCR was registered as a NRSRO with the U. S. SEC as of September 24, 2007. JCR partially withdrew from NRSRO registration, specifically with respect to Asset-Backed Securities on December 2, 2010; however, JCR maintains its registration with respect to the following four classes.
(1) Financial institutions, brokers and dealers
(2) Insurance Companies
(3) Corporate Issuers
(4) Issuers of government securities, municipal securities and foreign government securities.

[7] JCR received Certification for a Credit Rating Agency under EU Regulations on Credit Rating Agencies on January 11, 2011. JCR's ratings have become certified to be used by credit institutions, investment firms, insurance undertakings, institutions for occupational retirement provision, etc. inside the EU for the regulatory purposes.

[8] On the other hand, R&I, one of the two biggest CRAs of the Japanese origin, withdrew from NRSRO registration in 2011 and have decided not to be registered to EU CRA system.

[9] For the detail of the ACRAA's activity, see the AKI's report.

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Chapter 4 : The various efforts for comparable credit rating system

4-1. Initiatives of GCRAs to integrate domestic credit universes into a global credit universe-- Introduction of National Scale Ratings (NSRs)

4-1-1. Background

4-1-1-1. Domestic markets in the countries subject to the transfer and conversion risk

In domestic markets, especially of emerging countries whose sovereign credit rating levels are below or at lower level of investment grades, credits tend to be considered within universe of each domestic market. This is because:

-Bonds are issued mainly in local currencies, by local issuers, purchased by local investors and traded by local intermediaries.

-Foreign exchange market is under control. For international investors, the conversion and transfer risk relating to domestic bond investments is a major credit risk which restricts cross-border transactions.

-In those ring-fenced markets, however, the conversion and transfer risk does not become a major factor which differentiate credit ranking within domestic issuers. This is because most domestic transactions are ring-fenced and domestic participants will be subject to almost same magnitude of the conversion and transfer risk of the country. And the conversion and transfer risk will be mitigated because domestic bonds are mainly issued in local currencies and repaid via domestic financial systems.

-Thus in the emerging markets Domestic Credit Rating Agencies (DCRAs) provide ratings within domestic credit universe. They serve local market participants mainly in local languages. Their ratings also function as regulatory measures ruled by domestic regulatory authorities.

-Except for sovereign or public sector issuers engaged in hard-currency funding in the international capital and financial markets, market participants, both domestic and international, will not have serious interests in local issuer's rating levels in global scale provided by GCRAs because it is often too low for their investment targets.

For GCRAs whose strength exists in global credit markets, business environment may be tough in those markets.

4-1-1-2. Developments in emerging countries whose rating levels shifting towards investment grades

As national economies of emerging countries develop, sovereign credit ratings of those countries improve towards investment grades. Leading local issuers of top credit quality may become qualified as issuers of international markets. This is because:

-As the conversion and transfer risk decreases, international investors' concern over cross-border transactions will recede.

-International investors will become interested in domestic credits of top quality as new investment opportunities. And those leading issuers may in return try to tap international markets for their funding.

As cross-border transactions start to pick up, international intermediaries will also start to cover those domestic markets as their new business opportunities. Domestic debt capital markets develop in terms of volume, issuer diversities and liquidity which increase rating business opportunities in the domestic markets.

This is the stage where GCRAs attempt to enter into those domestic markets of high growth potential. NSRs are rating products strategically designed by GCRAs to penetrate domestic markets competing with existing DCRAs.

4-1-2. Definition and characteristics of NSRs

4-1-2-1. Definition of NSRs

Global scale ratings of GCRAs are provided within a credit universe of global market where credits can be compared with all the rated issuers globally. Global scale ratings are designed to be comparable in the global credit universe across every sector and country. By definition, credit worthiness of an issuer of the industry X in the country Y rated "single A" in global scale is comparable with that of another issuer of the industry Z in the country W rated the same.

On the other hand, NSR is defined as relative measure of creditworthiness within a credit universe of domestic market of a single country. NSRs are provided within scope of peer group active in each domestic market. Accordingly NSRs are neither comparable with global scale ratings nor with NSRs of other countries.

In order to differentiate from prevailing global scale ratings, NSRs have unique subscript to represent its country.[10]

[10] Note: Countries where GCRA operate in national scale

S&P: Argentina, Brazil, Israel, Kazakhstan, Mexico, Nigeria, Russia, South Africa, Taiwan, Turkey, Ukraine,

Table4-1 Example of NSR subscript for Brazilian issuers

Global Rating Agencies	Rating example
S&P	bra.AAA
Moody's	AAA.br
Fitch	AAA(bra)

4-1-2-2. Characteristics of NSRs

Although scope of credit universe for NSRs is narrower than global scale ratings, NSRs are assigned by the application of same rating criteria and methodologies used for global scale ratings thus reflecting same key rating factors. With respect to rating process, NSR follows basically the same rating process of global scale ratings except for scope of peer comparison. Therefore every debt can be rated in a national rating scale as well as in global rating scale and NSRs are expected to function as credit products to link between domestic credit universes and the global credit universe.

For every debt, rating level in global rating scale reflects that of its sovereign mainly due to its conversion and transfer risk involved. In contrast rating level of NSRs indicates only relative strength within domestic credit universe. An issuer of highest credit quality in a domestic credit universe of a country rated BB in global scale may be rated even AAA in national scale, which means NSR become comparable with ratings provided by DCRAs operating in the same country.

With respect to mapping global scale ratings to NSRs, each NSR rating level is considered individually by key rating factors such as industry, financial strength, business environment etc. No directly convertible mapping table which automatically link between the two scales is provided except for guidelines to indicate corresponding range of rating levels.

Uruguay

Moody's: Argentina, Bolivia, Brazil, Czech Republic, Kazakhstan, Lebanon, Mexico, Russia Slovakia, South Africa, Tunisia, Turkey, Ukraine, Uruguay

Fitch: India, Mexico, Colombia, Brazil, Russia, Argentina, Taiwan, Turkey, Dominican Republic, Indonesia and 23other countries

(Source: S&P, Rating Direct "ASEAN Regional Rating Scale Explained"22November2012, Moody's, "Mapping Moody's National Scale Ratings to Global Scale Ratings"30March2011, Fitch, "National Ratings Criteria" 19January2011)

Table4-2 A visionary mapping image of global scale ratings to NSR				
Advanced countries Global scale	**Emerging country X** Global scale	NSR xx	**Emerging country Y** Global scale	NSR yy
AA				
A	Sovereign : A	AAA xx		
	Issuer1: A-	AAA xx, AA+ xx		
BBB	Issuer2: BBB	AA+ xx, AA xx	Sovereign: BBB	AAA yy
	Issuer3: BB+	AA- xx, A+ xx	Issuer1:BB+	AA+ yy
BB			Issuer2: BB	AA yy
	Issuer4: B+	BBB+ xx, BBB xx, BBB-xx		
B			Issuer3: B	A- yy, BBB+ yy
	Issuer5: B-	BB- xx, B+ xx, B xx	Issuer4: B-	BBB yy BBB-yy
CCC	Issuer6:CCC	CCC xx	Issuer5: CCC	CCC yy

4-1-3. NSR introduced in emerging markets of growth potential

4-1-3-1. Business expansion required in emerging countries

When sovereign ratings of certain emerging countries improve towards investment grades, it becomes essential for GCRAs to increase coverage for those domestic markets in order to maintain and develop existing businesses. This is because:

-International investors, GCRAs' major client base for investor-sponsored businesses, will become interested in those markets as their new investment opportunities.

-Those local issuers of top credit quality may try to tap international financial markets for their hard-currency funding. This is a new and most important rating business opportunities for GCRAs.

-Certain international issuers, active already in global markets, may start to consider tapping foreign bond markets of those countries to diversify their funding sources by making themselves known among local investors. And also some global corporate issuers may become interested in the domestic market for their local currency funding for their direct investments. These could be another rating business opportunities for GCRAs.

However, it is not easy for GCRAs to establish stable business model in those countries if they stick to traditional rating services in global scale. This is because:

-Number of local issuers to be active in international markets is small.

-Number of local investors to be active in international investments is small.

-Rating process for issuers of below/low investment grades will require cautious and costly analytical process due to relatively high credit risks and insufficient data for analysis, i.e. costs and risk of local analytical operations for GCRAs will be higher in those countries.

Accordingly it is essential for GCRAs to capture domestic rating businesses targeting not only top-tier local issuers, candidates for international issuers for future, but also local issuers mainly playing in the domestic markets.

4-1-3-2. Necessary adjustment of global scale for local application

For issuers of the emerging countries whose sovereign ratings are below/low investment grades, rating levels of local issuers in global scale are usually capped by those of sovereign ratings. This is mainly because the conversion and transfer risk remain as significant risk factor in those credit categories. For example it is not likely the issuers rated AAA by DCRA are rated above BBB in global scale by GCRA if the country's sovereign credit is rated BBB.

Domestic issuers, not expecting to tap international markets in near future, will not attempt to obtain global scale ratings from GCRAs. For domestic investors, mainly operating in the domestic market, ratings of GCRAs in global scale are not comparable with prevailing rating levels of DCRAs. Also for regulatory purpose rating levels of GCRAs in global scale may be handicapped because they are much lower than those provided by DCRAs.

In order to penetrate domestic rating businesses, GCRAs needed to introduce NSRs so that they could produce rating products comparable with those of DCRAs.

4-1-4. Do NSRs of GCRAs help increase cross-border transactions in emerging markets?

This question may have certain implications for a development of Asean+3 regional credit markets.

4-1-4-1. Supportive view points

NSRs provided by GCRAs will help increase cross–border transactions. This is because:

-GCRAs have unique strength in providing ratings in both global and national scale at the same time.

And ratings are often announced in both scales in the same rating reports. This is a useful and helpful presentation of credits for both domestic and international market participants, providing certain mapping image of rating levels between global and national scale.
-GCRAs use same rating criteria and methodologies for rating processes both for global and national scale. To use common criteria is a key to link between the two credit universes. In future when sovereign credit rating level of a country advances further to A/AA levels, NSR may be integrated into global scale smoothly under the same rating criteria and methodologies applied.
-GCRAs have strength in delivering credit reports both regionally and globally. GCRAs can produce rating reports in both in English and local languages, targeting international market participants and domestic markets participants respectively.

4-1-4-2. Critical view points

Some people may argue differently such as follows:
-NSRs are rating products only targeting domestic market participants. NSRs will not promote cross-border transactions since they are not comparable with credits elsewhere.
-Infrastructure of rating businesses of emerging countries is in general under-developing. Volume and quality of data and statistics, especially in English translation, may not be sufficient. Rating process may be conducted based on the insufficient information especially with respect to accounting, auditing and disclosure rules, although they apply the same criteria and methodology. Quality of rating products for domestic issuers in certain countries may be behind to GCRAs' global standards.
-Number of issuers to sponsor rating business will be small. Ratings may be publicized without adequate number of peer comparison. Small revenue potential may also result in poor resource allocation of local analytical staffs having deep insight and experience in local credit markets with communication skill both in local language and in English.

4-1-5. Introduction of ASEAN Regional Scale Ratings

4-1-5-1. ASEAN regional scale introduced

In 2009 S&P introduced 'ASEAN Regional Rating Scale'[11]. Like NSRs described above, ASEAN regional scale ratings are assigned for the application of the same rating criteria and processes of global rating scale but credit risk is compared within the context of ASEAN countries. To differentiate from global scale ratings and NSR, ASEAN regional scale ratings use 'ax' prefix as an identifier. Mapping table of Global rating scale to ASEAN regional scale is publicized. (Table4-3) ASEAN regional scale covers 10 ASEAN countries with over 120 issuers.

[11] "Standard & Poor's Expands Coverage OF ASEAN Regional Rating Scale" Rating Direct 22 November2012.

4-1-5-2. Do 10 ASEAN countries already share a single credit universe？

ASEAN Regional Rating Scale was designed to serve market participants with a scope of ASEAN as an asset class defined regionally. This initiative clearly reflects recent growth and integration efforts of the financial markets within ASEAN. As cross-border transactions increase within the region, credit universe of each domestic country will expand and be integrated into the regional one. This is the stage where ASEAN Regional Scale starts to function as designed.

However, despite recent favorable developments of financial markets of ASEAN, basic credit culture and financial infrastructure still differ significantly within the region. There it may be very difficult to compare credit between X of the country A and Y of the country B.

It is clear ASEAN Regional Rating Scale is a rating product foreseeing an integrated regional market of ASEAN. However it may be too soon to classify 10 domestic markets as if they were in a single market. We need to promote a mechanism to let regional leading issuers and investors play proactively within the region across the borders.

Table4-3 Mapping of S&P Global Rating Scale to ASEAN Regional Rating Scale

Global scale (Long-term rating)	ASEAN Regional Scale (Long –term rating)
AAA	axAAA
AA+	axAAA
AA	axAAA
AA-	axAAA
A+	axAAA
A	axAAA , axAA+
A-	axAA+, axAA, axAA-
BBB+	axAA-, axA+
BBB	axA+, axA, axA-
BBB-	axA-, axBBB+
BB+	axBBB+, axBBB
BB	axBBB, axBBB-, axBB+
BB-	axBB+, axBB
B+	axBB , axBB-
B	axBB-, axB+
B-	axB+ , axB , axB-
CCC+	axCCC+
CCC	axCCC
CCC-	axCCC-
CC	axCC
SD	SD
D	D

References

Fitch Ratings, “National Ratings Criteria” 19 January2011

Moody's, "Mapping Moody's National Scale Ratings to Global Scale Ratings"30 March 2011
S&P, "General Criteria: Understanding National Rating Scales" 31 October 2011
"ASEAN Regional Rating Scale Explained" 22November 2012

4-2. Commercial banks' capacity to perform horizontal comparison of risk assessment

Bank finance is still a major financial intermediary in Asia. Region-wide commercial banks are expected to have their own methods and capabilities to analyze credit risks in a regionally comparable way. To research the possibility of comparable credit rating system in Asia, this section studies on the commercial banks' capacity to perform horizontal comparison of risk assessment. We focus on the credit risk management and credit rating and introduce a internal risk assessment practice of a well known global commercial bank which has a long history of Asian financial business, based on the interview with the credit risk manager of it.

4-2-1.Commercial banks' capacity of credit risk management and credit rating

(1) Internal rating system

The main function of credit risk management is to estimate the default risk of loan claims. Its objective is proper and timely evaluation of the loan claims which dominate the assets of commercial banks. Commercial banks analyze for themselves quality of their loan assets by materializing vast amount of information of macro economies as well as each individual and corporate clients which they are privileged to access.

The process of credit risk management starts with measuring the default risk of each loan claim quantitatively. Because the goal for them is to estimate and manage their credit portfolio as a whole, they pay attention to region wide comparability of their claims to customers.

The bank we interviewed developed its own internal rating system. They developed this system under a consultation of a global credit rating agency. The process of the development is as follows:

i) Corporate financial data and other qualitative information are simply put into the rating model of the GCRA.

ii) The numerical rating result which the model produces is compared with the bank's existing evaluations of the borrowers. If the rating and existing evaluation do not fit to each other, they adjust the weight of input data or adjust the processes of through-put until the rating result fit to their sense. As their clients spread in wide range of industries, size of corporate and regions, models of rating calculation became differentiated into nine as below:

Table4-4 Nine models of internal rating system of a commercial bank

		Region		
		Asia	Europe	US
Size of corporate	Global	V	V	V
	Large	V	V	V
	SME	V	V	V

iii) Rating ladders are divided into 22 notches. The highest rate is 1.1 and the lowest is 10.2. Companies rated between 1.1 and 2.2 are the central target of global rating by GCRAs. The ceiling of unaudited companies is 5.1, which corresponds approximately to B in global scale ratings. A company group between the higher groups and lower groups, which spread in six notches between 3.1 and 4.3, correspond to BBB to BB in global scale ratings. Quite a number of companies belong to this range in Asia according to the interviewed bank. They are good bankable customers of conventional loans and potential active bond issuers in future.

iv) It took about five years until they reached considerably reliable internal rating models. Today they are confident that they can estimate the actual default ratio of a company on or above the grade of 4.3 only by its internal rating results.

Table4-5 The interviewed banks internal rating ladders

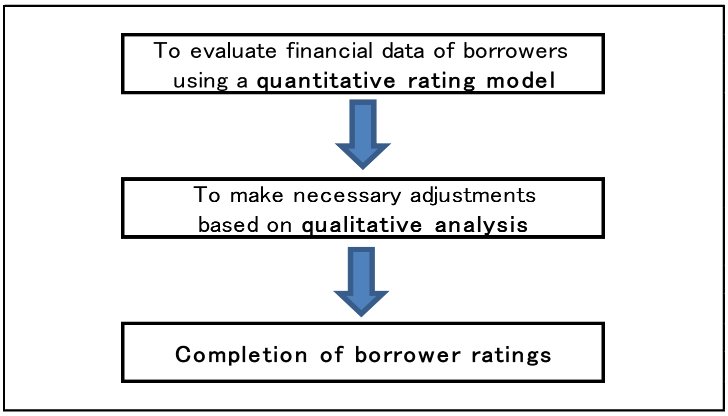
Borrower Rating			Relation to Global Rating	Borrower Classification	Probability of Default
1.1	1.2			nomal	low
2.1	2.2			↑	↑
3.1	3.2	3.3	→ corresponds to BBB		
4.1	4.2	4.3	→ corresponds to BB		
5.1	5.2		corresponds to the Ratings below B		
6.1	6.2				
7.1	7.2			↓	
8.1	8.2			de facto bankrupt and bankrupt	
9.1	9.2				↓
10.1	10.2				high

(2) Data which input in the rating model

90% of the input into the models is a quantitative data such as the financial statements. The rest 10% includes growth potential of industry which borrowers belong, the years in operation, and other qualitative information. The credit risk of companies which has a rating of 5.1 or below is scrutinized on each credit disbursement instead of relying only on the calculated rating.

Country risk and transfer risk are also quantified and added or reduced in the calculation of the rating of a company. As a general rule of the bank, the principle of country ceiling is applied. The highest rating of borrowers in a country is capped by the rating of the country. But they admit some exceptional cases for excellent multinational companies in low rated countries. The corporate rating could exceed the country ceiling in such a case.

Figure4-1 The interviewed bank's Borrower Ratings Process



4-2-2. Suggestion for policy recommendations

Although the detail of methodology itself is not disclosed and there is no direct contribution to the establishment of credit rating systems of bond markets, the following findings would be useful in thinking of feasible and realistic proposals of this study.

(1) Regionally comparable credit rating

By precise scrutiny of each individual company data, region wide comparison of corporate credit is possible and it is actually conducted by the interviewed commercial bank. The bank combines knowledge of rating method possessed by a global rating agency with knowledge of each individual local client possessed by themselves. They apply this combined knowledge to a group of company which is located in the upper-middle range of credit ladders in regional markets. After five year long trial and error, they established internal rating models which are reliable in measuring credit risks of those companies who disclose audited financial statements.

(2) Existence of credit universe of local good companies

Another finding is the number of such companies. They are good quality in local market but not yet focused by GCRAs as a business target. They may be known among local lenders or investors country by country. But they are not necessarily recognized in a collective way in whole region. They are composing a universe of potential bond issuers who should be targeted by regional scale ratings. The commercial bank makes the best use of credit data of such companies rated in their uniformed measure within six notches from 3.1 to 4.3 (approximately BBB and BB in global scale ratings). They use it in their regional portfolio management and credit policies.

This group of companies should be made use of in creating a new scheme that could improve the comparability of local credit ratings in Asia, which we discuss in the section 4-1 under the chapter 4 and in the subsection 6-2-4 under the chapter 6.

4-3. Default Data Study, a trial of improving comparability of national scale ratings

One of the trial of improving the comparability and credibility of national scale ratings in each country is a study conducted by a professional who is engaged in credit rating business in Asia. This study was conducted under the support of a supranational organization and it is supposed to develop further to become a useful reference for the development of credit rating capacities in Asia. It resulted in an unpublished report in summer 2012, which tries to build up a certain comparability between national scale ratings by using cumulative default ratios and actual default ratio as a key to bridge each national scale.

The writer admits there are some limitations of this study due to the differences of methodology and data of each country. But the report succeeded in providing a certain image of mapping of credit rating of individual countries to each other in a form of “comparative matrices,” although there is still much to be completed until this study will become reliable enough for practical uses.

Chapter 5: Regional Credit Rating Agencies in Europe and Latin America

5-1.Credit Rating Agencies in Europe

AKI conducts in-depth analysis about credit rating business in Europe in its Paper 1: International Discussions on Global CRAs and Current Conditions of Domestic CRAs in Europe, written by Marvin Castell. Though the detail of the contents should be referred to the AKI's report, we would like to explore very briefly the "regional" feature of credit rating system and capacity in Europe in order to support better understanding of the Latin American analysis for the convenience of readers.

The essence of the report is:

1. Although there are 30 credit rating agencies in the European Union, 16 institutes are operated by the three GCRAs through their subsidiaries and affiliates in the EU. The big three are dominant players in this region, too. Most of local agencies cover their local markets only and a few operate on a regional or global basis. Local agencies' resources are not sufficient to compete with the big three agencies. Most agencies rely on the fees from the issuers.
There is no region-wide credit rating agency in Europe.

2. The credit rating agencies in the EU now have strict internal control mechanism, reporting arrangements and other principles/procedures as the requirements of the EU. The discussion for the region-wide regulation has started as a result of the global financial crisis and the regulation started in 2009. Now the European Securities and Market Authority are given full authority to supervise the credit rating agencies' operations.

3. Although there was strong criticism against the rating agencies among politicians in Europe after the global financial crisis, the EU currently implements non-interference with the content of the credit rating. The only law regarding content is the upfront requirement on registration among rating agencies to provide the description of the procedures and methodologies used for issuing and reviewing credit ratings.

5-2.Credit Rating Agencies in Latin America and the Caribbean Region

5-2-1. Outline of Credit Rating Agencies in Latin America

Three global credit rating agencies (GCRAs) are leaders in the Latin America and Caribbean region, too. Although there are 31 credit rating agencies in the region, more than half are owned by GCRAs. For example, Fitch that has the largest number of affiliates in the region, has established bases of operations in Argentina, Bolivia, Brazil, El Salvador (covering Central America), Chile, Mexico, Uruguay, and Venezuela.

Even independent agencies often link up with the GCRAs. The relationships are capital tie-ups and involve various types of collaboration, including technical guidance and data sharing. For example, Colombian credit rating agency, BRC, was originally established as a local subsidiary of Thomson Financial in 1997. The company is now independent, but received technological support from Moody's between 2009 and 2011.

In short, the rating business in the region appears to have developed since the 1990s, led by GCRAs.

Table 5-1: Independent Credit Rating Companies in Central and South America (including affiliated companies)

1	SR Rating Prestacao de Servicos Ltda.	Brazil
2	Caribbean Information & Credit Rating Services Ltd. (CariCRIS)	Caribbean
3	Clasificadora de Riesgo Humphreys, Ltda.	Chile -- Moody's Affiliate
4	Feller Rate Clasificadora de Riesgo	Chile -- S&P Affiliate
5	BRC Investor Services S.A.	Colombia
6	Duff & Phelps de Colombia, S.A., S.C.V	Colombia -- Fitch Affiliate
7	Sociedad Calificadora de Riesgo Centroamericana, S.A. (SCRiesgo)	Costa Rica
8	Bank Watch Ratings S.A.	Ecuador -- Fitch Affiliate
9	Ecuability, SA	Ecuador
10	HR Ratings de Mexico, S.A. de C.V.	Mexico
11	Apoyo & Asociados Internacionales S.A.C.	Peru -- Fitch Associate
12	Class y Asociados S.A. Clasificadora de Riesgo	Peru
13	Equilibrium Clasificadora de Riesgo	Peru -- Moody's Affiliate
14	Pacific Credit Rating (PCR)	Peru
15	Calificadora de Riesgo, PCA	Uruguay

Source:DefaultRisk.com

Rating agencies basically assign ratings for the domestic markets of their respective countries. The entities rated have expanded from public enterprise bonds to project finance, structured debt, banks and investment trusts.

But some rating agencies also rate corporate or financial products of their less-developed neighboring countries. For example, Colombia's rating agencies assign ratings to bonds and other credits in Bolivia.

Further, Mexico's HR Ratings assigns ratings to domestic and some US entities. HR Ratings was founded in 2007, and became in November 2012 the first rating agency in Central or South America to be accredited as a Nationally-Recognized Statistical Rating Organization (NRSRO) by the US Securities and Exchange Commission.

HR Ratings provides a linkage between domestic and global scales, and domestic AAA is equal to a global A-.

Table 5-2. Mexico's HR Ratings' Rating Scale

Equivalencies in HR Ratings Credit Rating Scales	
Local Scale (Mexico)	**Global Scale**
HR AAA	HR A- (G)
HR AA+	HR BBB+ (G)
HR AA	HR BBB (G)
HR AA-	HR BBB- (G)
HR A+	HR BB+ (G)
HR A	HR BB (G)
HR A-	HR BB- (G)
HR BBB+	HR B+ (G)
HR BBB	HR B (G)
HR BBB-	HR B- (G)
HR BB+	HR C+ (G)
HR BB	HR C (G)
HR BB-	HR C- (G)
HR B+	HR C- (G)
HR B	HR C- (G)
HR B-	HR C- (G)
HR C+	HR C- (G)
HR C	HR C- (G)
HR C-	HR C- (G)
HR D	HR D (G)

Source: HR Ratings HP

However, domestic standards are not always linked to international standards, as in the case of Brazilian credit rating agency, SR Rating. In Table 5-3, shows the global scale and local scale of SR Rating (Brazil). The two ladders seem to have a similar structure but there is no direct relevance to each other as there is in case of the Mexican agent on the previous page. The local rating scale reflects the standards of payment guarantees compared within Brazilian borrowers.

Table 5-3: SR Rating (Brazil) Credit Rating Scale

SR RATING - GLOBAL SCALE

(LONG –TERM SCALE – 5 YEARS)

AAA^{SR}			Maximum guarantees, risk almost null. Default probability, in the analyzed period, minor than 0,5 in 100.
$AA+^{SR}$	AA^{SR}	$AA-^{SR}$	Very strong guarantees, very low risk. Default probability, in the analyzed period, minor than 1 in 100.
$A+^{SR}$	A^{SR}	$A-^{SR}$	Strong Guarantees, low risk. Default probability, in the analyzed period, minor than 2 in 100.
$BBB+^{SR}$	BBB^{SR}	$BBB-^{SR}$	Suitable Guarantees, reasonable risk. Default probability, in the analyzed period, minor than 5 in 100.
$BB+^{SR}$	BB^{SR}	$BB-^{SR}$	Modest Guarantees, medium risk. Default probability, in the analyzed period, minor than 15 in 100.
$B+^{SR}$	B^{SR}	$B-^{SR}$	Insufficient Guarantees, high risk. Default probability, in the analyzed period, minor than 30 in 100.
CCC^{SR}			Traces of default, very high risk. Default probability, in the analyzed period, higher than 30 in 100.
CC^{SR}			Probable default, very high risk. Default probability, in the analyzed period, higher than 50 in 100.
C^{SR}			Imminent default, maximum risk. Default probability, in the analyzed period, higher than 75 in 100.
D^{SR}			Default.

SR RATING – "EQUIVALENCE BR"

(LOCAL RATING SCALE)

brAAA			Maximum guarantees, in comparison with other local credit risks.
brAA+	brAA	brAA-	Very strong guarantees, in comparison with other local credit risks.
brA+	brA	brA-	Strong Guarantees, in comparison with other local credit risks.
brBBB+	brBBB	brBBB-	Suitable Guarantees, in comparison with other local credit risks.
brBB+	brBB	brBB-	Modest Guarantees, in comparison with other local credit risks.
brB+	brB	brB-	Insufficient Guarantees, in comparison with other local credit risks.
brCCC			Traces of default.
brCC			Probable default.
brC			Imminent default.
brD			Default.

Characteristcs

•Only obliquely translates the probability of default by the issue or issuer.

•Reflects the standard of payment guarantees compared with other Brazilian credit risks evaluated in the same equivalence.

•Includes risk aspects of the country.

•Not directly comparable to any other so-called "national" scale.

•Projects outlooks of maintenance of guarantees within a maximum horizon of 24 months.

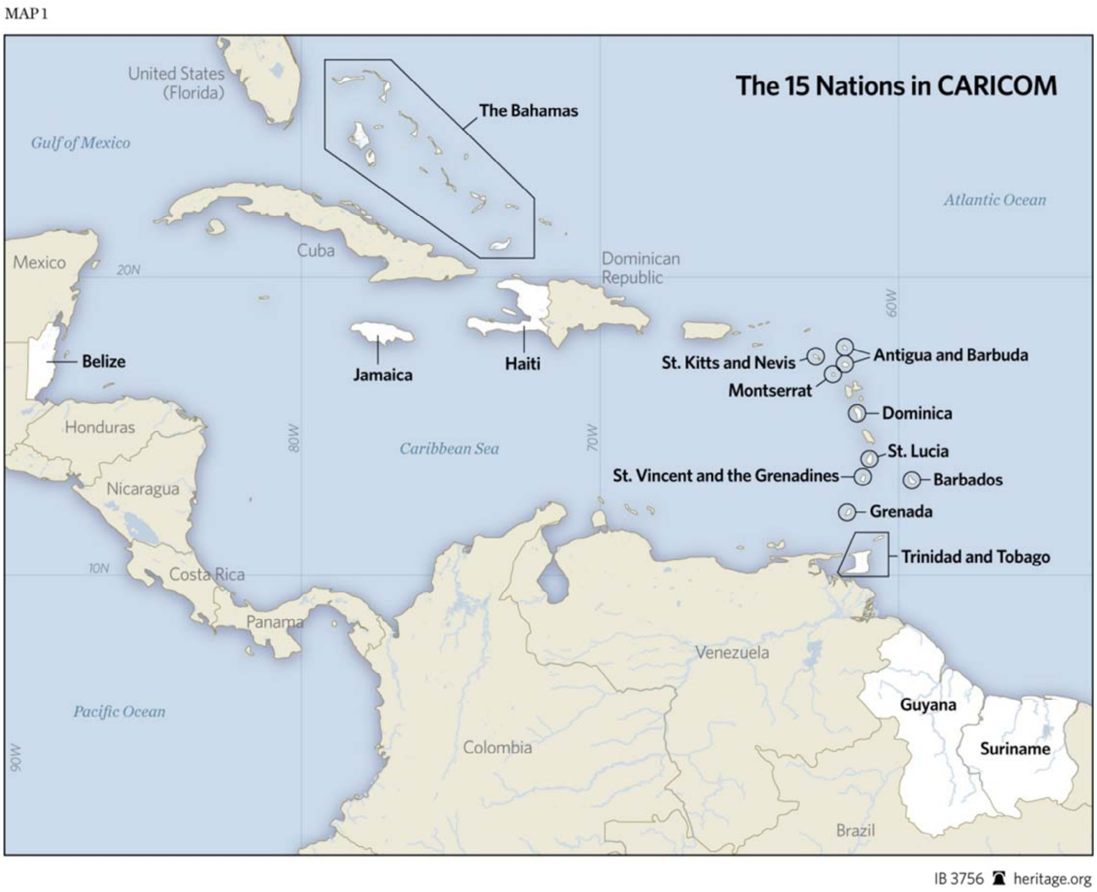
Source: SR Rating HP

5-2-2. Credit Rating Agency in the Caribbean Region

(1) Characteristics of the Caribbean Region

According to the definition of the Caribbean Community (CARICOM), the Caribbean region could be comprised of fourteen countries and one UK territory: Antigua and Barbuda, the Bahamas, Barbados, Belize, the Dominica, Grenada, Guyana, Haiti, Jamaica, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname, Trinidad and Tobago, and Montserrat (a UK territory).

Figure 5-1. The Caribbean Community (CARICOM)



The GDP of CARICOM is approximately USD66.3bn (as of 2010, or approximately JPY5.3trn), less than 1.4% of the GDP for the entire Latin American region, and as large as the GDP of Ecuador (approximately USD67.0bn). Trinidad and Tobago and Jamaica are the big countries in the region, and these two comprise 53% of the region's total GDP. As for the income level, average per capita GNI is approximately USD12,200(in terms of purchasing power), but there is a significant gap between the highest (Trinidad and Tobago at USD24,400) and the lowest (Haiti at USD1,120). Also, the Caribbean region usually includes the Dominican Republic in addition to the CARICOM region.

(2) Bond Markets in the Caribbean Region

Bond markets in the Caribbean region are still on an initial stage of development, and both issuance amounts and liquidity are low. Although the markets are dominated by government bonds, even government bonds are not fully well developed. Because of the lack of breadth in issuances, there is no clear yield curve in the government bond markets. Also, secondary market trading is very thin even in the government bond markets. The Treasury Bills are dominant in the money markets, too. There are only limited issuances of commercial papers.

The bond markets are relatively small to the size of economy. Though Trinidad and Tobago's bond market is the most developed within the region, the outstanding of the country's bond issuance is no more than 5.3% of GDP. Compared with the loan outstanding of the commercial banks which stand at 32% of GDP, this is an extremely low level (as of 2010). [12]

Note that Trinidad and Tobago's stock market valuation is approximately 57% of the country's GDP, exceeding the amount of loans and bonds issued.

[12] Caribbean Bond Markets – Characteristics, Recent Developments & Role of Ratings, CariCRIS, 2008

Table 5-4. Caribbean Bond Markets - Characteristics

1. Underdeveloped bond markets
   - Relatively fragmented, very thin, limited range of securities
   - Dominated by Govt. securities, e.g. Jamaica – resulting in crowding out of private sector
   - Lack of breadth in issuances (no yield curve)
   - Private placements abound
   - Exclusively private placements in T&T btw 2000–2004 with several auctions from GORTT and SOE in 2005–2007
   - Very little secondary market trading
   - Information asymmetry & inadequate transparency
   - Low usage of credit ratings. (In CariCRIS' universe of 19 countries, there only 33 ratings of which 11 are sovereigns)
   - No scientific risk-based pricing of debt hence anomalies and inconsistent pricing
   - Impacting valuation and growth

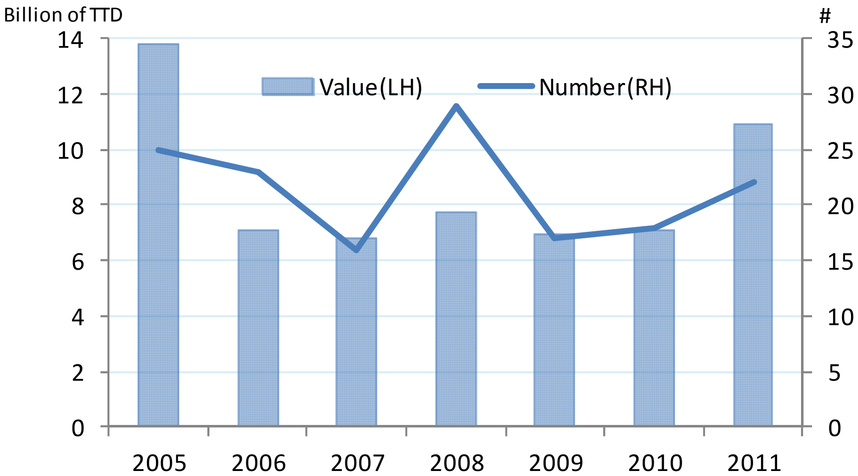
2. Money markets also dominated by treasury bills
   - Limited corporate issuances of commercial paper

3. Small bond markets relative to the size of financial sector
   - T&T leads the regional corporate bond market
   – but still very small in relation to size of the economy and banking sector
   - Bonds issued was only 3.9 % of GDP in 2007
   - Bank credit to the private sector was about 30% of GDP in 2007

* GORTT: Government of the Republic Trinidad and Tobago

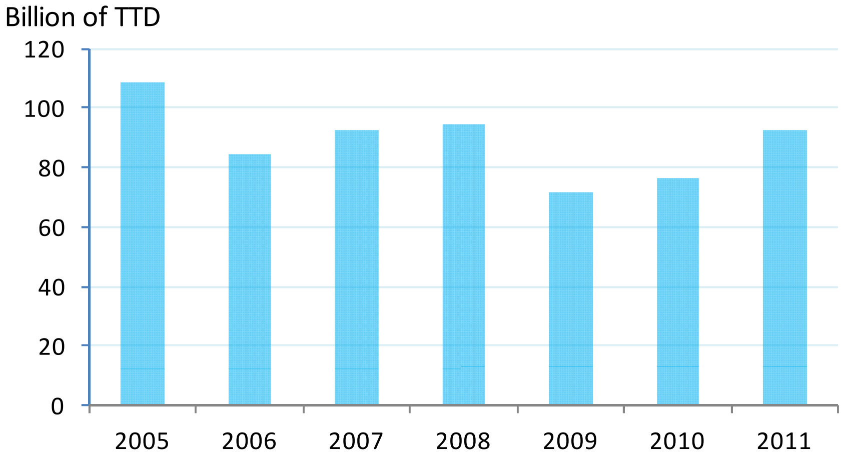
Source: CariCRIS

Figure 5-2. Trinidad and Tobago's Securities Issuances



Source: Trinidad and Tobago Securities and Exchange Commission

Figure 5-3. Trinidad and Tobago's Stock Market Valuation



Source: Trinidad and Tobago Securities and Exchange Commission

(3) Regional Credit Rating Agency and Regional Integration

Caribbean Information & Credit Rating Services, Ltd., (CariCRIS) serves each Caribbean country and the entire region. According to the company's HP, it is the first "regional" credit rating agency in the world and was founded in 2004 with the objective of assigning consistent credit ratings to bond issuers within the region using uniform standards. The company is headquartered in Port of Spain, the capital of Trinidad and Tobago.

The Caribbean region has a number of small countries and the domestic market is small even after all countries are bound together. About the companies there, corporate creditworthiness cannot be compared by using global ratings. CariCRIS was established to address this issue and assigns ratings that measure the soundness of companies in the region.

The regional credit rating agency was jointly founded primarily because establishing separate credit rating agencies in individual countries would not be efficient in terms of economy since each Caribbean country and its market is too small.

In addition, the high degree of economic and systematic integration in this region also helped to set up the regional credit agency.

The Caribbean Free Trade Association (CARIFTA) was formed in 1968 in order to increase regional trade. Later it developed into the Caribbean Community, or CARICOM. [13]

[13]CARICOM collaborates on foreign relations and social policies and has a bureaucratic structure. The Conference of the Heads of Government is the top decision-making body, and the Community Council of Ministers drafts and adjusts CARICOM strategy in the fields of economic integration, functional collaboration, and foreign policy based on the Conference of the Heads of Government policy. Below this, cabinet-level boards of directors are established by function, including foreign relations and community relations, trade and economic development, labor and social development, and fiscal and planning. The Council for Foreign and Community Relations (COFCOR) manages policy collaboration. Also, legal, budgetary, and central bank governor committees have been established as assisting structures. CARICOM's head offices are located in the Republic of Guyana and employ 470 workers.

In 2006, the 13 members of CARICOM (excluding the Bahamas and Montserrat) formed the CARICOM single market and economy (CSME) in a move toward economic integration. Under CSME, the region has introduced a common tariff, liberalized movements of labor, goods, and capital, standardized financial regulations, and harmonized corporate law and accounting practices within the region. For example, workers can work anywhere within the region without permits, and pensions are fully portable. Companies can do business anywhere within the region freely and make transactions at banks in any country within the region. Regulations are also standardized, and intellectual property is uniformly protected within the region.

CSME member countries use both fixed and managed float exchange rate systems. The Barbados dollar (BBD) and the Belize dollar (BZD) are fixed against the US dollar (USD) at 2:1 (2BBD = 2 BZD = USD1). East Caribbean dollar (XCD) is pegged to USD at 2.7 XCD. Jamaica uses a managed float system for its currency, and monetary officials frequently intervene in the market to keep the currency at USD/JMD85-90. Guyana, Suriname, and Trinidad and Tobago also use a managed float system to stabilize their currencies against the USD. The region keeps relatively stable exchange rates.

In this way, the CSME region's market integration has been as strong as the EU after 1992.

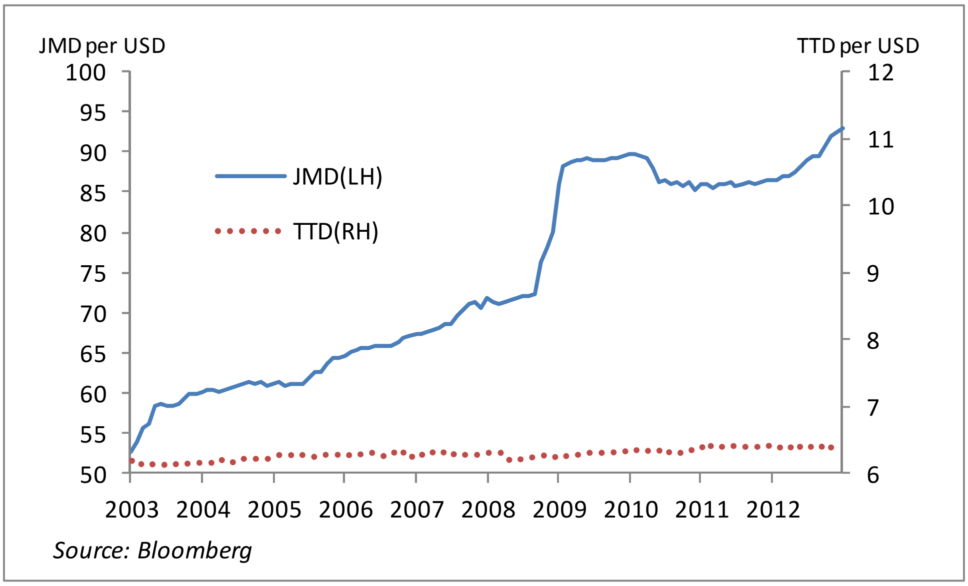
The region's strong uniformity and fairly advanced regional integration were behind the formation of CariCRIS.

Table 5-5. Currency system in the Caribbean area

Currency	Circulated Area	Regime
Barbadian dollar (BBD)	Barbados	Pegged to 1US Dollar at 2BBD
Belize dollar (BZD)	Belize	Pegged to USD at 2BZD
East Caribbean dollar (XCD)	Antigua and Barbuda, Dominica, Grenada, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Anguilla and Montserrat.	Pegged to USD at 2.7XCD
Guyanese dollar (GYD)	Guyana	Managed float system Recent rate: USD = 205 GYD
Jamaican dollar (JMD)	Jamaica	Managed float system Recent rate: USD = 92.9 JMD
Suname dollar (SRD)	Suriname	Managed float system Recet rate: USD = 3.3 SRD
Trinidad and Tobago dollar (TTD)	Trinidad and Tobago	Managed float system Recent rate: USD = 6.4 TTD

Source: IMF, Bloomberg

Figure 5-4. JMD and TTD exchange rate to USD



Box: An Introduction of the CARICOM Single Market and Economy (CSME)

In the Grande Anse Declaration and Work Program for the Advancement of the Integration Movement, Heads of Government expressed their determination to work toward establishing a single market and economy.

The CARICOM Single Market and Economy is intended to benefit the people of the Region by providing more and better opportunities to produce and sell our goods and services and to attract investment. It will create one large market among the participating member states.

The main objectives of the CSME are: full use of labor (full employment) and full exploitation of the other factors of production (natural resources and capital); competitive production leading to greater variety and quantity of products and services to trade with other countries. It is expected that these objectives will in turn provide improved standards of living and work and sustained economic development.

Key elements of the Single Market and Economy

Free movement of goods and services - through measures such as eliminating all barriers to intra-regional movement and harmonizing standards to ensure acceptability of goods and services traded;

Right of Establishment - to permit the establishment of CARICOM owned businesses in any Member State without restrictions;

A Common External Tariff - a rate of duty applied by all Members of the Market to a product imported from a country which is not a member of the market;

Free circulation - free movement of goods imported from extra regional sources which would require collection of taxes at first point of entry into the Region and the provision for sharing of collected customs revenue;

Free movement of Capital - through measures such as eliminating foreign exchange controls, convertibility of currencies (or a common currency) and integrated capital market, such as a regional stock exchange;

A Common trade policy - agreement among the members on matters related to internal and international trade and a coordinated external trade policy negotiated on a joint basis;

Free movement of labour - through measures such as removing all obstacles to intra-regional movement of skills, labour and travel, harmonizing social services (education, health, etc.), providing for the transfer of social security benefits and establishing common standards and measures for accreditation and equivalency.

Other measures:

Harmonization of Laws: such as the harmonization of company, intellectual property and other laws.

There are also a number of economic, fiscal and monetary measures and policies which are also important to support the proper functioning of the CSME.

These include:

Economic Policy measure: coordinating and converging macro-economic policies and performance; harmonizing foreign investment policy and adopting measures to acquire, develop and transfer appropriate technology;

Monetary Policy measures: coordinating exchange rate and interest rate policies as well as the commercial banking market;

Fiscal Policy measures: including coordinating indirect taxes and national budget deficits.

Source:CARICOM

(4) The CariCRIS Structure

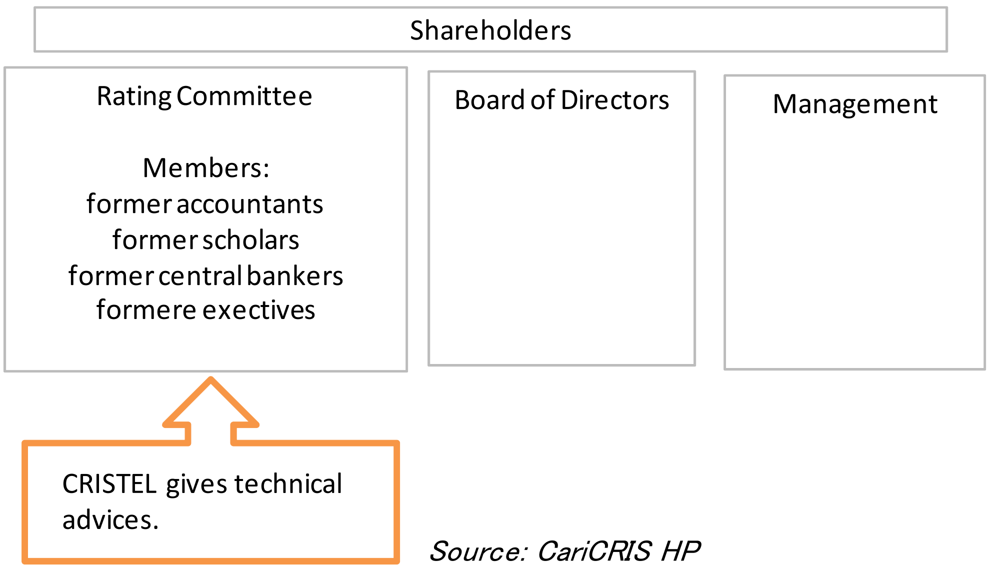
Stakeholders in CariCRIS include local financial institutions, central banks, and regional development banks (the Inter-American Development Bank and Caribbean Development Bank, see the following table). By regional distribution, two countries—Trinidad and Tobago and Jamaica—hold 60% of shares. Diversified shareholding limits the influence of individual shareholders.

The Rating Committee, an independent body within the company, actually assigns ratings. The Rating Committee is independent from both shareholders and management and they do not interfere in a rating process. This is in order to keep strict rating assessments when it rates shareholders.

Further, the Rating Committee is comprised of accountants, scholars, former central bank officials, and former executives of foreign banks, and is structured so that assessments are neutral.

CariCRIS was founded with CRISTEL Limited of India acting as a technical advisor. CRISTEL is a major Indian rating company which has ties with S&P. It holds an 8% stake in CariCRIS.

Figure 5-5 Governance Architecture of CariCRIS

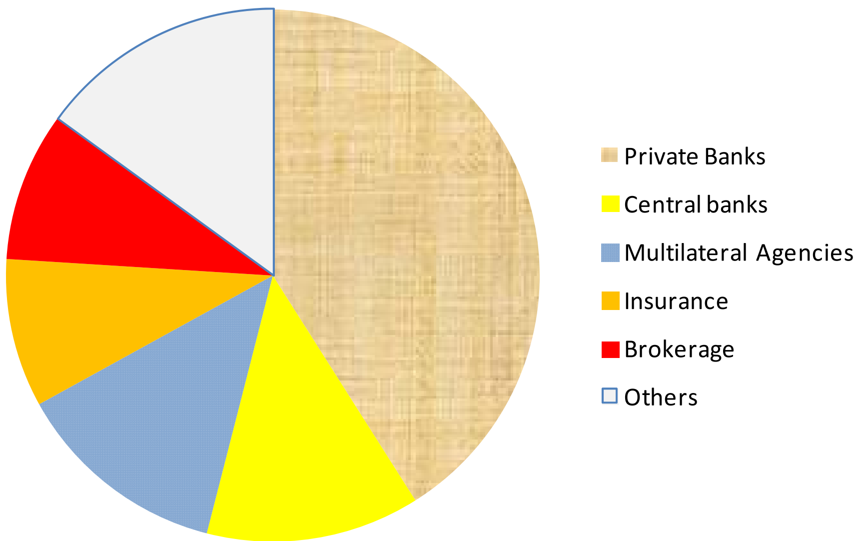


Source: CariCRIS HP

Table 5-6. Major CariCRIS Shareholders

Central Banks
Central Bank of Barbados
Central Bank of Trinidad and Tobago
Eastern Caribbean Central Bank (ECCB)
Private Banks
Capital & Credit Merchant Bank Limited
Citibank (Trinidad & Tobago) Limited
First Caribbean International Bank Limited
First Citizens Bank Limited
Intercommercial Bank Limited
National Commercial Bank Jamaica Limited
RBTT Financial Holdings Limited
Republic Bank Limited
Scotia Trinidad and Tobago Limited
Dominica Agricultural, Industrial and Development Bank
Source: CariCRIS

Figure 5-6. Subscribers by Type of Institution



Source: CariCRIS

(5) CariCRIS Activities

Since CariCRIS was founded in 2004, the company has made 91 rating assignments. Of these, nine sovereigns, 37 private companies, and 45 small and mid-size enterprises (SMEs) were rated.

CariCRIS long-term credit ratings have eight levels (14 when counting ±) and its short-term ratings have five levels (eight when counting ±). The company has both regional and domestic standards, and a company may be rated under both standards if desired.

Figure 5-7. CariCRIS' Rating Scale & Definitions

Long-term rating scale			Short-term rating scale		
Regional	National	Definition	Regional	National	Definition
Cari **AAA**	****AAA**	Highest	*Cari* **P1 / P1+**	****P1 / P1+**	Very Strong
Cari **AA**(+/-)	****AA**(+/-)	High	*Cari* **P2 / P2+**	****P2 / P2+**	Strong
Cari **A**(+/-)	****A**(+/-)	Good	*Cari* **P3 / P3+**	****P3 / P3+**	Adequate
Cari **BBB**(+/-)	****BBB**(+/-)	Adequate	*Cari* **P4**	****P4**	Speculative
Cari **BB**(+/-)	****BB**(+/-)	Speculative	*Cari* **P5**	****P5**	Default
Cari **B**(+/-)	****B**(+/-)	Weak			
Cari **C**(+/-)	****C**(+/-)	Very Weak			
Cari **D**	****D**	Default			

Source: CariCRIS

CariCRIS does not provide unsolicited ratings. Unsolicited ratings are undertaken by rating agencies for entities using publicly available information. Unsolicited ratings are not paid by the issuers.

CariCRIS began trial ratings of SMEs in 2010 as part of efforts to expand the company's scope of operations. This was in order to support SME fundraising. It is generally evaluated that companies that are rated by CariCRIS have more negotiating power with banks.

According to technical advisor CRISTEL, many Indian SMEs are rated, and their borrowing costs can be lowered by 0.25%-1.25% as a result of being rated.

Figure 5-8. Examples of ratings for Corporates and Sovereign

Company Century Eslon Limited

Issue	Country	Sector	Date of Rating Action	Regional Scale			National Scale		Watch
				Currency	Term	Rating	Term	Rating	
USD 20 million (Notional Debt Issue)	Trinidad & Tobago	Mfg. & Services	10/08/2010	LC	LT	*Cari* **A**		--	No
USD 20 million Debt Issue (Notional)	Trinidad & Tobago	Mfg. & Services	01/07/2009	FC	LT	*Cari* **A**		--	No
USD 20 million Debt Issue (Notional)	Trinidad & Tobago	Mfg. & Services	08/07/2008	FC	LT	*Cari* **A+**		--	No

Company Government of the Commonwealth of Dominica

Issue	Country	Sector	Date of Rating Action	Regional Scale			National Scale		Watch
				Currency	Term	Rating	Term	Rating	
USD 25 million Debt Issue (Notional)	All Countries	All Sectors	15/03/2012	FC	LT	*Cari* **BBB-**	LT	--	No

Figure 5-9. Examples of ratings for Financial Institutions

Company	Eastern Caribbean Home Mortgage Bank								
Issue	Country	Sector	Date of Rating Action	Regional Scale			National Scale		Watch
				Currency	Term	Rating	Term	Rating	
USD 30 million Debt Issue	All Countries	Financial Institutions	11/04/2012	FC	LT	*Cari* **AA-**		--	
USD 30 million Debt Issue	All Countries	Financial Institutions	05/04/2011	FC	LT	*Cari* **AA-**		--	No
USD 30 million Debt Issue	All Countries	Financial Institutions	23/04/2010	FC	LT	*Cari* **AA-**		--	No
USD 30 million Debt Issue (Notional)	All Countries	Financial Institutions	14/04/2009	FC	LT	*Cari* **AA**		--	
USD 30 million Debt Issue	All Countries	Financial Institutions	25/02/2008	FC	LT	*Cari* **AA**		--	No

Source: CariCRIS

(6) CariCRIS' Business Results

CariCRIS has reported weak results in recent years. The Caribbean region suffered an extended downturn since 2008, and requests for ratings have been sluggish. With aggregate losses of USD3 million over the six years through 2011, the company's performance cannot be considered successful.

The SME rating business is expected to become more active in FY13 (October 2012 – September 2013) and contribute to company profits.

Figure 5-10. CariCRIS Financial Data

	FY2012	FY2011	FY2010
Total Income	715	832	673
Total Expenses	1043	965	896
Gain(Loss) for Period	−328	−132	−223
Paid Up Capital	4534	3560	3560
Total Shareholders Equity	1165	519	652

Thousand USD
Fiscal year runs from April 1 to March 31
Source: CariCRIS

(7) Implications for Asia

CariCRIS is unique in that it is a region-wide credit rating company. Although the company is still young at just seven years, nearly 100 issuer ratings have been made and the company has already contributed to nurturing the capital markets of the region.

The Caribbean region's long history of systemic economic integration was behind the creation of a region-wide credit rating company. In particular, standardized corporate law and accounting methods were extremely important for ratings using a common scale. This is because knowing the residual value of a company is critical to determining corporate bond risk, and assessments would change if bankruptcy laws and accounting standards were not consistent. In order to evaluate the corporate bonds of different countries similarly, standardized bankruptcy laws and accounting treatments are necessary. CARICOM thus played an important role in this regard.

Harmonizing corporate legal systems and accounting standards would be an important precondition to assigning region-wide credit ratings in Asia as well.

Chapter 6: Summary and Policy recommendations

6-1.Promoting Robust Credit Rating Systems to Promote Cross-Border Investment in Asian Local Currency Bonds

Credit rating systems can play an important role in promoting cross-border investment in local currency bonds across Asian markets. Given high-quality credit ratings for bond issues that can be compared across markets with a sufficient level of reliability, investors can be encouraged to expand their bond investments in the region. This will significantly contribute to the development of local currency bond markets, as more investments undertaken by a wider range of investors and institutions inject more depth and liquidity into markets, which in turn will make them more attractive to more investors and thus initiate a virtuous cycle.

Under the current situation, much remains to be done to create favorable conditions for credit rating agencies to play this role in the context of the region's local currency bond markets. A number of key challenges need to be addressed, among which are the following:

- Global credit rating agencies (GCRAs) have been playing this role for a long time in the more advanced North Atlantic markets and also serve governments and many companies in developing economies that are raising funds in global markets, by issuing global credit ratings to which investors can refer to in comparing investment opportunities across markets. Their role in Asian developing economies have been more limited, however, due to the much smaller number of companies in these markets seeking global ratings and the inadequate differentiation among credit in these markets, where most companies are bunched together in the portion of rated entities below the investment grade level.

- Domestic CRAs (DCRAs) are the dominant industry players in the region's emerging local currency bond markets. Divergent rating practices among DCRAs across the region, which to a large extent are also due to differences in the local environment discussed later in this section, pose a serious problem for cross-market comparability. Major areas of divergence include default definitions, rating principles, frequency of rating reviews, transparency of rating methodology and criteria, standard of disclosure in rating reports and timeliness in rating actions.

- While GCRAs also offer country-specific (national) scales in addition to their global scale ratings, and so have the potential to offer opinions about credit risk that are based on each GCRA's consistent practices across markets, they do so only in a very limited number of markets in emerging Asia, where in most cases they have preferred to establish tie-ups with DCRAs rather than set up their own operations.

- Related to the preceding point is the fact that national scale ratings currently used by CRAs for domestic bonds are based on relative scales and not on absolute scales that are used in global ratings, which are meant to be comparable across markets. National scale ratings represent relative ranking of creditworthiness within a particular market and are intended for use by investors in relation solely to their exposure to this market. This problem is exacerbated by the fact that, within the region, where there is great divergence among sovereign ratings of economies, on which the national scale ratings are based.

- Local currency bond markets across the region differ in terms of levels of development, financial reporting standards, disclosure practices, legal and regulatory regimes and legal protection for investors. Consequently, it is very difficult for investors without a clear understanding of these differences to use credit ratings to compare the riskiness of financial instruments across these markets.

- Investors have yet to develop sufficient trust in ratings issued by most Asian DCRAs, many of which have been only established in the 1990s or later. Since Moody's started rating railroad bonds in 1909, GCRAs have accumulated more than a century of performance experience over a number of economic cycles in the advanced markets behind them. In contrast, many Asian DCRAs are still very much in the process of developing robust and proven methodologies, as their markets and instruments have not yet been in existence for a sufficiently long period and much relevant data is not yet available.

- While local currency bond markets will need a robust and trusted credit rating industry in order to grow, the development of the credit rating industry in Asia, including its viability as a business and ability to attract and retain talent is, in turn, dependent on the growth of these markets. Many Asian economies are thus faced with a chicken-and-egg problem.

Addressing these challenges in a way that supports sound market mechanisms will involve a long-term evolutionary process, whose direction is still difficult to discern at this point, given the still early stage of development of financial markets and cross-border financial cooperation and integration processes and structures within the region. As local currency markets grow and cross-border transactions increase, it is expected that GCRAs will consider expanding their operations to serve issuers and investors in these markets. Successful DCRAs may also find it possible to expand their business by establishing offices in other markets in the region or tying up with other DCRAs. Other possibilities that cannot be excluded in the future are the establishment of a CRA mainly focused on Asian markets as a region and the development of new business models for the industry, such as one where investors pay instead of issuers, followed by the entry of new players.

6-2.Recommendations

As the value of CRAs to investors lies in their independence to rate according to each one's stated criteria and methodology, it is important to carefully design interventions by government and public institutions in promoting the development of the credit rating industry, so as to enable CRAs to retain such independence. Market competition is also important in promoting a healthy industry and the continuous development and enhancement of rating methodologies and practices that will benefit investors and issuers. For this reason, it is important that measures to promote robust credit rating systems with increased cross-border investment in Asian local currency bonds in mind be designed to allow a natural evolution of the market for credit ratings, while creating conditions that would be conducive to this market's development.

Such an approach could be attained by focusing on the development of building blocks that will support the natural growth and evolution of robust credit rating systems. To develop such building blocks, the following recommendations are proposed:

6-2-1.Development of a guidebook for basic rating methodologies and basic rating criteria for selected industries and business sectors

To help DCRAs across the region develop rating methodologies and criteria that will make their ratings more comparable, it is proposed that a project be undertaken to develop a guidebook on common basic rating methodologies and basic rating criteria that a large number of Asian DCRAs can voluntarily adopt. The guidebook could establish minimum standards for the credit rating process and for transparency in this process, including the methodology and criteria used in formulating credit opinion. Given that rating methodologies and criteria differ with the peculiarities of each particular industry or business sector, the guidebook should address these different industries and sectors in separate chapters.

The project would best be carried out in cooperation with the Association of Credit Rating Agencies in Asia (ACRAA) and a consultant, preferably with the support of a multilateral institution. This project would have the following components:

- A conference to identify, select and prioritize the industries and business sectors for which methodologies and criteria are to be developed.

- Compilation of published methodologies and rating criteria of ACRAA members in these industries and sectors for comparative study.

- A series of workshops, each one featuring a number of the selected industries, to focus on updating of basic knowledge of and current developments in each selected industry and sector, describing the nature and peculiarities of each industry and sector, their products and services, their markets and competition and their regulatory environment. Industry and sector experts will be invited to make the presentations with a view to making comparisons across markets. These workshops would address three principal questions:

  - What are the key drivers of viability and profitability of companies operating in the industry or sector?
  - What is the nature and peculiarities of the business risks specific to the industry or sector, and how are these translated into credit risks?
  - How are these business and credit risks mitigated or avoided?

- The output of the workshops and the published methodologies and criteria collected from ACRAA members would be used to draft a Guidebook on Basic Rating Methodologies and Basic Rating Criteria.

- The guidebook would be reviewed by a panel and editorial board including ACRAA members and relevant experts, finalized in a conference and presented for adoption by ACRAA members. It will be published, disseminated and also promoted for adoption by other DCRAs in the region.

6-2-2.Promoting convergence of accreditation criteria for CRAs across Asian markets

Significant work has been done on regulatory issues related to CRAs, rating processes and practices by various international bodies such as the BIS, IMF, IOSCO and APEC. Building on these foundations, ASEAN+3 could convene a forum for regulators to look at best practices and develop a set of minimum standards in the region for the accreditation of CRAs, which can be adopted by member economies on a voluntary basis. Examples of criteria that may be considered are the following:

- *Structure, size and quality of organization.* This criterion is to determine the organization's capability to thoroughly and competently evaluate an issuer's credit. The quality of the rating agency's staff is the important component of the rating process. Since rating is always an opinion' the more experienced and qualified the personnel, the better the opinion quality generally.

- *Financial resources and independence.* This determines whether a CRA is able to operate independently of financial and political pressure. The financial resources of the company would determine how capable the company is to withstand economic and financial pressures. A company which is financially weak may lower its standards in order to attract more issuers who desire higher ratings. The financial health of the organization would also have a direct correlation with the quality of its analyst, since it is able to hire and retain more qualified personnel.

- *Systematic rating procedures.* This criterion ensures that there are systematic procedures and consistency of ratings across the board. Proper and systematic rating procedures would ensure that the quality of ratings produced does not vary considerably from one issue to another. A good process would also mean that the organization would not suffer too greatly from a loss of key personnel since the knowledge would have been implicitly integrated within the rating process.

- *Internal compliance procedures.* This criterion ensures that there are internal procedures to prevent the misuse of nonpublic information and to determine if these procedures are followed. Client confidentiality is extremely important in the ratings industry. Access to management accounts and inside information is necessary to construct an accurate assessment of the company risk profile. Any violation of the implicit or explicit trust that the client has on the ratings organization would have drastic impact on not just that organization but may become reflective of the entire industry as a whole. Thus this criteria helps safeguard the industry's reputation.

- *Rating scales that are comparable with other GCRAs.* Comparable rating scales with other GCRAs are important to avoid market confusion. To encourage cross border flows, rating comparability is important.

- *Public disclosure of rating methodology and rationale.* Rating agencies are an integral component of market development in view of the transparency they bring. It is only proper that rating agencies set an example by being transparent about their rating process. Full disclosure of the methodology and rationales serves as good start to the process.

- *Full disclosure on any possible conflict of interest.* There must be proper disclosure of possible conflict of interests. In the event that members of senior management of the rating agency concurrently holds a significant position in a clients company. This should be revealed and disclosed to the public through the rationales or any public media.

- *A proven track record via default studies.* An objective method of determining credibility of a credit rating agency is to have published default studies. Ideally, although not required, DCRAs should aim for default rates that are comparable to the GCRAs worldwide.

- *Independence from political pressures and ownership pressure.* It is very important the market perceives the rating agency to be independent of these pressures. Thus measures must be undertaken to push this perception to the marketplace. Rating agency management should be allowed to perform its duties without facing strong opposition from its owners who may have vested interest. Many rating agencies ensure this by having a large number of shareholders and that no one shareholder has a majority control or controls a substantial block.

ASEAN+3 governments could consider going further and develop a mechanism whereby the minimum standards could be used to issue to any CRA meeting those standards a regional designation as a regionally recognized issuer of credible and reliable ratings, providing a seal of quality that investors can rely upon. While individual governments can issue designations, consideration may be given to an independent committee of regulatory bodies' representatives across the region to issue the designation, to ensure that the same standards are used in issuing such designations and consequently, the trust of investors in the regional designation.

6-2-3.Promoting convergence of financial standards and regulations to facilitate comparable credit ratings across markets

Comparability of credit ratings across markets will be promoted by undertaking measures such as the convergence of financial reporting standards and disclosure rules across the region, in conjunction with the promotion of a high level of transparency and information flows from governments and firms, as well as relevant legal and regulatory regimes and legal frameworks for investor protection. Such measures would be best undertaken within a broader regional framework in order to benefit from wider engagement of investors and financial institutions both within and outside the ASEAN+3 member economies.

6-2-4.Creating an official information website viewing credit information of leading issuers representing each domestic market

In order to promote cross-border transactions within the region, it should be helpful to create a common credit information website where every market participant, either regional or international, will be able to access reliable and updated credit information of leading issuers of the region.

This issuer-information website (tentative naming), sponsored by regional governments jointly or multinational organization, will be open also to the rating agencies (both for DCRA and GCRA) operating in the region to upload on the website the rating information of the issuers they rated, i.e. rating levels, rating rationale (comments, reports etc.), record of rating actions,.etc.

This website will provide every market participant, interested in funding or investment in the region, with the essential credit information of the leading issuers in the standardized templates so that they compare credits across the border. [14]

One of the core problems in cross border credit measuring has been a lack of comparability between each national rating scale. A clue that has been expected to bridge national rating scales of different countries is default data. Default data is an objective figure with which we can compare national credit scales of different countries. But this approach goes into a chicken-and-egg type of discussion that we need a historical record of bond market to collect default data while we cannot make this history because we don’t have enough default data.

Instead of long historical default data, what we need for this recommendation is present corporate information. Financial statements of the latest three years would be long enough. By using such information of issuers, relevant parties can compare national scales to each other. Here a proactive engagement of such parties who care the credibility and comparability of national rating scales is required.

They will compare not only rating levels of the issuers but also quality of rating services of the rating agencies by accessing their rating products on the website.

For the rating service industry this website will become an important stage of business promotion and competition to expand their service coverage from their home markets to regional market in line with the regional market development.

To serve market participants interested in cross-border transactions, it will be essential for DCRA to expand their credit universe from domestic to regional. This proposal is not a top-down approach led by regulatory authorities but rather a market driven approach with a partial public support so as to enhance regionalization of DCRA through competition.

(1) Background: Barriers which ring-fence domestic market

In order to promote cross-border transactions within the region, following four conditions need to be satisfied to lift off barriers which may ring-fence each domestic market.

(i)To minimize the transfer and conversion risk

This is the core risk factor for cross-border transactions in the area of foreign exchange

[14] In order to check the feasibility of proposal, we conducted interviews to region wide investors regarding the preliminary design of this official information website. Almost all have positive views of this. As reported by one investor, with respect to cross-section comparison of credit risks in the region, this has the similar function as Asia Bond Online has achieved in the ASEAN+3economies. According to their view, Asia Bond Online provides bond related region wide data on macro and semi macro basis in a comparable way while the proposed site seems to further provide credit information of the leading issuers within the region.

control. To mitigate this risk, safety net mechanism for the regional governments against financial crisis should be developed. And also certain official agreements to secure external settlements for cross-border bond transactions within the region may be considered.

(ii) To secure efficient and stable financial system

Each domestic market should establish efficient and reliable financial system which provides banking and bond related services (i.e. custody, fiduciary, payment, settlements etc.) In later stage, each settlement mechanism needs to be linked to accommodate cross-border settlements until a common clearing system starts in the region.

(iii)To standardize legal and regulatory requirements

Differences in legal documentation, regulations on market rules, taxation, accounting rules etc. may also create barriers for regional cross-border transactions. As cross-border transactions pick up, the most efficient and fair market will be selected through competition as a core issuing/trading market for the region. Also governments' initiatives for local deregulation and regional integration will be required in the area of regulatory issues.

(iv)To expand domestic credit universes into a regional credit universe

To activate cross-border transactions, domestic credit universes need to be expanded so as to let leading market participants make funding and investment decisions based on the regional credit universe.

To start with, it is helpful for every market participant to access easily the reliable and updated credit information of leading issuers active in the region. Setting up a quasi-official, disclosure-website, sponsored by regional governments jointly or regional multinational organization such as ADB, to provide leading regional issuers with a stage of disclosure is proposed.

For rating agencies operating in the region, to expand scope of business in the area of cross–border rating services will be required. This website will create a stage where rating agencies, either DCRA or GCRA, will compete for cross-border rating businesses by showing their sample rating products at first and then their credential information to show their capability in the next phase. Therefore for a credit rating agency as a private corporate this will become an important business promotion platform to survive a competition. When domestic markets are integrated into a regional market in a long run, restructuring of rating industry may take place within the region.

The above (i), (ii) and (iii) are external factors in our discussion for policy recommendations. We focus the issue raised in (iv) to lead our policy recommendation.

(2) How do domestic rating businesses change as cross-border transactions pick up?

This section reviews briefly how rating agencies will be able to increase business opportunities and in later stage be exposed to competition as regional cross-border transactions increase.

There are many leading issuers in the region who already fund across capital markets either within or outside the region. In this section, however, the discussions will be limited to cross-border transactions within the region, i.e. between domestic market A and domestic market B, excluding external transactions with the international markets such as Euro bond market. Let us explain the process of bond market development from domestic to regional and how relevant parties such as issuers, investors and credit rating agencies are engaged there by using a simple model.

DCRA-A and DCRA-B represent recognized domestic credit rating agencies of the market A and the market B respectively.

We assume the Issuer X of the market A is the excellent leading issuer of the region of high credit profile with good name recognition of sizeable issuing capacity providing liquidity in the markets. Investor Y of the market B is the active investor buying foreign bonds issued by X.

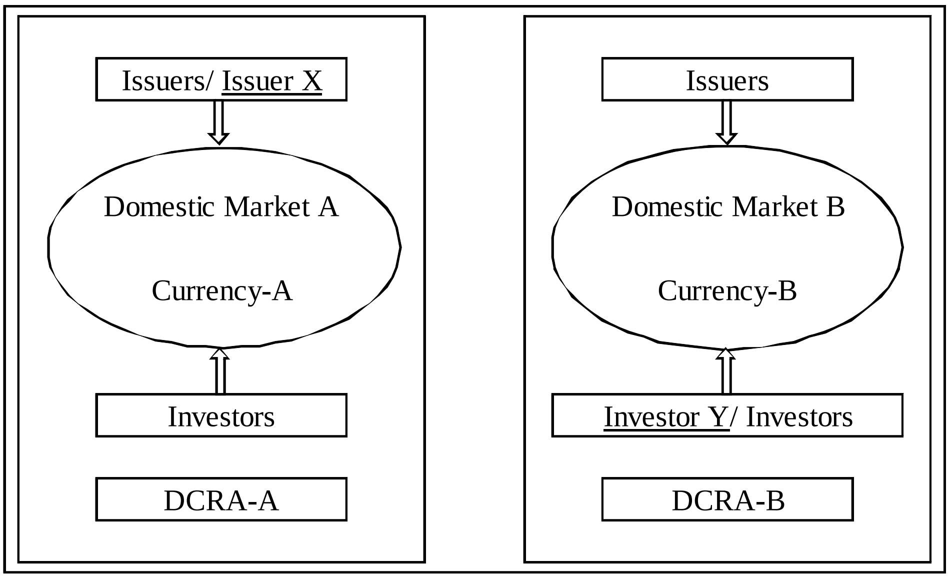
And we assume that external bond issuance and foreign bond investments are subject to rating requirements by local regulatory authorities of the country A and B.

Stage 1: Transactions are closed within highly ring-fenced markets

In both markets A and B, domestic bonds are issued in local currency by domestic issuers and bought by domestic investors.

Both DCRA-A and DCRA-B rate their respective domestic debts in local currency. These ratings are referred only by market participants of each market. Thus each credit universe is closed to each other.

Chart 6-1 Stage (1) Transactions within ring-fenced markets A and B



Stage 2: Cross-border transactions start to pick up

As cross-border transactions start to pick up, there will be changes in rating business environment both in primary and secondary markets.

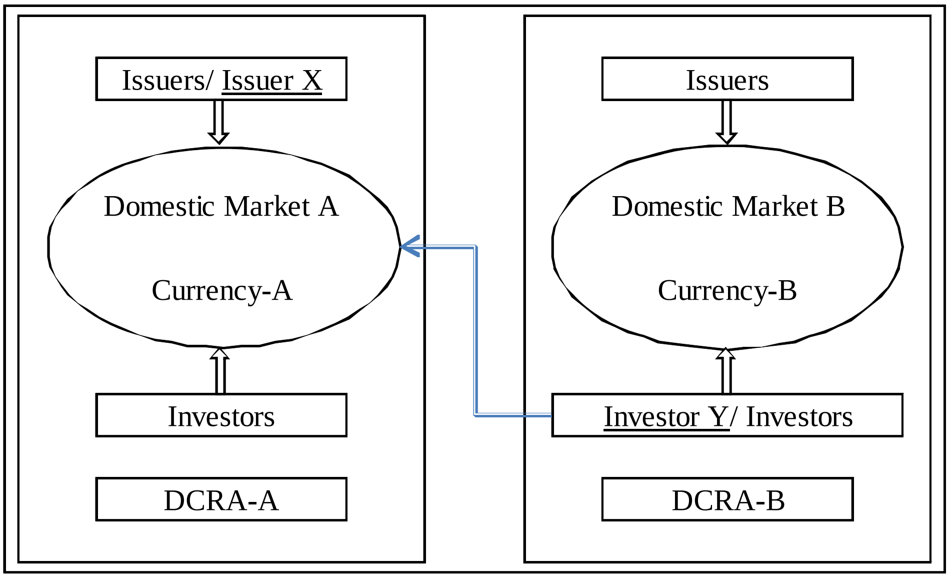
Stage 2-a: Changes in the secondary markets through cross-border investments

As the debt of the leading issuer X of the market A attracts interest of investor Y of the market B, the credit rating of the issuer X will be referred by the investor Y to support their investment decision as well as to clear regulatory requirement of the country B for foreign investments.

The rating of the issuer X provided by DCRA-A will be used outside the domestic market A.

And DCRA-B may be asked by the investor Y to provide credit risk assessment of the debt issued by X for the purpose of portfolio risk management. For DCRA-B, this investor-sponsored rating business may expand scope of businesses to foreign issuers issuing foreign currency debt.

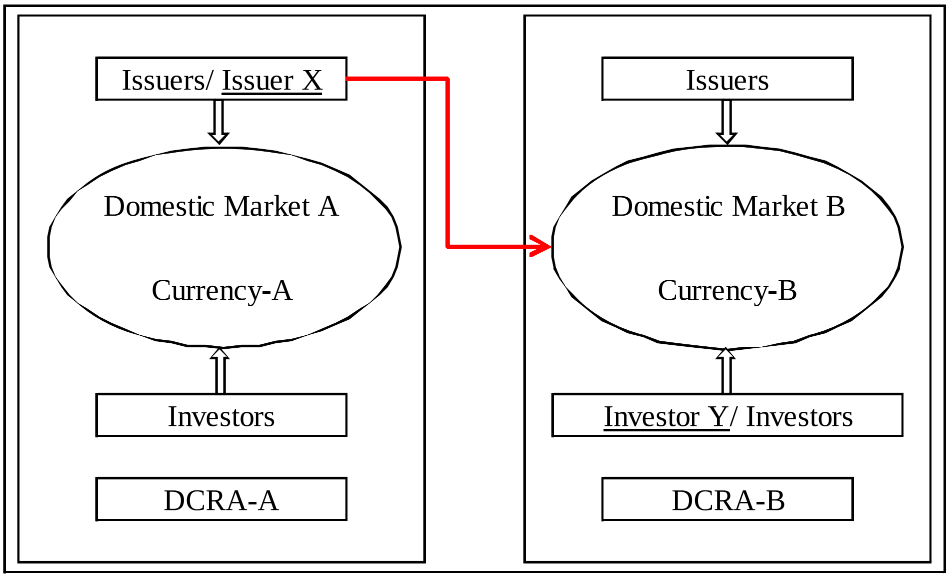
Chart6-2 Stage (2)-a Cross-border transactions start in bond investments



Stage 2-b: Changes in the primary market through foreign bond issuance (Type of Samurai-bond issue)

When the Issuer X of the market A issues foreign bonds in the market B in local currency-B, this external transaction will bring new rating business to DCRA-A and DCRA-B.

Chart6-3 Stage (2)-b Cross-border transactions starts in the primary market



Stage 2-b-1: Developments in the market A

To clear regulation of the country A to issue foreign bonds in the market B, the issuer X needs to be rated by DCRA-A for its debt in foreign currency-B.

For this rating, DCRA-A need to consider the transfer and conversion risk factor between the two countries in addition to the regular creditworthiness of the issuer X for its foreign (currency–B denominated) debt obligation.

Stage 2-b-2: Developments in the market B

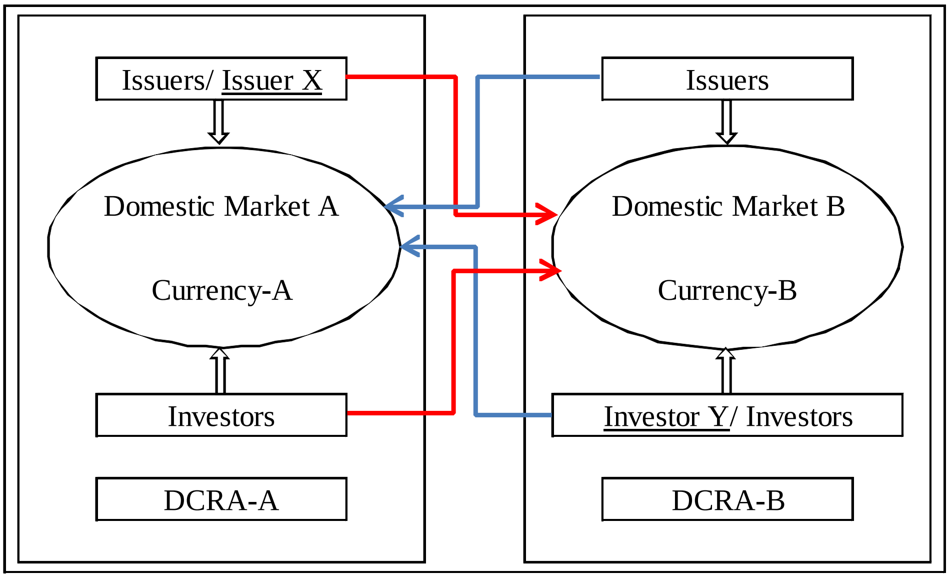
To offer foreign bonds of the issuer X to local investors in the market B, the issuer X needs to be rated by DCRA-B. This rating requirement may also apply as an issuer eligibility rule of the country B for the domestic debts issued by foreign issuers.

For this rating, DCRA-B needs to rate the foreign issuer X with its foreign currency debt obligation which include credit assessment of the transfer and conversion risk between the two countries. This rating service is a new business opportunities for DCRA-B rating foreign issuers issuing debts in home currency B.

Stage 3: As cross-border transactions increase, credit universes converge on a regional one.

As cross-border transactions increase in both primary and secondary markets, credit environment between the two countries will change.

Chart 6-4 Stage3: Credit universes expands as cross-border transactions increase in the region



At first the number of rated issuers and credit diversity of leading issuers will increase within the region where the leading issuers will be rated by several rating agencies in both markets.

Table6-1 Change in business environments of domestic rating agencies as cross-border transactions pick up

	Rating agencies	DCRA-A/Country-A			DCRA-B/Country-B	
		Currency: A (local)	Currency: B (foreign)	Needs for ratings	Currency: B (local)	Currency: A (foreign)
Stage1	Ring-fenced transactions	Iss.X/Cu.A		Risk management: investors-A		
Stage2 -(a)	Foreign bond investment	Iss.X/Cu.A		Risk management :investors-B Regulation-B: Bond investment		Iss.X/Cu.A
Stage2 -(b)	Foreign bond issue		Iss.X/Cu.B	Regulation A/B:Foreign bond issue Risk management : investors- B	IssX/Cu.B	

Rating levels provided by rating agencies will be compared each other and quality of rating products will be assessed by market participants. Rating agencies will be exposed to competition in terms of quality of credit products.

In addition, rating agencies will be facing another competitive pressure when regulatory authorities start to recognize rating agencies of other countries as their domestic recognized rating agencies for their regulatory purposes. Moreover as regulatory authorities start to lift off rating requirements for cross-border transactions, rating agencies will enter another phase of competition where no rating requests will be made for regulatory reasons from domestic issuers and investors.

These changes in the credit environments will result in a situation where selected leading rating agencies of good market recognition will increase fee-based cross-border businesses. And those rating agencies will be the leaders to expand credit universe from domestic to regional.

What we are going to propose in the following section is a scheme which encourages and accelerates this process of expanding credit universe from domestic to regional by setting up a common place in web. The common place is expected to function as an arena where both issuers' information and rating information are concentrated and disclosed, which in turn would encourage credit rating agencies to improve the quality of credit analysis, encourage investors to conduct self-checking the rating information by comparing corporate information and encourage issuers to disclose more standardized corporate information. We can expect as a result of this process credibility and comparability of each national rating scale is improved.

(3)Proposal: To start "official information website viewing credit information of leading issuers representing each domestic market"

< Road map>

Step1: To set up an official website to upload key credit information of leading issuers

This website, sponsored by governments in the region or regional multinational organization, is designed to create a common regional credit universe among market participants.

This website accepts application from leading issuers in the region to upload their key issuer credit information. (Note: The rules for issuer qualification and disclosure contents will be defined by discussions of regulatory authorities under consultation with regional major market participants such as issuers, investors, securities companies and rating agencies etc.) , and all information must be written in English. Market participants, both regional and international, are able to access accurate and updated issuer credit information on the website filed with standardized templates for easy comparison.

The administration of the website will be under strict control by authorized personnel appointed by the sponsoring regional governments or organizations such as the ADB. The issuers, rating agencies including their agents may change the information on the website only when application of the change is accepted by the authorized personnel.

Key issuers' credit information includes a basic corporate profile and financial statements and other relevant information as shown in Table 6-2. The financial statements should be audited by credible auditors in each country.

Table 6-2 A sample: key issuer credit information:

-corporate profile
-audited financial statements
-details of outstanding debt issues
-offering circular of each outstanding issue
-current ratings, rating reports, historical developments of rating actions (solicited ratings only)

<u>Step2: To upgrade the website to include credential information of rating agencies</u>

This is a stage to show credentials of rating agencies, either DCRA or GCRA, who are willing to expand its business in the region. Market participants will select their rating agencies from the information of credential disclosed on this website.

From a business promotion perspective, this website will provide rating agencies with an ideal business origination platform for publication of their credentials to every market participant globally.

From a regulatory perspective, this website will enhance voluntary disclosure of rating agencies because rating agencies, not active in disclosure, will be handicapped in their business competition. Thus sound competition among DCRAs and GCRAs may in a long run lead to the development of rating agencies that cover the whole regional credit universe.

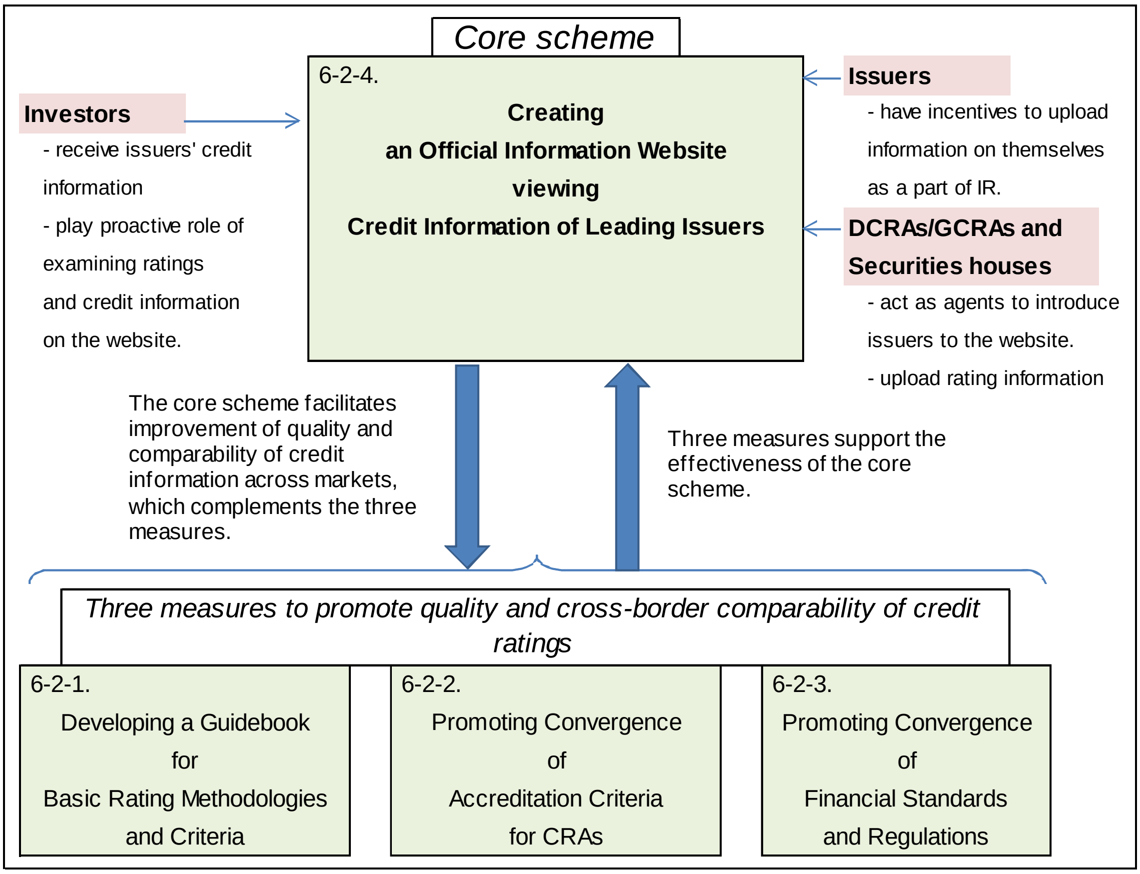
The details of disclosure contents will be discussed between regulatory authorities and representatives of rating agencies such as ACRAA. (See Table6-3)

It is advisable these credential information should be selected in line with the recommendations in "Handbook on International Best Practices in Credit Rating" issued by ADB in December 2008.

Table 6-3 Sample credential information of a DCRA

-corporate profile and type of license
-profile of business ownership
-updated number of issuers (issues) rated
-a list of all outstanding ratings
-financial summary (net revenue, operating income, net income, net worth, D/E ratio etc.)
-revenue segments (issuer sponsored, investor sponsored, ancillary business etc.)
-broad fee structure including minimum and maximum rating fee
-number of analysts who have voting rights at rating committees
-sector allocation of credit analysts
-sample of sector research reports covering credits of major industries and sovereign

Chart 6-5: The structure of IIMA's Recommendations



Reference

Asian Development Bank: "Handbook on International Best Practices in Credit Rating" December 2008.

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Chapter 5