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

October 2013

Korea Institute of Finance

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Summary

1. Background

ASEAN+3 member countries have been cooperating on the development of regional capital market to secure financial stability in the region since 2002. Asian Bond Market Initiative is in promotion as part of such cooperative efforts 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. ASEAN+3 also recognized the importance of enhancing regional credit rating capacity as an indispensable market infra in promoting issuance of and cross-border investment into local currency-denominated bonds. Currently, however, the region is heavily dependent upon global CRAs for such a function and the sentiment is that those GCRAs are not providing wanted level of rating frequency and coverage with less than expected level of fairness and promptness. In this regard, efforts have been made to standardize the rating terminologies and methodologies, hoping this would lead to emergence of regional credit rating agencies or at least regional credit rating services by DCRAs. Disappointingly, no visible advancement has been witnessed, yet. RCRA has also been proposed as a more substantial and practical alternative to pure private initiatives. Therefore, the goal of this study is set to evaluate available alternatives in the context of regional credit rating capacity enhancement, and to make policy suggestions. We also review the past and recent global discussions on CRA reforms to draw relevant policy implications.

2. Global Discussions on CRA

CRA Reform Act (2006) in the US focused on strengthening disclosure obligation of CRA, thereby inducing more oversight by investors. Since the meltdown in the US credit market in 2008~2009, there have been calls for reform of credit rating market. Dodd-Frank Act (2010) requires CRAs liable as experts for omission or ignorance at reasonable level regarding information gathering and research on credit rating. The Act also requires CRAs to improve rating process by strengthening internal control, analyst qualification, transparency and SEC's oversight. The SEC is expected to require separation between strict sales/marketing and rating department. FSB and G20 set principles for reducing reliance on CRA ratings.

The EU also made CRA reforms since the subprime debacle. CRA 1, which entered into

full application on Dec. 7, 2010, requires all CRAs with their credit ratings to be used in the EU to apply for registration. CRA 2, in force on June 1, 2011, made ESMA have the exclusive supervision power on CRAs. The EC made CRA 3 proposals on the issues of over-reliance on credit ratings, more transparent and more frequent sovereign ratings, elimination of conflicts of interest, more accountable ratings.

3. A View on the Asian CRA Market

There exist about 30 DCRAs in the ASEAN+3 region. Many of them are affiliated with global big 3 CRAs. The DCRAs mostly concentrate their business in the local markets, and may have better access to local information than global CRAs. 80% of DCRAs agreed that harmonization would enhance their credibility and help to improve rating quality (ADB Survey (2004)). There have been efforts toward harmonization. The ACRAA, an informal regional caucus, organized in Sep. 2001. It published in April 2011 "ACRAA Code of Conduct Fundamentals for Domestic Credit Rating Agencies", a compilation of recommended practices based on the IOSCO Code of Conduct issued in 2004 and the ADB Handbook of International Best Practices for Credit Rating Agencies published in 2008.

Despite ACRAA's effort, Asian DCRAs' ratings are not comparable across borders. In addition, it seems that Asian DCRAs are hard to extend their coverage of ratings due to their small size and human capital compared to global CRAs. Setting up a new RARA may be an alternative to overcome the DCRAs' limitations because Asian region is in a different situation from the EU where a publicly funded European CRA was not proposed by the EC. While the EU has a centralized supervisory authority, ESMA, making other alternatives plausible, no such an exclusive supervision power exists in Asian region. Unlike the European CRA model, considered for the fairness of credit ratings, a new RCRA in Asian region might be cost efficient because it could achieve extension of coverage as well as fairness of credit ratings.

4. RCRAs in Other Regions

CariCRIS is acknowledged as the 1st regional credit rating agency. It was established in 2004 to foster and support the development of a vibrant and integrated regional capital, more specifically debt market. Its 1st regional rating was released in 2007, 3 years from opening. It performs regional scale and national scale ratings and has released 107 ratings as of Nov. 2012. Diversified shareholding to limit the influence of individual shareholders is worth mentioning. Its BOD mainly consists of representatives from shareholding institutions including central banks, development banks, multilateral agencies, etc. It also maintains rating committee independent of the shareholders and the board. Its financial performance in recent years is somewhat disappointing, which shows that RCRA may require subsidization

from the public sector.

In preparing for CRA 3 in EU, there have been serious discussions about possible alternatives to break the oligopolistic market structure. The alternatives include setting up a public European credit rating agency, private credit rating foundation, and a network of small and medium-sized CRAs. 1st and 2nd option was vetoed by the Parliament since the alternatives require public expenditure. It should be noted that EU was not seeking for broadening of coverage like ASEAN+3 but was only searching for an option that can heighten the level of competition. From such a perspective, raising competition with public entity does not make sense.

5. Evaluations on Policy Alternatives

We evaluate the alternatives based on 3 perspectives, effectiveness in promoting the ASEAN+3 bond market, effect on the credit rating market competition and innovation, and feasibility. We set two alternatives. The first one 'private initiatives' is facilitating market initiatives by DCRAs with ACRAA which reflects the strategy pursued so far. The second one 'setting up a RCRA' is literally setting up a regional credit rating agency collectively funded by ASEAN+3 member countries.

The first alternative (Alt.1 hereafter) intends to enhance regional credit rating capacity mainly through standardization. The best thing about Alt.1 is it virtually cost nothing to the member governments and the harmonization of regulation including recognition is left to regulatory authorities. The problem is that there are doubts about whether this would lead to credit rating capacity enhancement. SEC report to congress questions on the feasibility and desirability of standardization and recommends congress not to take any further action regarding standardization. Furthermore, there are not enough incentives for DCRAs or regulators to eagerly pursue Alt.1 to change the status quo. Standardization has been and will be progressing only at a very staggered pace and therefore it is not expected to be reachable in the near future. Same can be said about future prospect of unilateral/bilateral recognition and broadening of rating coverage in the region. To summarize, future loss of benefits from indefinite delay in Asian bond market vitalization would exceed the current cost saving from pursuing private initiatives, Alt.1. Just as we haven't seen meaningful progress toward RCR capacity, continuation of private initiatives wouldn't bring about much change.

The second alternative (Alt.2 hereafter) is about setting up a regional credit rating agency, and participating countries mutually recognize the RCRA into their regulatory system. With Alt. 2, the members should bear reasonable cost at the beginning only to break the vicious circle and make the wheel to start rolling into a virtuous circle with lasting benefits. With agreement among the members, it can be considered as a highly feasible alternative. Since ASEAN+3 can impose direct mandates, it guarantees enough rating coverage for less developed member countries. For the best, mutual recognition is included in the package. It is

true that some concerns can be raised, but they are manageable with proper structuring of the organization and processes. Regarding the concerns about credibility from the agency being public entity, we can refer to "OECD Export Credit Arrangement" which is a good example of collaborations among governments can be credible. Seeing the matters from the less developed members' point of view, financial burden to the members at initial stage needs to be seen as bearable costs considering the lasting benefit. The best part is that we do not have to give up the private initiative, and we leave room for private RCRAs' emergence. To summarize, despite some financial burden and strenuous effort from the participating governments, Alt.2 would promise to deliver what we hoped for in the first place, broader coverage, credit-cycle neutral ratings, streamlined regulation, all of which would contribute to investment growth, financial stability, and one more step closer to "Asia Bond Market."

Conclusion from the evaluation of the two alternatives; Alt.1 is an easy approach with little gain, while Alt.2 is an approach with some level of efforts with high expected gain. At least for now, to enhance credit rating capacity in ASEAN+3, establishing a RCRA seems to be the only substantial initiative.

6. Suggestions for the Future Roadmap

Although we can expect significant enhancement in regional credit rating capacity in setting up a regional credit rating agency, it would require strenuous effort of the ASEAN+3 countries. In this chapter we try to lay out a roadmap to which authorities can refer.

First, for our RCRA to succeed, its independence and accountability need to be secured. We suggest structuring the board appointed by various interest groups. Three inside directors are appointed by the ASEAN+3. The equal number of independent directors, on the other hand, may consist of the ones appointed by the ADB, the region's private CRAs, and the institutional investors in the region.

The worries about the independence of the RCRA can be further quelled by having the ASEAN+3 exercise the authority only through devising the rulebook by which the RCRA has to be run. In so doing, the ASEAN+3 or any other regional institution can be prevented from influencing the RCRA's management such as what securities to rate, the rating assignments, and the rating fees.

The ASEAN+3 should own a majority of shares of the RCRA, but public institutions or semi-private institutions such as development banks and pension funds can also invest in RCRA. In the long run when we observe regional competition from private agencies, the IPO of the RCRA can also be considered. The ASEAN+3 governments probably need to cover running costs in the form of contribution in the first few years when investment is necessary.

The revenue of the RCRA would come from rating fees. To promote bond market growth in the less developed markets, asymmetric fee structure charging lower fees to the bonds in those markets should be considered. The main target of rating in the short run should be

public companies and project financing. Though infrastructure such as housing, utilities, waterworks, metro transit, highways, etc. needs financing of long term and of magnitude, the lack of rating coverage of public companies by global CRAs often limits both emerging economies and investors. Moreover, the RCRA would issue “fairer” sovereign ratings in the sense of credit-cycle neutral, through-the-cycle ratings, thereby enhancing financial stability of each country. The RCRA would also rate large companies though it is not the initial focus of the RCRA; the RCRA’s focus on public companies and sovereigns minimizes the crowding out effect.

The rating process along with other processes like internal control should follow the rulebook that ASEAN+3 writes up with the help of the ACRAA. It would not only accelerate standardization of credit rating system in the region, but also lay ground for the recognition of private CRAs by other member countries. The rulebook should be consistent with the NRSRO regulation and the IOSCO code to assure the quality of ratings and to gain investor confidence.

The most difficult task, however, would be the member countries’ changing regulatory framework in cooperation. First, the financial regulatory bodies should try to harmonize the CRA regulation in the region. With the RCRA aiming to meet the international standards, the CRA regulation should also be improved toward the international standards. Second, the regulators of member countries should collectively acknowledge the RCRA. Then, the RCRA’s bond ratings can be circulated and used throughout the ASEAN+3 region. Third, the members should try to set up the regional CRA regulator, “Regional Credit Rating Supervisory Committee(RCRC).” Even with the standardized set of regulatory rules, the supervision in each and every country is neither efficient nor feasible: paper handling, public disclosure, complaints management, litigation, sanctions, etc. The RCRA would be subject to the U.S. supervision with the NRSRO status, but we cannot solely leave supervisory right to the U.S. in the long term. As European regulators created Committee of European Securities Regulators (CESR), now ESMA, the ASEAN+3 authorities should arrange a collective supervision scheme and set up a regional regulator.

We expect that these works will enrich regional credit rating market also by laying the foundation for local CRAs to grow into vibrant regional CRAs. The private CRAs would benefit from regulatory streamlining in standardization, regulatory recognition, and unified supervision. They also reap the benefits of the development of ASEAN+3 bond market that the RCRA would contribute to.

Chapter 1. The International Discussions on the Credit Rating Agencies and Enhancing Infrastructure to Strengthen the Regional Credit Rating Capacity in the ASEAN+3 Region

I. Background

The bond markets in the ASEAN+3 countries have shown meaningful progress over the years. If we examine and assess our current situation beneath the surface, however, we can understand why we should strive to further develop our cross-border bond markets.

On one hand, a group of economies such as Japan, Korea, and Singapore has matured and aged. They find themselves having accumulated a huge sum of assets. The matured economy also inevitably means the lower rates of economic growths, pushing down the yields on the domestic financial assets. The aged population would like higher yields to fund their retirements. On the other hand, there is the other group of economies that can be categorized as either emerging or frontier. These countries have higher rates of growth and thus need capital inflow to fund their growth. Naturally, the needs of both groups fit perfectly each other; both groups would gain on net if the capital in advanced economies can be invested in emerging economies. Yet, the cross-border bond investments in the ASEAN+3 have been quite limited. Thus, it is no wonder that the ASEAN+3 has been trying to develop more integrated and active regional bond market, which in turn would match the supply and demand noted above.

Against such background, we turn our attention to the credit rating capacity in the ASEAN+3 region. Credit rating is one of the most important infrastructures for well-functioning debt markets. The deficiency of credit rating capacity in our region, however, has been pointed out as one of the key impediments to the development of the Asian Bond Market (ABM). If we can somehow foster more credible and transparent information about the credit worthiness of the bonds issued in the region, it can and will fill the information gap.

Note that we are now trapped in a vicious circle. Without regional credit rating agencies, the growth of cross-border bond market growth has been hampered. Likewise, the underdeveloped cross-border bond market has not given incentive for rating agencies to become regional. Our object in this research project is that enhancing credit rating capacity in the ASEAN+3 to promote cross-border bond investments. Thus, we are aiming to break the vicious circle by having enhanced rating capacity *lead* the Asian bond market to the next level of integration and development, *not follow* the bond market evolution.

The status quo of the rating capacity is characterized by the dependence on the global credit rating agencies, S&P, Moody's, and Fitch. Our view is that even with the global agencies, we find not enough rating frequency and coverage for the ASEAN+3 region. Also, the questions of fairness and promptness of ratings by these global agencies have been being raised.

Based on these observations, the member countries have been discussing the matter only to find little evidence of progress. Since 2003, the Working Group has been discussing rating harmonization, utilizing domestic credit rating agencies, and other options to enhance rating capacity. Still, no visible advancements have been made except the level of effort regarding default data study.

This hold-up implies that we need a substantial, practical, and proactive initiative. In the following chapters, we show that there is such one actually and try to convince readers why our proposal would work out for the ASEAN+3.

II. Global Discussions on the CRA

2.1. U.S.

2.1.1 Calls for Reform of Credit Rating Market

The U.S. credit market experienced the meltdown, especially in the mortgage securities market, in 2008~2009. Since then, there have been calls for reform of credit rating market. As the IOSCO(2008) and the BIS(2008) noted, the AAA rating by the global credit rating agencies enabled the unchecked growth in the mortgaged related structured credit in the U.S. As studied in Mathis et al(2009), in credit rating market where credibility and reputation effect persists, market concentration produces negative effect. Partnoy(2010) points out that the regulation of credit rating agencies actually strengthens the oligopolistic nature of credit rating agencies and therefore it is necessary to actively supervise the status and role of credit rating agencies. Calls for reforms are mainly dealing with the issues of the incentive problem inherent in issuer-pay model, strengthening market discipline and public supervision.

2.1.2 U.S.

After the Enron Scandal, Sarbanes-Oxley Act of 2002 had the SEC study Nationally Recognized Statistically Rating Organization (NRSRO). The continuous discussions between the SEC and the congress led to the Credit Rating Agency Reform Act of 2006. The Credit Rating Agency Reform Act focused on strengthening the disclosure obligation of the credit rating agencies, thereby inducing more oversight by investors. The Act introduced the

concept of NRSRO in the regulatory framework. For a rating agency to be certified as a NRSRO, it needs to be qualified in the following aspects: (a) three years of practice; (b) certified by qualified institutional investors; (c) rating performance; (d) rating process and methodology; (e) compliance and internal control of private information and conflict of interest; (f) list of issuers and subscribers, etc.

Since the Subprime Crisis, the SEC conducted the Study on Moody's, S&P and Fitch in 2008 and the Credit Rating Agency Roundtable in 2009. Based on these studies and numerous discussions, the Obama administration proposed a new round of credit rating agency reform in July 2009. The proposal suggested (a) prohibiting consulting of credit rating agencies and business causing conflict of interest, (b) disclosing the cost of rating in the past two years, (c) appointing compliance officer, (d) disclosing preliminary ratings and reporting reliability of documents, probability of default, and expected loss related to ratings, and (e) the SEC registration of credit rating agencies.

The proposals were incorporated in the Dodd-Frank Act of 2010. The Act reformed the credit rating agencies in the two important aspects. First, the credit rating agencies are now liable as experts. Changing the SEC rule 436(g), the credit rating agency's consent is required in prospectus for bond issuance. And the credit rating agency is now liable as experts for omission or ignorance at reasonable level regarding information gathering and research on credit rating.

Second, the credit rating agencies are now regulated as financial institutions; it basically relied only on market discipline before the Act. The Act mainly focuses on improving rating process in terms of consistency, quality, transparency, conflict of interest, and oversight. For consistency and quality of ratings, the law requires the following: internal control to comply with policy, process, and methodology; using outside information aside from those submitted by issuers or underwriters; disclosure of meaning of rating symbols. And it stipulates that credit analyst must be qualified to the SEC standard on analyst education, experience, and capability with respect to each rating category. To enhance transparency, the SEC imposes various disclosure obligations: initial ratings; information such as assumptions, documents, and reports used in rating; rating change or uncertainty; limit, etc. The SEC now regularly evaluates and discloses the credit rating agencies' policy, process, methodology, and conduct. To tackle the conflict of interest, on the other hand, the SEC will require strict separation between sales & marketing and rating department. Last but not least, the SEC will have strengthened sanction right, conduct annual review, install Office of Credit Ratings, reduce hardwiring of ratings in the regulatory system, and others to enhance oversight.

< Box II.1: FSB/G20- Reducing Reliance on Credit Ratings >

The G-20 commissioned the Financial Stability Board (FSB) to come up with the

comprehensive financial reform to enhance financial stability and sustain growth. The FSB has been working on the reform proposal ranging from SIFI to shadow banking. In the studies, the FSB considers that the financial system must reduce its reliance on credit ratings and announced the principles of how the countries should approach this.

Principle 1: Remove the hardwiring of credit ratings in laws and regulations

Principle 2: Banks, institutional investors, and market participants make their own credit assessments

Principle 3.1: Central banks should reach their own credit judgments in market operations as collateral/purchases

Principle 3.2: Banks should be able to conduct their own credit assessments of their assets

Principle 3.3: Internal limits and investment policies of investment managers and inst. investors should rely on their own credit assessments

Principles 4: Traders and CCP should not use change in CRA ratings in margin agreements on derivatives and securities financing

Principles 5: Issuers of securities should disclose comprehensive, timely information that enables investors to make their own credit assessments.

2.2 EU

2.2.1 Early Stage of EU legislation on Credit Rating Agencies

The European Commission committed itself to analyze related issues of credit rating agencies (CRAs) at the Oviedo Informal Economic and Financial Affairs (ECOFIN) Council in April 2002 after the Enron scandal. The European Parliament then adopted a Resolution on credit rating agencies in February 2004, calling on the Commission to assess the need for legislative intervention in this field. The main concern in the Resolution was on the quality of credit ratings provided by CRAs. Credit ratings must be updated on a regular basis, and CRAs are independent and entirely objective in their approach. In addition, CRAs must not be compromised by the relationships with the issuers. Since CRAs have inside information, they should not use it for their other activities. The European Parliament also expressed concern about the degree of concentration in the ratings industry and its possible anti-competitive effects.

The Commission asked the Committee of European Securities Regulators (CESR)[1] to

[1] The CESR is an independent advisory group to the European Commission composed of the

provide the Commission with technical analysis and advice the need for European legislation. CESR gave answers to the request in March 2005. In January 2006, the European Commission published a Communication setting out its approach to credit rating agencies. The Commission's conclusion was in line with the advice provided by CESR, insisting that no new legislative proposals were needed at that moment. Their argument was twofold. First, a number of key EU legislative measures had been adopted as part of the Commission's Financial Service Action Plan (FSAP) and already covered credit rating agencies related issues. Second, the International Organization of Securities Commissions (IOSCO) published its Code of Conduct Fundamentals for credit rating agencies in December 2004.

There were three FSAP Directives related to CRAs. The most important Directive related to CRAs was Market Abuse Directive (MAD) which tackled the issue of insider dealing and market manipulation. The Directive 2003/125/EC addresses the fair presentation of investment recommendations and the disclosure of conflicts of interest. Although credit ratings are not regarded as a recommendation, the Directive states that CRAs should make internal policies and procedures to ensure that their credit ratings are fairly presented. In addition, they should disclose any conflicts of interest concerning the financial instruments or issuers to which their credit ratings are related. The Directive 2003/6/EC prohibits any person holding inside information from using it by acquiring or disposing of financial instruments to which information relates. According to Directive 2003/6/EC, the CRAs should keep a duty of confidentiality if they are allowed to access inside information by an issuer. As a result, a CRA or an employee with inside information is prohibited from any trading using the information. The Article 6(3) of Directive 2003/6/EC states that issuers, or persons acting on their behalf or for their account, draw up list of persons with access to inside information. This provision allows Member States to require CRAs to draw up lists of insiders.

The Capital Requirements Directive (CRD) is the second EU legislation relevant to CRAs. Based on the new international capital requirements by Basel Committee on Banking Supervision (Basel Ⅱ), the CRD introduced a new capital requirements framework for banks and investment firms. The CRD provides the guideline of the determination of risk weights and consequential capital requirements for a bank or investment firm's exposures. Only recognized External Credit Assessment Institutions (ECAIs) can provide assessments, and mainly CRAs belong to ECAIs. Since ECAIs play an important role in deciding the amount of capital required by financial institutions, the CRD sets out a number of requirements for ECAIs, such as objectivity, independence, ongoing review, credibility and transpanrency, before the competent national authority grants them recognition. In order to promote convergence, the Committee of European Banking Supervisors (CEBS) had issued guidelines

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national supervisors of EU securities markets.

on the recognition of ECAIs[2]. Of course, the CRD does not directly govern ECAIs' conduct of business issues, but the objectives and effects of the ECAI recognition system have meaningful implications in setting conduct of business regulation of CRAs in the future, if necessary.

The third legislation relevant to CRAs was the Markets in Financial Instruments Directive (MiFID). MiFID is not directly applicable to the rating process of CRAs in the case that the rating process does not belong to the investment services and activities defined in MiFID. Issuing credit ratings is not normally considered providing investment advice within the MiFID. However, if CRAs do business in investment services and activities on a professional basis, they need to get authorization. In this case, the MiFID provisions regarding conduct of business and organizational requirements apply to the firm and its investment services and activities. Also the provisions on conflicts of interest require appropriate separation of investment services from the credit rating process in order to guarantee the quality and objectivity of credit ratings.

The European Commission's conclusion in the Communication was affected by IOSCO Code of Conduct Fundamentals for CRAs as well as the three Directives. The IOSCO Code is applied to CRAs of all sizes and business models and in every jurisdiction. At that time, several CRAs had set up their own Codes of Conduct in line with IOSCO Code. The Commission concluded that three Directives combined with self regulation by IOSCO Code would resolve the concerns raised by the European Parliament. However, CRAs' own Codes of Conduct based on the IOSCO Code is not enough if they are not implemented in practice on a daily basis. Hence, the Commission asked CESR to monitor compliance with the IOSCO Code and to report back to it on an annual basis. Although the Commission did not present new legislative proposals at that time, it made clear that it would consider introducing new proposals if compliance with EU rules or the IOSCO Code is unsatisfactory or if new circumstances arise-including serious problems of market failure or significant changes in the regulation of CRAs in other parts of the world.

2.2.2 CRA 1

It was commonly agreed that CRAs contributed significantly to subprime debacle in 2008 by underestimating the credit risk of structured credit products Furthermore, they failed to adapt the ratings promptly when market conditions worsened. CRAs were responsible for the rating of structured instruments in which subprime mortgages were embedded. The structured

[2] Guidelines on the recognition of External Credit Assessment Institutions of 20 January 2006 (GL07)

instruments were so highly sophisticated that many investors relied predominantly on the CRAs' expertise and judgements. As a result, investors paid little attention to the risk characteristics of the instruments, the performance of the underlying assets or the general market outlook. As massive losses had been announced by financial institutions, regulators tried to see all the aspects of the crisis including the role played by CRAs.

CRAs active in EU area were mainly governed by IOSCO Code of Conduct, which is based on voluntary compliance, before the CRA Regulation (CRA 1)[3] was adopted in September 2009. The CESR assessed on a yearly basis whether they keep pace with the Code. In October 2007 EU Finance Ministers agreed to a set of conclusions on the crisis which included a proposal to assess the role of CRAs and to address any relevant deficiencies. Specifically they asked the Commission to examine possible conflicts of interest in the rating process, transparency of rating methods, time-lags in rating reassessments and regulatory approval processes. Other countries, such as US and Japan, also started reforms in CRA related issues at that time. In addition, Code of Conduct Fundamentals for CRAs (revised May 2008) by IOSCO, the Financial Stability Forum and the Committee on the Global Financial System had addressed the issue.

In November 2008, the Commission made a proposal for a Regulation on CRAs, mainly based on the revised IOSCO code of conduct. The Commission expected that it will limit adaptation costs significantly because many CRAs already complied voluntarily with the code. However, the Code has no enforcement mechanism but only invites CRAs to give reasons if they do not comply with it (the 'comply or explain' approach). In the US, where most of CRAs with significant EU activities have their headquarters, CRAs had been subject to regulation and supervision since summer 2007[4]. The Commission concluded in its proposal that legally binding legislation, rather than other options (self-regulatory approaches or a recommendation), is the best option to level the playing field between the EU and the US. In addition, the Commission proposed that a Regulation is preferred to a Directive because a Regulation can immediately put in place the uniform framework necessary to quickly restore the market's confidence in the credit rating activity.

Based on the proposal by the Commission, CRA 1 was adopted. The CRA 1 has four objectives aiming at improving the process of issuance of credit ratings. First, CRAs should avoid conflicts of interest in the rating process or at least manage them adequately. Second, CRAs should improve the quality of rating methodologies and the quality of ratings. Third, CRAs should act in a transparent manner by setting disclosure obligations for CRAs. Finally,

[3] Regulation (EC) No 1060/2009

[4] The US Credit Rating Agency Reform Act of 2006 entered into force on 27 June, 2007 establishing a legal framework for the registration of NRSRO (Nationally Recognized Statistical Rating Organizations).

the Regulation includes an effective registration and surveillance framework under which regulators will supervise CRAs.

According to CRA 1, all CRAs that would like their credit ratings to be used in the EU will need to apply for registration. The application should be submitted to the CESR and the decision is made in a consensual manner by the relevant securities regulators grouped in a college. The college of regulators takes the role of day-to-day supervision of CRAs.

In addition to the registration obligation, the Regulation includes the following:

- CRAs should not be allowed to carry out consultancy or advisory services although they can provide ancillary service where this does not bring about potential conflicts of interest with the issuing of credit ratings.

- A CRA should not issue a credit rating in cases where the lack of reliable data or the complexity of the structure of a new type of financial instruments, in particular structured finance instruments, raises serious questions as to whether the CRA can produce a credible credit rating.

- CRAs must disclose information to the public on the methodologies, models and key rating assumptions which they use in their credit rating activities.

- CRAs should differentiate between rating categories used for rating structured finance instruments on the one hand, and rating categories used for other financial instruments or financial obligations on the other, by adding an appropriate symbol to the rating category.

- CRAs are obliged to publish an annual transparency report.

- CRAs have to create an internal function to review the quality of their ratings.

- CRAs should have at least two independent directors on their boards whose remuneration is independent of the business performance of the rating agency. They will be appointed for a single term of office which can be no longer than five years. They can only be dismissed in case of professional misconduct. At least one of them should be an expert on securitization and structured finance.

2.2.3 CRA 2

The financial crisis in October 2008 enhanced the need to completely revise the financial supervisory framework. Especially, the supervisory framework of the financial sector within the EU needed to be strengthened to reduce the risk and severity of future financial crises. In

2009, the European Commission first proposed that a European System of Financial Supervisors (ESFS) should be created, comprising three European Supervisory Authorities – one for the banking sector, one for the insurance and occupational pensions sector and one for the securities and markets sector – and recommended the creation of a European Systemic Risk Council.

The ESFS replaced three existing Committees of Supervisors with three new authorities, called European Supervisory Authorities (ESAs): a European Banking Authority (EBA, taking over from the former Committee of European Banking Supervisors), a European Insurance and Occupational Pensions Authority (EIOPA, succeeding the Committee of European Insurance and Occupational Pensions Supervisors) and a European Securities and Markets Authority (ESMA, succeeding the Committee of European Securities Regulators (CESR)). There is also a European Systemic Risk Board (FSRB) under the responsibility of the European Central Bank in order to complement this framework. The three institutions went into operations on Jan. 1, 2011.

Although the CRA 1 introduced a system of supervision based on colleges of competent authorities of the Member States, which gives the possibility to all concerned competent authorities to participate in the process of registration and supervision of CRAs, the final decision is always taken by the competent authority of the home Member State. With the new supervisory structure, which has supervisory power over the EU, the supervision on CRAs needed to be changed. Moreover, as rating services are not limited to a particular territory and the ratings issued by a CRA can be used by financial institutions all around Europe. Hence, the need for a more centralized system for supervision of CRAs at EU level was strengthened. Corresponding to the new supervisory structure and the need for centralized supervision on CRAs, CRA 1 was amended.

The amended CRA Regulation (CRA 2)[5] states that ESMA should be exclusively responsible for the registration and supervision of CRAs in the EU. The exclusive supervision powers of ESMA include the European subsidiaries of the big three CRAs such as Standard & Poor's, Moody's and Fitch. In order to carry out its duties effectively, ESMA have powers to require all necessary information from CRAs, to conduct investigations and on-site inspections. CRAs could operate in a much simpler supervisory environment, and the users of ratings would be better protected as a result of centralized EU supervision of all CRAs.

2.2.4 Remaining Issues and CRA 3 proposals

Although the CRA Regulation entered into full application on Dec. 7, 2010 and an amendment to the Regulation came into force on June 1, 2011, a number of issues related to

[5] Regulation (EU) No 513/2011

credit rating activities and the use of ratings are not addressed in the existing CRA Regulation. These relate to the risk of overreliance on credit ratings by financial market participants, the high degree of concentration in the rating market, civil liability of CRAs vis-à-vis investors, conflicts of interests with regard to the issuer-pays model and CRAs' shareholder structure.

The European Commission submitted a set of proposals for the amendment of CRA Regulation (CRA 3 proposals) in Nov. 15, 2011 to further strengthen the regulation of CRAs. The need for better quality credit ratings was strengthened along with CRAs' sovereign ratings during sovereign debt crisis in Europe. This is reflected by Internal Market Commissioner Michel Barnier's statement. He said: "Ratings have a direct impact on the markets and the wider economy and thus on the prosperity of European citizens. They are not just simple opinions. And rating agencies have made serious mistakes in the past. I have also been surprised by the timings of some sovereign ratings - for example ratings announced in the middle of negotiations on an international aid program for a country. We can't let ratings increase market volatility further. My first objective is to reduce the over-reliance on ratings, while at the same time improving the quality of the rating process. Credit rating agencies should follow stricter rules, be more transparent about their ratings and be held accountable for their mistakes. I also want to see increased competition in this sector".

The proposals have four main goals to achieve: (i) to ensure that financial institutions do not blindly rely only on credit ratings for their investments, (ii) more transparent and more frequent sovereign debt ratings, (iii) more diversity and stricter independence of CRAs to eliminate conflicts of interest, and (iv) to make CRAs more accountable for the ratings they provide.

First, to mitigate over-reliance on external credit ratings, CRA 3 proposals require certain financial institutions to make their own credit risk assessments. It is also proposed that the ESAs should not refer to credit ratings in their guidelines, recommendations and draft technical standards where such references have the potential to trigger mechanistic reliance on credit ratings. In addition, more and better information underlying the ratings should be disclosed by CRAs and by the rated entities themselves, so that professional investors could make their own judgments easily. CRAs should consult issuers and investors on any intended change to their rating methodologies. Such changes must be approved by ESMA. ESMA is also mandated to establish a European Rating Index (EURIX) featuring a harmonized rating scale. CRAs would have to communicate their ratings to the ESMA, which would make sure that all available ratings on the market for a debt instrument are published under a EURIX, freely available to investors.

Second, the transparency and quality sovereign ratings will be improved by more frequent rating on Member States (every six months rather than 12 months), and investors and

Member States would be informed of the underlying facts and assumptions on each rating. To avoid market disruption, sovereign ratings should only be published outside trading hours.

Third, to eliminate conflicts of interest, issuers should rotate very three years between the agencies that rate them. In addition, structured finance transactions must have at least two ratings from two different rating agencies. A big shareholder of a CRA should not be a big shareholder a big shareholder in another CRA at the same time, i.e. cross-shareholding over 5% or more in two or more CRAs are prohibited.

Fourth, to make CRAs more accountable for their ratings, investors can sue a CRA if it does not comply with the CRA Regulation, thereby causing damage to an investor having relied on the rating that followed such infringement.

2.2.5 Issues Related to the European Credit Rating Agency

The European Commission issued a public consultation paper in Nov. 5, 2010 before it published CRA 3 proposals. The issues raised in the consultation paper include enhancing competition in the credit rating industry as well as other issues taken in the CRA 3 proposals. The credit rating agency sector is oligopolistic as it is characterized by a few large firms and shows entry barriers in terms of reputation and high start up costs. There have been concerns that the rating of large multinational entities and structured finance instruments is concentrated in the hands of the three largest CRAs. This low degree of competition may lead to affect the quality of credit ratings negatively. Naturally, it was discussed in the consultation paper that competition in credit rating agency sector could be enhanced by introducing substitutes for credit ratings. Competition might be enhanced by introducing new players in the CRA industry and/or by lowering entry barriers or expansion for new and existing CRAs. When the Commission discussed CRA Regulation with the European Parliament, the issue of the creation of a new independent, preferably European, credit rating agency was raised.

The European Parliament also issued a non-legislative resolution on CRAs on June 8 2011. The European Parliament also regarded stimulation of competition as an important task and considered that the establishment of an independent European Credit Rating Agency should also be explored and assessed by the Commission.

2.2.5.1 The Proposed Options

The consultation paper proposed four options to enhance competition in credit rating industry. The European Central Bank (ECB) or National Central Banks (NCBs) could be encourage to issue credit ratings, Member States could encourage new market entrance at national level or a new EU based credit rating agency could be created using either private or public funding or a combination of both.

(i) ECB or NCBs

The ECB or NCBs could be entrusted with the task of issuing rating to be used for regulatory purposes by European financial institutions. In the assessment of the credit standard of eligible assets, the current ECB Eurosystem takes into account credit assessment information from one of four credit assessment systems: namely, external credit assessment institutions (ECAIs), national central banks' in-house credit assessment systems (ICASs), and counterparties' internal ratings based (IRB) systems or third-party providers' rating tools (RTs). There are four National Central Banks which apply in-house credit assessment systems and form an official source to ICASs as defined by Eurosystem. The CRA Regulation already describes the possibility the European Commission exempts central banks from the registration process and ongoing supervision by the competent authorities, although they cannot make sovereign debt ratings of their own countries.

(ii) New National Entrants

Member States could be encouraged to enhance competition through the creation of new credit rating agencies at national level. The new credit rating agency could be in the form of either public or private entities. Such entity would be subject to the registration and operational requirements in the CRA Regulation. The consultation paper also suggests that small and medium-sized CRAs at national level could possibly seek State aid from Member States to help cover their start up costs or generate risk capital.

(iii) Public/Private Structures

A new independent European Credit Rating Agency could be considered in a public/private structure such as a Public Interest Company, a European foundation or a public-private partnership. The costs of establishing a new EU credit rating agency could be wholly or partially covered by the private sector. Such entity should be independent to guarantee its credibility, thus have autonomy of its management and staff. Public authorities' should be to ensure that the capital spending is assigned for the purposes for which it was created. The consultation paper proposed that subsidies could be provided through existing mechanisms by the European Investment Bank, the European Commission and Member States. Any initial public investment could then phase out, ultimately turning the new credit rating agency into a purely private entity. Alternatively, a new EU credit rating agency could be operated as a non-profit organization, relying on revenues generated by its rating activities.

(iv) European Network of Small and Medium-sized Credit Rating Agencies

European small and medium-sized credit rating agencies could establish a European network of agencies. They could collaborate in setting up a common rating platform by

sharing best practices and resources, building expert knowledge and enhancing the quality of ratings. Such a platform could give an opportunity to improve competitiveness of individual small and medium-sized credit rating agency, and thus they could expand their rating scope to a wider range of entities and products. The idea is to lead to the emergence of more sizeable market players which expand their services to the range currently provided by the three major CRAs and compete with them. The small and medium-sized CRAs within the network should remain independent legal entities and be under the current CRA Regulation. The EU could act as a promoter of such a network.

2.2.5.2 Effectiveness and Efficiency of the Proposed Options

Since there was not significant support among stakeholders for the first two options, the other two options were analyzed in terms of efficiency and effectiveness in the Commission's Impact Assessment.

(i) A new European Credit Rating Agency

The establishment of a new European rating agency would be promoted either via the establishment of a public institution entirely financed through the Union budget or by providing direct funding to a European agency in the form of a private foundation. Some Member States and the European Parliament suggested that further consideration and analysis on the idea of public/private structures are necessary. On the other hand, some Member States pointed out the problems of credibility and conflicts of interest that could be caused by direct funding arrangements. Some national regulators and several private enterprises opposed to the creation of a new European CRA. However, it would likely take at least 5-10 years for such new entity to become capable to compete with the established CRA.

<u>Public European Credit Rating Agency</u>

In terms of effectiveness an entirely public European rating agency would raise concerns of distortion of competition as it would be less under market pressure to develop competitive products and to price them adequately because it has no risk of bankruptcy due to the public structure. Furthermore, it is possible that the establishment of such an agency could hinder new private market entrants, which could be potential future competitors to the established CRAs, and thus further promote market concentration. In addition, there is a concern that such an agency could get a special treatment from supervisors. Moreover investors could be concerned about the conflict of interest that this model would entail particularly in the area of sovereign ratings. An appropriate design of the governance could partially reduce the problem by ensuring the agency's independence. On the other hand, the public nature of the

entity could positively impact on its credibility provided it is backed by a positive track record of rating activities. However, for the reasons mentioned above, it is uncertain if a purely public agency would obtain sufficient market confidence among investors. Regarding the profile of cost efficiency this option is very inefficient. Moreover, considering the current EU budget constraints, it would raise serious concerns on feasibility and sustainability in the long term.

Private Credit Rating Foundation

A European rating agency in the form of private foundation would have a lower capacity to distort competition within the rating services market than an entity of public nature. The agency would be more independent from governments if it received only initial funding and then had to compete on the market by running the entity with revenues from the sale of its products. Especially, the private entity would be more independent in issuing sovereign ratings than a public one. On the other side, this model might raise concerns on potential conflicts of interest because the new agency would try to develop business with issuers (in issuer-pays model) which could lead to inflated ratings. In order to facilitate its establishment, the European Rating Agency could be granted EU financing to cover part of start-up costs in the form of a Union loan, via a grant agreement of following a competitive procedure, or coming from the European Investment Bank. Regarding the efficiency profile, this option would imply a lower recourse to public resources even though its feasibility should be carefully analyzed.

(ii) A Network of Small and Medium-sized CRAs

The public consultation on this initiative outlined great interest of small and medium-sized CRAs in having an opportunity to share knowledge, enhance capacities for growth and extend the scope of their activities, particularly with a view of operating in cross-border context. There was therefore support from a group of small and medium-sized CRAs for this option. A network could contribute for small and medium-sized rating agencies to obtain economies of scale through sharing data and best practices, which is an important factor currently limiting market entry. While the European Parliament supported the creation of such a network, some regulators and governments questioned the effectiveness of such a network.

For investors, such a measure would increase choice to the ratings available for the same debt instrument or the same issuer. For issuers, this model could result in an increased offer of rating services and easier access to capital markets over time.

Moreover, due to the higher competition in CRA industry, CRAs increase their investments on information collection and processing and on the methodological tools. Since reputation is

a key factor for a CRA to run its business, underinvestment compared to its competitors would mean that conducting its business properly would be harder.

2.2.6 Implications

The impact assessment found that a publicly funded CRA may have benefits in terms of increasing competition in the ratings market and providing an alternative to the issuer pays model. However, the model raises concerns on conflicts of interest and its credibility, especially when the CRA rates sovereign debt. The European Commission did not propose to set up a European credit rating agency because an analysis showed that the establishment of a credit rating agency would be costly, could raise concerns on the CRA's credibility especially if a publicly funded CRA would rate the Member States which finance the CRA, and put private CRAs at a comparative disadvantage.

Asian region is in a different situation from Europe. The EU has the centralized supervisory authority, ESMA, on CRAs and thus it is possible that ESMA can make EURIX for a harmonized rating scale. However, no such an exclusive supervision power exists in Asian region. For this reason, it is very hard to make a rating system to cover all the issuers and financial instruments over the region. Setting up a regional credit rating agency (RCRA) in Asia may be an alternative although the idea has not been accepted in the European Parliament due to the costs and concerns on its credibility. Concerns on potential conflicts of interest and credibility can be resolved by appropriate design of the governance.

In addition, there is a difference in cost efficiency of a new RCRA in Asian region than in Europe. In the EU, the establishment of a European credit rating agency has been discussed for the purpose of fair credit ratings. The publicly funded European CRA model has not been proposed by the European Commission partly by low cost efficiency. However, a new RCRA in Asian region may have another function, extension of coverage, in addition to the fairness of credit ratings. Therefore, if we assume the same set-up costs for a RCRA, Asian RCRA can achieve more objectives, and thus it may be much more cost efficient than European one.

Ⅲ. Evaluations on Policy Alternatives

3.1 Principles of Evaluating Alternatives

Since the ASEAN+3 region does not have a truly regional credit rating agency yet, we could have vastly different approaches to reach the goal of developing regional credit rating market. We bear in mind that seemingly inferior policy option could still have comparative

advantage in certain aspects over comprehensively superior option. To prevent such pitfall, we first set up the three principles of evaluating policy alternatives.

First, we have the alternatives gauged by how effective they are in promoting the ASEAN+3 bond market. We regard the objective of enhancing of regional credit rating capacity as a necessary condition for the development in our bond market. What ultimately matters in these discussions is facilitating the bond issuances and trading within our region. In such light, the policy alternatives should help broaden the coverage of rating that is both active and fair on the bonds of the member countries. It should also lay the groundwork for the increase in the acceptance of regional credit ratings by member countries.

Second, the policy alternative should be effective in promoting both competition and innovation in the market. The member countries where there exist domestic credit rating agencies might balk at the implementation of policies. It is certainly not desirable that the new agencies only crowd out the incumbent ones without enlarging the market size. Therefore, the policy needs to be designed not to reduce the business opportunities of domestic credit rating agencies. And at the same time, it can also further promote competition and innovation. This is important since the credit rating market is prone to oligopoly due to the reputation effect, the economy of scale and scope.

Third, the alternative should be feasible. Shaking up the status quo and leading to better future, it needs to overcome economic and political obstacles. A barometer is how much the discounted present value of benefits exceeds the cost required. Since we expect the set of policies to be implemented in the foreseeable future, the alternative better provide a roadmap where the goal of enhancing regional credit rating capacity can be enhanced.

3.2 Alternative 1: Private Initiatives

The first alternative we consider is the private initiatives. As the name suggests, it relies upon the voluntary efforts by domestic agencies and regulatory bodies.

It suggests that we facilitate market initiatives, if any, by the national credit rating agencies with the ACRAA. And domestic agencies can continue the voluntary and cooperative efforts toward enhancing their credibility. It would probably involve standardizing rating scales, methodologies, data that are reviewed in rating, rating criteria, financial reporting standards, etc. On top of such standardizing, enhancing transparency would also be required in the areas mentioned above.

Building on such initiatives, the discretionary recognition is aimed to be achieved. As the rating is standardized and the rating capacity is enhanced in the region, domestic regulatory bodies can move toward gradual recognition of foreign domestic credit rating agencies that meet the certain level of standards. It is important to note that the regulatory bodies are not put in a bind; recognition is left to the discretion of each country in a unilateral or bilateral way.

Advantage of Alternative 1

The biggest advantage of this option is that it seems the least costly. If the standardization reduces the entry barrier enough, we may end up with the emergence of the ASEAN+3 based multiple private agencies that perform fair regional credit ratings with enough credibility, transparency, and coverage. Ideally, with a number of such agencies, the market competition would provide incentive for innovation. All in all, the governments of member countries would seemingly bear no nominal cost.

The other advantage is the autonomy that each member retains. Since each national regulator maintains the authority to recognize and regulate credit rating agencies, there would be no need for regulatory harmonization. Each member can design and improve the regulations of credit rating agencies as they see fit.

Alternative 1: Doubts about Standardization

We should not ignore, however, the doubts about regional credit rating capacity enhancement simply through standardization. The standardization is currently at the center of private initiatives; it is what would singlehandedly drive the initiatives and foster regional rating agencies. The ASEAN+3 and the ACRAA have been trying standardization, but it has been progressing only at a staggered pace and is not expected to be achieved in the near future. Perhaps more importantly, experts both in markets and academia have begun to question the merit of standardization; some assert that the standardization is neither feasible nor desirable. That was the reason why the report "Credit rating standardization study" by Securities and Exchange Commission in the U.S. recommended *not* taking further action regarding standardization.

Further, since the first alternative heavily depends upon the willingness of private, domestic credit rating agencies to march into other countries in the ASEAN+3, we have to carefully examine the incentives of the private agencies. The domestic credit rating agencies that currently operate within a single country simply lack of incentives to change the status quo. Countries that need enhancing rating capacity most are likely the ones where there is not sufficient volume of issuance. For domestic credit rating agencies to enter into such undeveloped market, they need significant early investment while the revenue base remains small for quite a long period. Under these circumstances, it might be unrealistic for private agencies to proactively become a regional company. Thus, we are afraid that standardization alone does not guarantee the emergence of regional credit rating agencies.

< Box III.1: SEC Report to Congress on Credit Rating Standardization >

The SEC report to Congress "Credit rating standardization study" concludes that

standardization is neither feasible nor desirable on the following grounds.

(1) The SEC does not have the authority to enforce standardization

(2) Only standardization in every aspect if meaningful, but it is not feasible

(3) Standardization would reduce incentives for credit rating agencies to innovate

(4) Standardization would reduce competition

The SEC report recommends *not* taking *any* action regarding the following:

(1) Standardizing credit rating methodology

(2) Standardizing the market stress conditions that the ratings are based upon

(3) Requiring a quantitative correspondence between credit ratings and a range of default probabilities and loss expectations.

(4) Standardizing credit rating terminology across asset classes

Alternative 1: Incentive Problem

Delving further into the incentive structure of private rating agencies, we can clearly see domestic credit rating agencies lack of incentives to pursue recognition abroad. First, the domestic rating agencies that are affiliated with the global credit rating agencies(S&P, Moody's, and Fitch) would not venture into regional credit rating agencies. The domestic agencies often are affiliated with the global big three. Take Korea's case for example. The credit rating market for bonds is divided by four big companies, three of which are affiliated with the global rating agencies, leaving NICE the only independent company. Since most sovereign and many large firms in the ASEAN+3 are already rated by the global credit rating agencies, the affiliates would not be encouraged to expand their operation abroad. Furthermore, even when a domestic company decides to advance into another country, it would find quite difficult shaking up that foreign market already dominated by either the global or domestic agencies. Even then, suppose a domestic agency succeed in entering into an emerging country in the region and obtaining regulatory recognition. Given limited volume of bond issuance, the revenue that the agency reaps would be marginal. The regulatory burden, however, would be probably doubled.

The incentive problem also lies with the regulators; they also lack of incentives to recognize foreign credit rating agencies. Recognition of a foreign credit rating agency would imply market loss for local credit rating agencies. Thus for recognition to be materialized, it probably must be a bilateral agreement. Given any couple of countries, even two advanced

economies, chances are two have uneven sizes and stages of development of credit rating market. With such discrepancies, local agencies of one side of a potential bilateral deal would probably object making regulator in that country balk at the deal. This alternative is based on the assumption that the competition and cooperation of private companies would develop the credit rating market. For a bilateral agreement to work, however, harmonization of regulation must come first. In reality, bilateral agreements are driven mainly by authorities, not by private credit rating agencies.

Alternative 1: Broadening Coverage Not Likely

Another issue with the first alternative is that it is difficult to expect private domestic credit rating agencies to broaden coverage beyond those of the global credit rating agencies. First, sovereign bonds are already rated by the global credit rating agencies. Additional private credit rating agencies would not meaningfully broaden rating coverage. Some may argue we can hope for fairer and more credit cycle neutral ratings owing to the entry of private agencies, but there is no guarantee. Second, for corporate bonds, if rating now-unrated firms makes a profitable business, the global or local credit rating agencies would have rated them already. It means that it is not likely for newly entered private agency to broaden coverage. In essence, in this scenario, regional credit rating service would still remain to be unprofitable business area for domestic credit rating agencies.

Alternative 1: Inefficient and Slow Recognition

If we rely on discretionary recognition, the resultant web of recognition would be mostly likely asymmetric. In a unilateral environment, regulators would be reluctant to recognize credit rating agencies from emerging countries. More probable result would be emerging countries' recognition, if they ever do, of the credit rating agencies from advanced countries. The problem is, however, that such recognition would not improve the status quo. It is the emerging countries that need financing from advanced countries, not vice versa. Credit investors in advanced countries rely on the ratings issued by the rating agencies in their countries, so the real benefit from emerging economies' recognizing the agencies in advanced economies may not be significant after all. This asymmetric recognition would lead to an inefficient equilibrium. Due to the discrepancy, it would take significant amount of time for even this inefficient equilibrium to develop since recognition would progress only at a very slow pace, if any.

It is not too difficult to see why mutual agreement is efficient than bilateral agreements. In bilateral settings, less developed countries would be left behind while advanced countries can each other try to recognize credit rating agencies. As in Free-Trade-Agreements, discrepancies in development stage would hinder bilateral recognition. Moreover, as in trade, a myriad of bilateral agreements could actually be more of a hindrance than a help in reaching a mutual agreement later.

Alternative 1: Regulatory Burden

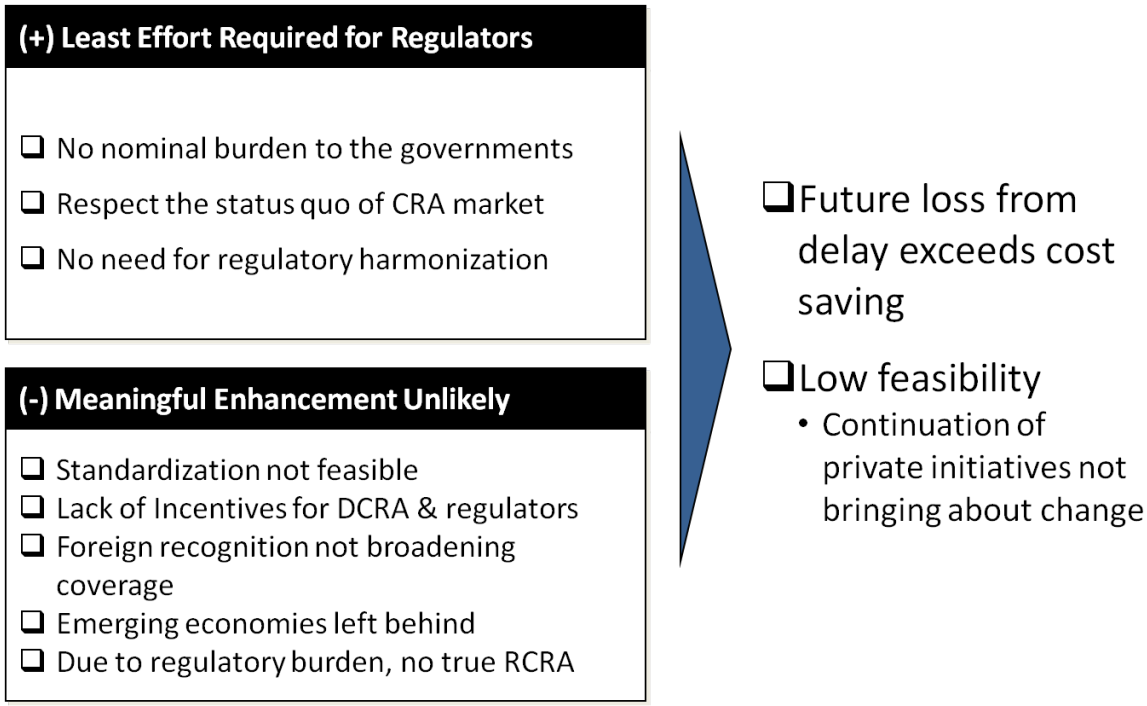
We also like to point out that the private initiatives cannot easily deal with regulatory burden that comes with foreign expansions. In bilateral initiatives, for credit rating agencies to become “true” regional credit rating agencies, it needs to be recognized in all sovereign in the ASEAN+3 individually. Considering vast differences in development stage, culture, market environment, etc within the region, it would be a huge challenge. Then credit rating agencies needs to submit dozens of kinds of documents to all regulators and to deal with public disclosure, complaints, lawsuits, supervisions, and sanctions in all jurisdictions. It is simply *not feasible*. We are afraid that such regulatory burden would hinder emergence of a regional credit rating agency. In sum, the best case scenario for the private initiatives would be that a few credit rating agencies become recognized in other one or two countries. We believe that this is not what we should aim for.

Alternative 1: All-in-all Evaluation

The first alternative obviously does not require coordination effort or monetary expenditure from the government of member countries. Though we do not see the loss now, however, there is future loss of benefits from indefinite delay in vitalization of the Asian bond market. All-in-all, we argue that the future loss from delay exceeds the cost saving.

Second, the first alternative also scores low on the feasibility. The credibility of regional credit ratings from pure private entity can only be achieved through competitive market condition. However, there are doubts about standardization that is a vehicle to lead to such market condition. We reviewed why business association may not be the best candidate to achieve this goal; with private initiatives alone, it is not likely to witness a competitive regional credit rating market with enough incentives to innovate. Therefore, it would be nearly impossible, we are afraid, to escape from the vicious circle, hindering our chances of enhancing regional credit rating capacity. Pros and cons along with the main implications of the first alternative are illustrated in the Figure IV.1 below.

< Figure III.1: Comprehensive Evaluation of Alternative 1 >



3.3 Alternative 2: Setting Up a Regional CRA

The second alternative is to set up a regional credit rating agency, which we will call RCRA. For creating and running this agency, initial paid-in capital is contributed by the participating countries and possibly multilateral institutions or private agencies. Let us discuss a bit later in detail on how to cover running expenses and the compensation model. Governance structure, rating procedures and decisions would be independent from the shareholding countries to shore up market confidence. And broadening rating coverage is guaranteed by mandatory rating services by RCRA for government and corporate bonds of less developed member countries. Though the member countries set up this RCRA, we are open to and should be welcome to the possibility of the emergence of private regional credit rating agencies. Unlike the first alternative where countries have discretion to recognize rating agencies from other countries, here participating countries mutually recognize the RCRA into their regulatory system.

<u>Alternative 2: Feasible with Expected Benefit</u>

The biggest advantage of the second alternative is it is feasible and yet would enhance regional credit rating capacity significantly. The member countries bear reasonable cost in the beginning to break the vicious circle and make the wheel to start rolling into a virtuous circle with lasting benefits. Figuratively speaking, it aims to hatch the egg (strengthening the credit rating capacity of the region) first, so that the chicken (the regional bond market) can grow. It

guarantees enough rating coverage for less developed member countries to lead the region's bond market development. The RCRA initially may record losses, but the initial profitability might be the secondary concern. One other point is that this process can be smoothly integrated with the CGIF, another initiatives of the ASEAN+3. For this RCRA to work, the member countries must reach agreement which includes mutual recognition, but it is highly feasible compared with emergence of regional credit rating agency from discretionary recognitions.

Alternative 2: Manageable Concerns

Since the governments take the initiative to set up this RCRA of quasi-public status, concerns may be raised in the area of credibility, independency, or hampering development of private credit rating agencies. We will show, however, that how such concerns can be dealt with under proper structuring of the organization and processes.

Some other concerns need to be understood as inevitable costs. The member countries need to share financial burden at the initial and start-up stage, but the costs are bearable when we consider the lasting benefit. It needs to be stressed once again to see the matters from the less developed members' point of view. Some would judge that the ASEAN+3 countries cannot work on the necessary coordination, but as the example in the box shows, governments can collaborate to reach desirable equilibrium.

< Box III.2: OECD Export Credit Arrangement >

Some might challenge that sovereign credit ratings by the RCRA backed by the Asean+3 member countries would suffer from credibility issues. "OECD Export Credit Arrangement", however, is a good example of how collaborations among governments can be credible. The OECD governments together were able to agree on the deal "The Arrangement on Export Credits" in an effective and objective manner by assessing one another on the basis of a much broader range of social, political and economic expertise. That arrangement allows the establishment of minimum premium interest rates for country credit risk, i.e., basically performs risk classification.

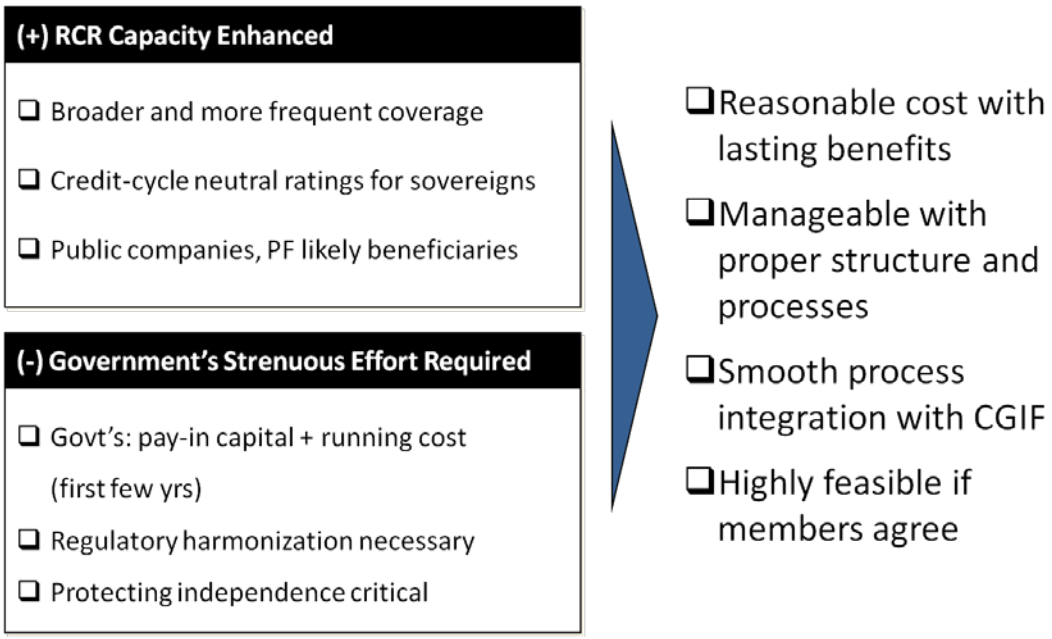
- D. Johnston, New York Times, Feb. 11, 2013

Alternative 2: Dual Track Approach Not to Hamper Private Development

Some may claim that this initiative to set up a new semi-public RCRA would hamper development in private sector. We can counter that argument by taking a dual track approach. First, we cannot but pursue a RCRA as a public initiative in the beginning, but we would

surely leave room for private initiatives. The member countries should be careful to design our regulatory framework so that we would be open to the possibility of private RCRAs' emergence. Note that a RCRA needs to either have a physical presence in the country of issuer or cooperate with existing DCRAs there. Second, apart from setting up a new RCRA, private efforts would continue. The important thing is that the second alternative encompasses the first one: even in the second alternative, countries and private agencies can continue the voluntary and cooperative efforts toward enhancing the credibility of domestic credit rating agencies. They can try standardizing rating scales, methodologies, data, rating criteria, financial reporting standards, etc. or enhancing transparency in credit rating methodologies, data, rating standards, etc.

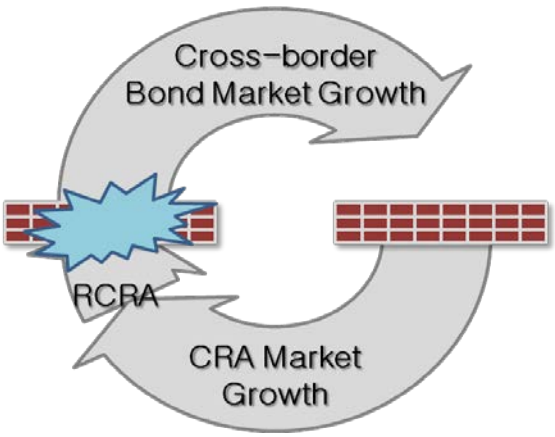
< Figure III.2: Comprehensive Evaluation of Alternative 2 >



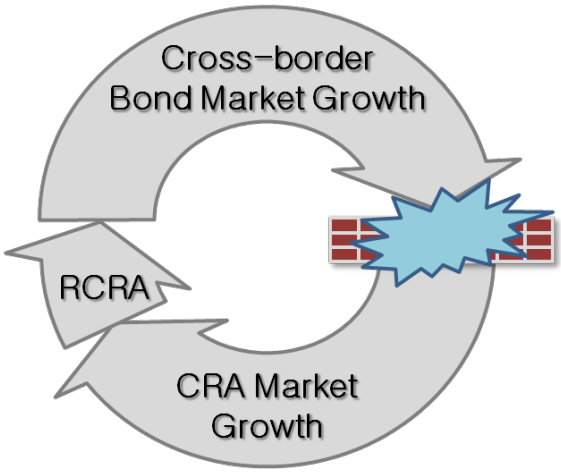
3.4 Evaluation: Pursue Alternative 2 and Establish a RCRA

Based on the comprehensive evaluations on both the alternative 1 and 2, we strongly suggest that the ASEAN+3 countries pursue the second alternative: establish a regional credit rating agency (RCRA). We explain how setting up a RCRA would enhance regional credit rating capacity in the following diagrams.

< Figure III.3: Changing Vicious Circle into Virtuous Circle>

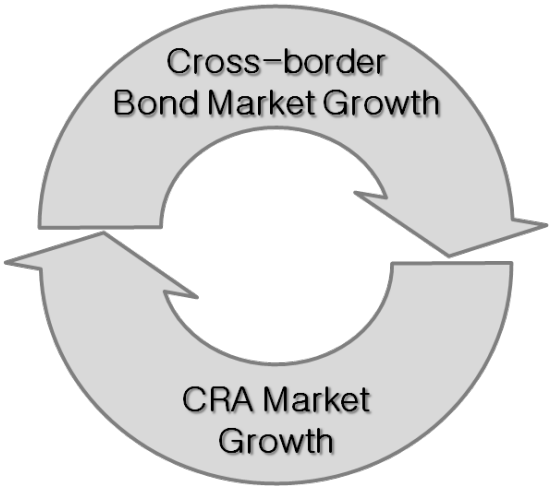


The diagram in the left illustrates the vicious circle that the ASEAN+3 countries are put in. Since there is not enough cross-border bond investments, the credit rating market has not been formed in emerging economies. On the other hand, with insufficient rating coverage on the bonds of emerging economies, the investors in the region do not readily put their money in cross-border bonds.



The crux of the alternative 2 is that to break up this vicious circle, the member countries set up a new RCRA. This RCRA would broaden the coverage of rating, which would then enable the institutional investors in the ASEAN+3 region including mutual funds,

pension funds, insurance companies and others (breaking up the barrier in the left hand side).



As the cross-border bond market investments grows, it can then break the barrier in the right-hand side, inducing credit rating agencies in the region to enlarge their rating coverage, especially in the emerging economies. In this sense, establishing a RCRA can lead the Asian bond market to the next level of integration and development, thereby changing the vicious circle between bond market and credit rating market into virtuous circle.

IV. Suggestions for the Future Roadmap

4.1 Governance Structure: Independence and Accountability

As stressed before, there is a risk of losing market confidence in the ratings by this RCRA that is set up by the governments. It is critical, therefore, to organize the governance structure of the RCRA to ensure independence and yet accountability.

As a first step toward that direction, we suggest the board of directors consist of three inside and three outside directors. The shareholding governments, the ASEAN+3 appoint the three inside directors. The three inside directors should be fairly distributed among the member countries in terms of development stage. That is, for example, one director from advanced-tier economies of the ASEAN+3, another from mid-tier economies, the last from frontier economies. That way, we would not let emerging economies of the ASEAN+3 that needs most help in the credit rating and bond market initiatives be underrepresented. On the other hand, the three independent directors could each be appointed by the domestic credit rating agencies in the region, the users of rating service (investors), and the ADB.

To have a director not wield too much influence while serving independently, the term would be set to be three years, with the cap of continuous terms being the two. Also to ensure smooth transition, terms should be staggered for independent directors. For equitable distribution of power among the countries, no more than single director from any country can serve concurrently. Also for the balance of power in the board, no country shall be represented on the board for three consecutive terms (nine years).

We also further need to safeguard the operation of the RCRA from the influence of the ASEAN+3 or the ADB. We would like the RCRA to be accountable, but should either institution or any other entity for that matter meddle in the rating business of the RCRA, the credibility of its rating will suffer, dooming the very success of this project. It is, thus, critical to prevent the ASEAN+3 or any other regional institution from influencing the RCRA's management in what securities to rate, what ratings to assign, or how much fee to collect, etc. Of course, the ASEAN+3 should be able to appoint directors through open invitation. It shall, however, exercise its authority to the RCRA *only through the rulebook* that the ASEAN+3 devise. Ultimately, the RCRA is held accountable to the ASEAN+3 through the rulebook.

The relationship between the ASEAN+3 and the RCRA should be benchmarked with the one between Financial Services Authority (FSA) and FSCS (Financial Services Compensation Scheme) or FOS (Financial Ombudsman Service) in the U.K. The FSA appoints directors both at the FSCS and the FOS and the FSA devise the rulebook by which the FSCS and the FOS must run. The FSA can't, however, influence the individual cases at the FSCS or the FOS. In so doing, the U.K. has been able to garner the trust from the market

that both the FSCS and the FOS are independent organizations.

4.2 Financing and Stakeholders: ASEAN+3 Governments

The RCRA would be a newly set up organization, so another issue to address is how to finance this organization. Naturally, in the beginning, the shareholders would consist mainly of the ASEAN+3 governments. But we would like to be open to the possibility of willing participants' other than the ASEAN+3 becoming shareholders. In the early stage, the likely candidates are expected to be multinational institutions, public institutions, or even semi-private shareholders. The semi-private shareholders would most likely be major investors or lenders such as development banks, pension funds, etc. In this process, the governments may want to impose a certain limit to the percentage of shares by a single non-government shareholder until the operation of RCRA stabilizes to gain the market trust. It must be pointed out, in the long run, the possibility of privatization or initial public offering (IPO) has to left open in case where competition arises from private sectors.

In addition to this paid-in capital in the set-up stage, the RCRA would probably require funding from the ASEAN+3 governments to cover operational costs in the first few years. Note that we expect the RCRA to regularly rate the sovereign bonds of the ASEAN+3. The rating agency cannot collect rating fee from sovereign, however. And since one of the main goals of this endeavor is promoting bond issuance in the less developed members, we strongly believe that *the asymmetric fee structure* should be considered. That is the rating fee differs according to the country the rated target belongs to: charging less fee onto the emerging market bonds. This might limit the upside of the revenue of the RCRA in the short run.

And before the RCRA garner the issuers and basically *make* the market, the volume of issuance that would determine the size of revenue of the RCRA would not justify the operating costs. Therefore, during the initial few years when investment is necessary, the RCRA would need additional funding to cover the running costs. Such additional funding can be in the form of contribution rather than paid-in capital. This may test the patience of the ASEAN+3 members who needs to finance the agency. In time, however, the business of rating public agencies and companies, project financing, and large corporation would start contributing to the revenue.

4.3 Alternative Compensation Models

The compensation model of credit rating agencies has been under attack. Since they levy rating fees on issuers, they have incentive to curry favor assigning higher ratings than should have been. Against such background, in the U.S., both GAO and SEC have conducted studies on alternative compensation models. In the studies, they reviewed issuer-pay, investor-pay, and other alternative compensation models. Other alternative models included investor-owned, stand-alone, designation, user-pay, issuer and investor-pay, and assignment systems.

After evaluation, they still have not reached a definite answer for which compensation model to pursue.

Since discussions and studies are still in progress in the U.S., EU, etc., it would be the best not to set a definite course with the compensation model of the RCRA. Bearing the market norm in mind, it is assumed for now that the RCRA relies on issuer-pay model with asymmetric fee structure. As discussed above, “asymmetric” means lower fees for the bonds issued in less developed countries.

4.4 Securities to Rate

Public Companies

Emerging economies in the ASEAN+3 often do not yet have many private corporations that have enough size to claim access to bond market. That is why we first turn to the public companies and agencies in the ASEAN+3. Most of the ASEAN+3 economies have huge financing needs in infrastructure: housing, utilities, waterworks, metro transit, rail, highway, plants, etc. In many cases, they also need financing for public bad banks, deposit insurance corporations, or local governments. The governments might directly take up these missions and put the assets on the books, but each one of these missions requires massive investments and financing. That is why governments usually set up public companies (sometimes, even privatizing the public companies) and spin off those missions.

However, the rating coverage of the public companies in emerging economies of the ASEAN+3 by the global credit rating agencies is not broad as we would like it to be. One of the reason is that the size of investor base do not justify rating these public companies. It is a pity because the credit risks of these public corporations are essentially the same as their sovereigns and oftentimes, the global rating agencies are rating those sovereigns.

We take the view that the institutional investors in the ASEAN+3 are currently not investing in these public companies in the region due to lack of ratings. The RCRA would rate the bonds of public companies, facilitating both emerging economies and institutional investors. It would also enable governments to spin off these public businesses having the public companies finance themselves.

Project Finance

In order to continue their rapid pace of growth, the emerging economies of the ASEAN+3 need substantial investments in social infrastructure, so-called SOC. They are, to name a few, highways, bridges, tunnels, water & sewage, telecommunication networks, and plants along with real estate developments. To finance such investments, government can use the taxpayers’ money taking up the projects themselves, have the public companies in those specific categories raise money, or finance private capital project-by-project base. The last method can be the most efficient one if governments can easily find financiers. Even the

World Bank acknowledged that project financing (PF) for financing large "greenfield projects" had been gaining attention in developing countries. (The greenfield projects refer to new projects without any prior track record or operating history)

For the emerging economies including ours in the ASEAN+3, the search cost to find willing banks, investment banks, pension funds, or insurance companies are too high. We can, however, have the RCRA assess the credit risks of these projects, which then help governments' projects to attract capital. This business of PF rating would work as additional competition to investment banks and it would drive down the underwriting fee for PF's.

Sovereign Bonds

In terms of the ASEAN+3 and emerging economies in general, the critique of the global credit rating agencies have been mainly the following: not enough rating coverage on emerging sovereign, procyclical ratings that help to amplify the credit cycles, asymmetric adjustments in ratings (gradual upgrading yet severe, abrupt, belated downgrading).

The governments should have the RCRA give broader and more frequent rating coverage than those of the global credit rating agencies. It is important to stress that we do not expect the RCRA to give higher sovereign ratings than the global agencies. Rather, what we hope for is "fairer ratings" in the sense of 'through-the-cycle' or 'credit cycle neutral' ratings, thereby enhancing the financial stability of the ASEAN+3

Large Corporation

Even the firms of size and with very good credit have limited access to international debt market due to both low sovereign credit ratings and narrow coverage by the global credit rating agencies. However, emerging economies typically need additional foreign capital to sustain their high rates of growth and expand their opportunity sets. The RCRA's rating these firms would draw attention and interest from foreign investors at least in domestic currency corporate bonds. The rating of foreign currency bonds of large corporation will most likely be capped by their sovereign ratings, which are often under single A.

Comprehensive Strategy

The public companies and PF's should be the main target of the RCRA in the short-run; the rating service would help emerging economies to finance infrastructure investments. The RCRA can also reap rating fees paid by public companies or governments, but the further study is necessary to estimate how much this business is self-financed. Owing to the asymmetric fee structure, the fee on these public companies and PF's would be lower than those of the global credit rating agencies.

The RCRA will also offer regular sovereign coverage, indirectly funded by the ASEAN+3. And the initial focus is not on private corporate bonds. The existing private credit

rating agencies may protest such service in fear that the RCRA might crowd them out. However, the matter of fact is that the RCRA does regional scale rating while domestic credit rating agencies do national scale rating. Therefore, crowding out would not be a concern until a private RCRA emerges.

We aim to have the RCRA start from regional scale and move on to global scale. The initial focus should be on coverage expansion with respect to intra-region relative scale rating. In time, the RCRA acquire the Nationally Recognized Statistically Rating Organization (NRSRO) status in the U.S., build up reputation, progress in commercialization. Then the RCRA can achieve credibility in absolute scale rating as well.

4.5 Rating Process, Internal Control, and Methodology

The RCRA should be run according to the rulebook that the ASEAN+3 devises. The RCRA rulebook by the ASEAN+3 would be naturally "the Standard" in the region. The ACRAA's work in the standardization of rating methodology, model, used information, and others can be incorporated in the rulebook. This is expected to yield the two positive externalities: (1) standardizing of credit rating system in the ASEAN+3 and (2) laying ground for discretionary recognition of domestic credit rating agencies by governments.

We suggest that the ASEAN+3 write up the rulebook in a way consistent with the international standards. The rulebook should facilitate the RCRA's acquiring an NRSRO status in the U.S. It should also be consistent with the IOSCO Code of Conduct while incorporating the principles laid by the FSB. Making the code of conduct of the RCRA be consistent with the international standards would assure the quality and independence of ratings and help to garner investor confidence.

4.6 Regulatory Framework:

<u>Regulation Streamline</u>

As we argued, the alternative 2 that sets up a new RCRA clearly has merits. But the difficult part lies in how to design and agree on the regulatory framework. The financial regulatory bodies of the ASEAN+3 countries must work together on streamlining and improving the credit rating regulation, first and foremost. Its goal is to harmonize the credit rating regulation in the ASEAN+3. The process is a *two-way street*: (1) the RCRA's meeting the international standards (NRSRO, IOSCO, etc), (2) regulatory bodies' improving credit rating regulation toward the international standard. This requires the financial regulatory bodies along with the Treasury departments (and others if necessary) of the ASEAN+3 to collaborate. In addition, we propose that the ASEAN+3 discuss the ways to mitigate the dependency of other regulations on credit ratings.

<u>Acknowledging the RCRA</u>

With the harmonization of credit rating regulation, the regulatory bodies of participating countries should collectively acknowledge the RCRA. Then, for example, the RCRA's rating on the bonds of a public company in one member country can be circulated throughout the ASEAN+3 region. It then allows the investors such as a public pension fund in another country can purchase those bonds based on the RCRA's ratings. We believe that the more difficult part is the regulatory streamlining; with the regulatory streamlining in place, mutual recognition would not be a difficult task.

Supervision

The ASEAN+3 countries mutually recognizing the RCRA does not necessarily mean that the RCRA are subject to supervision of each country. It is neither efficient nor feasible for every regulating or supervisory body to perform supervision on the RCRA. Of course, after the member countries recognize the RCRA, there still remains need for routine supervision on the RCRA. Even with the standardized set of regulatory rules and the rulebook, supervision in each and every country would severely hamper the RCRA's efficient operation. It needs to handle the operational burden includes, but is not limited to paper handling, public disclosure, complaints management, litigation, sanctions, and so on.

Supervisory Committee

Noting that the RCRA might not be able to normally function without the effective plan for supervision, we propose that the member countries take a dual track supervision strategy for the RCRA. First, the ASEAN+3 should have the RCRA acquire and maintain a NRSRO status in the U.S. Then the RCRA would be subject to the SEC supervision on credibility, transparency, performance, and others.

Second, concurrently with the first track, the member countries arrange a collective supervision scheme in the ASEAN+3. We strongly suggest setting up "the Regional Credit Rating Supervisory Committee (RCRC)" for that aim. The super-structured RCRC would coordinate regulation and supervision of RCRA's. The credit rating agencies in EU have been licensed and supervised by the EU-wide organization called the European Securities and Markets Authority (ESMA), formerly known as the Committee of European Securities Regulators (CESR). Our view is that this ESMA can be seamlessly benchmarked into our regulatory framework. The RCRC, as the ESMA does, would monitor and maintain the quality of rating service of RCRA's. Furthermore, the RCRC would be able to handle dispute resolutions among RCRAs, issuers, and investors. In order to facilitate the coordination among the national regulators, the staff of RCRC could consist mostly of regulators detached from local supervisors, mixed with some permanent staff.

4.7 RCRA's Laying Foundation for Local CRA's Development

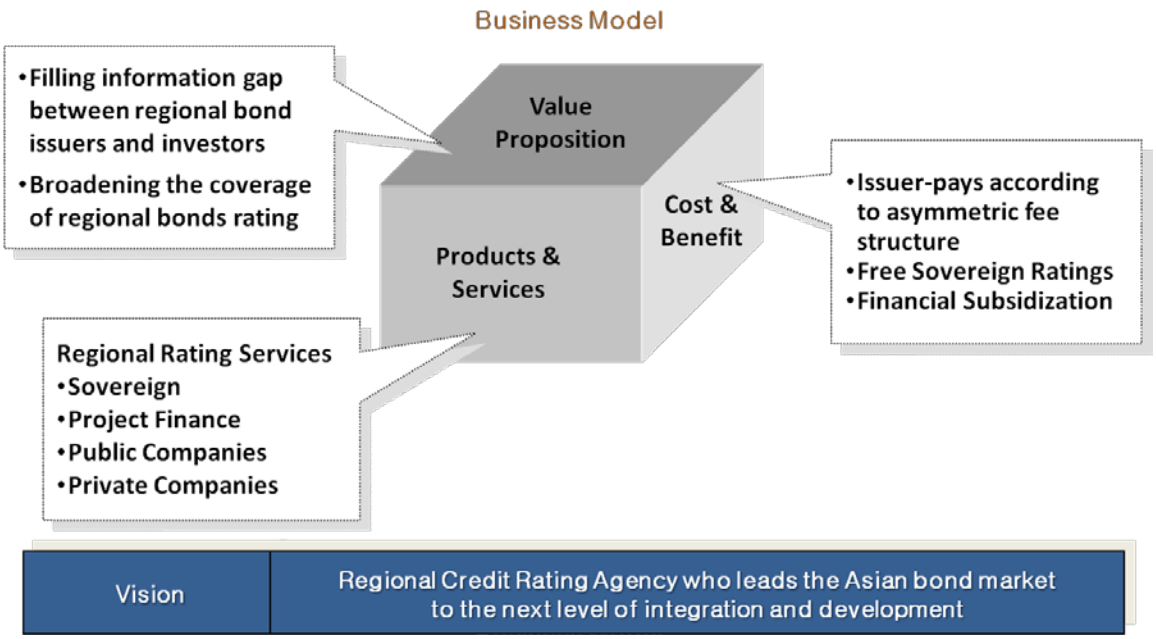
Ultimately, we expect the private credit rating market to develop and mature. The RCRA starts with a semi-public stature. It will, however, lay the foundation for local credit rating

agencies to grow into vibrant regional players, thereby enriching regional credit rating market. First, we expect the RCRA to lay groundwork for the regulatory system in terms of standardization, regulatory recognition, regional regulator, and so on. Domestic credit rating agencies aiming to become a truly regional player now can use a RCRA playbook: licensed by the super regulator, RCRC and acknowledged throughout the region. Second, the RCRA would also lay the foundation for the market development. With the vibrant rating service by the RCRA, the local investors' interest would be raised in the bonds in other countries of the ASEAN+3. Owing to the RCRA's activities, much more issuers would want to be rated by regional credit rating agencies to attract foreign capital within the ASEAN+3. Now with the intra-regional bond market grown further, private rating agencies find it profitable to expand into the regional market.

4.8 Tasks and Timetable

The figure below visualizes the business model that we propose.

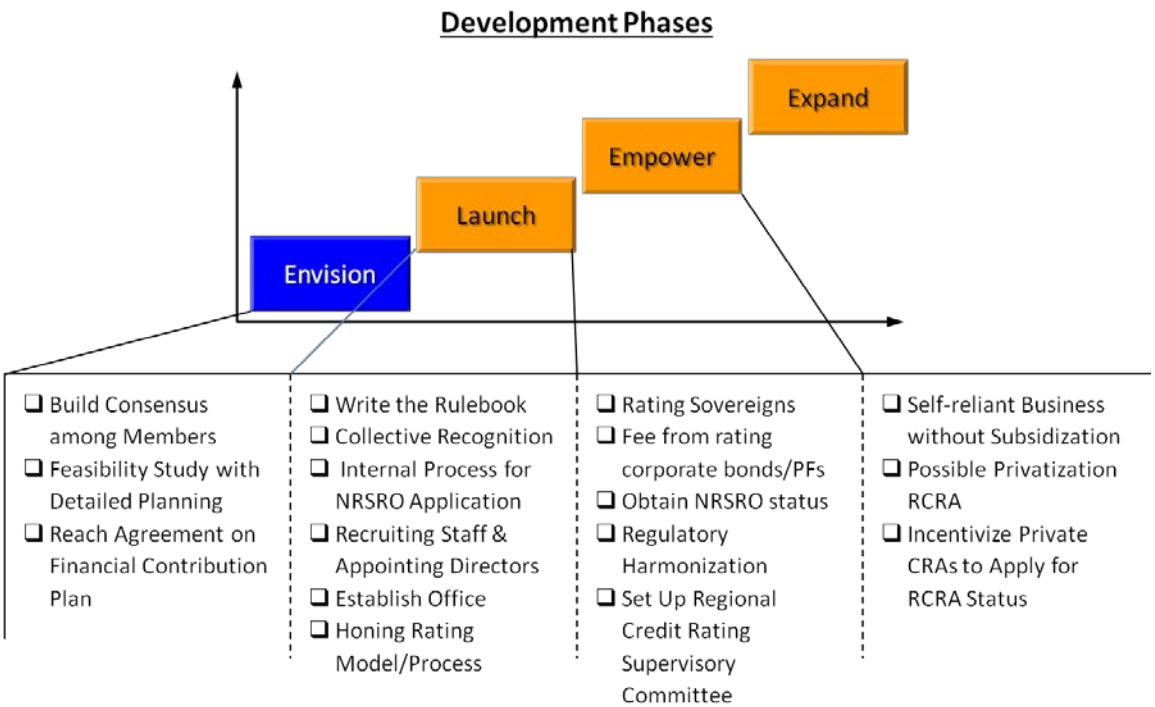
< Figure IV.1: Suggested Business Model >



Our vision is that the Regional Credit Rating Agency (RCRA) will lead the ASEAN+3 bond market to the next level of integration and development. The primary value from this model would be (1) filling the information gap between bond issuers and investors in the region and (2) broadening the rating coverage of regional bonds. To achieve these goals, the RCRA will offer regional rating services on sovereign, project finance, public companies, and

private companies. Considering the cost and benefit of the model, the RCRA regularly rates sovereign for free and relies on the issuer-pay model with an asymmetric fee structure. Financing the RCRA would require the initial paid-in capital from the member countries along with subsidization to cover operation costs in the first few years.

< Figure IV.2: Development Phases >



Next, we offer how this RCRA model should develop going through different phases. The first stage is "Envision." In this first stage, the ASEAN+3 members concentrate on building consensus that is essential for the success of this project. While building consensus, the ASEAN+3 should consider commissioning a feasibility study with the detailed planning. Based on these two works, the countries should be able to reach agreement on financial contributions.

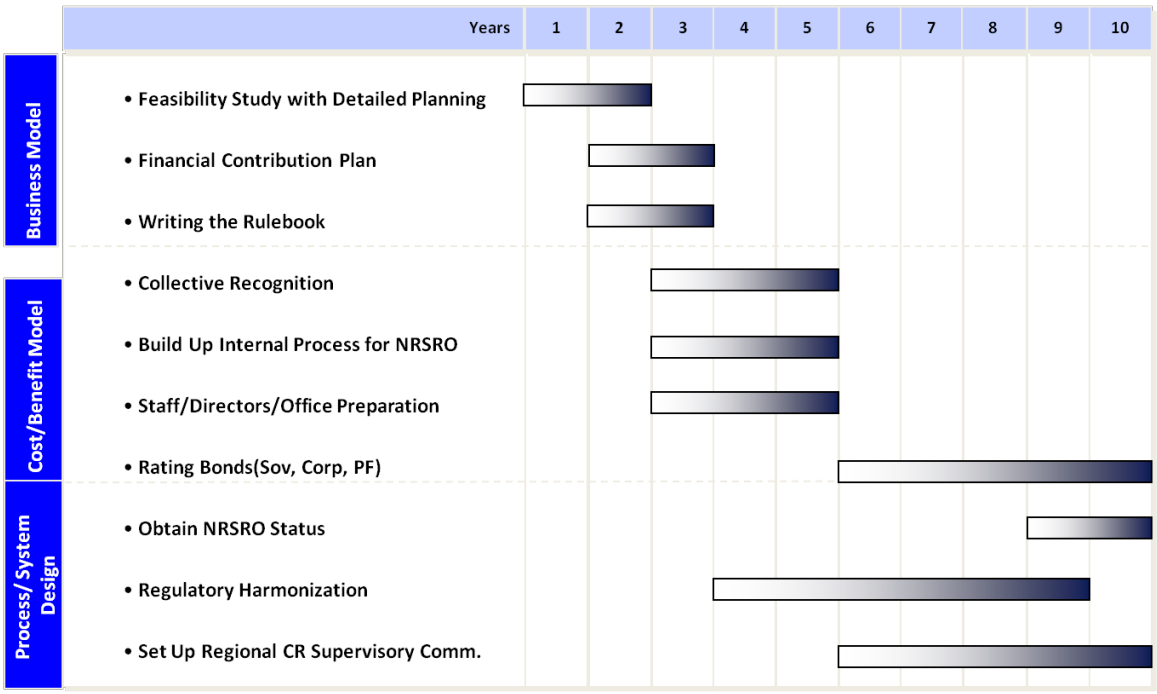
The second stage is "Launch." As the name suggests, the members work on the launching process of the RCRA. They need to write the rulebook for the RCRA and to prepare for collective recognition of the agency. The RCRA needs to begin preparation for a NRSRO application. The most importantly, the agency would establish office, hone its rating model and process, recruit staff and form the board of directors.

After the launch, we need to "Empower" the agency in the third stage. The RCRA begins rating sovereigns and collects rating fees from rating corporate bonds and PF's. The agency can obtain the NRSRO status while after the regulatory harmonization, the ASEAN+3 succeeds in setting up the Regional Credit Rating Supervisory Committee (RCRC).

The fourth and last stage is "Expand," where the RCRA becomes a self-reliant business

without further subsidization. The members then can consider privatization of the RCRA and needs to incentivize private credit rating agencies to apply for a RCRA status.

< Figure IV. 3: Suggested Time Plan >



According to the phase-based development plan, we can devise the more concrete time plan. We suggest one in the figure above, but we would like to point out that unlike the development phase, this time plan should be taken as an example. Depending on the political and economic environments, the members can tailor the time plan. We have the view that it takes no less than five years for the RCRA to begin rating service and no less than ten years before the ASEAN+3 co-found the super regulator of credit rating market, the RCRC. Taking the case of the CGIF into account, the time of ten years is probably underestimated. We strongly believe, however, that with the strong will of the ASEAN+3 countries it can take less time than anybody currently imagines.

Chapter 2. CRA Markets in ASEAN+3 and Other Regions

Summary

1. Background

The credit rating landscape post 2008 global financial crisis is characterized by regulatory reforms at the national and regional levels such as the revision of IOSCO's Code of Conduct Fundamentals, G-20 Declaration on Strengthening the Financial System that includes an oversight regime for Credit Rating Agencies (CRAs) whose ratings are used for regulatory purposes, U.S. SEC regulation amendments, and EU registration and regulation of CRAs. In Asia, the fragmented nature of regional credit rating market, however, means that any regulatory oversight that has been introduced is confined to the national authorities concerned. The increasing role of global regulatory changes and the continuing involvement of Global Credit Rating Agencies (GCRAs) with growing influence in domestic markets, therefore, become important factors to be considered in the development of regional CRA markets. Given the present conditions of ASEAN+3 CRAs, there are potential benefits in terms of regional credit market integration and expansion for greater investors' access and investment opportunities through accelerated rating harmonization process and the establishment of a regional credit rating agency (RCRA).

2. CRA Market Conditions in Other Regions

The 2008 global financial crisis and the subsequent Euro crisis brought about a wave of regulatory changes in the European region. Following the introduction of CRA Regulation (Regulation No 1060/2009 and amended by Regulation No 513/2011) to protect investors and assure the stability of the financial market, the European Securities and Markets Authority (ESMA) was established as an independent EU Authority exclusively responsible for registration and supervision of the credit rating agencies (CRAs) in European Union. There currently 32 registered and 2 certified CRAs from 13 countries inside and outside the EU.

ESMA requires these registered CRAs to provide historical rating information and statistics such as rating activities, default ratios and transition matrix to its central credit rating information repository (CEREP) which is open to anyone and can be used for commercial purposes. ESMA's evaluation of registered CRAs performance, based on information obtained from the CRAs through formal information request, suggested that further formalization and disclosure of CRAs methodologies, policies and procedure including internal control is required and that CRAs should monitor the adequacy of resources in terms of number of employees and expertise, within the context of market development and their impact on the organization.

In Latin America, there is no single regional regulator that is responsible for CRAs registration and supervision. There are around 13 credit rating agencies in the Latin America region, many of which are affiliated with GCRAs and some operate in several countries. Pacific Credit Rating, Inc. for example, has branches in Bolivia, Ecuador, El Salvador, Guatemala, Panama and Peru. HR Ratings in Mexico is also registered in the United States as a Nationally Recognized Statistical Rating Organization (NRSRO) and thus has a global presence.

In the Caribbean region, Caribbean Information and Credit Rating Services Limited (CariCRIS) was established as the world's first regional credit rating agency in 2004 as a result of cooperation among 19 members from 23 economies in the Caribbean region in order to support the development of regional capital markets. CariCRIS formation was supported by feasibility studies that indicated the benefits of having a collective regional debt market with substantial economic size, cross-border financing and progressive regulatory regime. CariCRIS offers national and regional scale (foreign and local currency) ratings to fill in the gap left by GCRAs' global scale that are typically capped by sovereign ratings. Since sovereign ratings of the Caribbean are comparatively low at BBB or below, the non-sovereign counterparts are inevitably compressed towards the lower end of the global scale leaving little variations for investors to differentiate risks at the regional level. Thus CariCRIS's role is to facilitate investors' risk identification and diversification, and act as a regional credit rating agency that provides transparent, independent, and unbiased risk assessments thereby enhancing credibility, acceptability and investors' access. The development of CariCRIS also supports regulatory authorities in increasing investor protection and market discipline and assists local authorities in infrastructure policy formulation and financial sector regulation.

3. **ASEAN+3 CRA Market**

The development of ASEAN+3 early domestic credit rating agencies (DCRAs) in Japan and Korea during 1980s, followed by those in emerging markets (such as Indonesia, Malaysia and Thailand) during the early 1990s, has preceded respective countries bond market development. Many DCRAs in Plus Three countries have substantial experience at the global level. In addition, larger DCRAs in one country inside or outside the ASEAN+3 region often provide technical assistance to the more recent DCRAs in other countries. However, the picture of the present regional market condition is still that of a fragmented market with relatively few DCRAs especially within the ASEAN region. Most ASEAN DCRA's operations concern domestic issuance. There are relatively few newcomers in the rating business since established DCRAs, most of which were formed during the 1980s and 1990s, have gained expertise and position in the respective domestic market. Most of established DCRAs are now members of Association of Credit Rating Agencies in Asia (ACRAA). ACRAA was established in 2001 with the help of the ADB to represents DCRAs in Asia in order to enhance credit rating practices to achieve rating comparability and common standards. Research studies commissioned by ACRAA committees under the Capacity Building Initiative point to the necessity of having high standards of corporate governance, accounting policies and practices, transparency in disclosures, and adequacy of regulatory oversight. These requirements and other credit rating principles are featured in ACRAA Code of Conduct for DCRAs which is based on the IOSCO Code and ADB Handbook on International Best Practices in Credit Rating.

In parallel with local market development, GCRAs have deepened their involvement in the region through ownership, affiliation and technical service agreements in order to increase their regional presence. As a result, GCRAs have been transferring technical expertise that in turn improves DCRA's capacity. ASEAN DCRAs are still in the process of gaining their expertise and expanding their rating capabilities in order increase their appeal to wider investor base however. As identified in the Asian Bankers Association study on the development of regional credit rating standards since 2000 and also referred to in the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies, DCRAs' credibility can be enhanced through greater Independence, Transparency, Accuracy and consistency of ratings, Quality of analysis, and Timeliness and effectiveness of rating actions. Accelerated rating

harmonization process to recognize standards and rating practices, and the establishment of an independent RCRA providing alternative regional benchmark ratings under internationally recognized rating standards are possible options that can lead to significant improvement in these characteristics necessary for gaining investors' acceptance.

4. Toward a Regional Credit Rating System

A regionally coherent credit rating market development such as one that follows the establishment of a RCRA will consist of practical measures for implementation such as the utilization of an alternative/common regional scale, a regulatory system for CRAs registration and reporting, support for DCRAs capacity building, and agreement on essential best practice and monitoring. There is currently a gap between services provided, on the one hand, by GCRAs with limited capacity in terms of number of employees and analysts to cover greater number of regional issuance, and on the other hand, services by DCRAs that are limited to their respective country coverage. Thus an independent regional CRA, that leverages on the expertise of GCRAs and greater local reach of DCRAs as well as coordination and facilitation from ACRAA, and financial and technical resources from international organizations under a roadmap for market acceptance would facilitate regional bond market development.

In order to effectively create a regional credit rating system that is able to facilitate cross-country and cross-currency issuances in the context of intra-regional investments as well as outward investment in other regions by local firms, the roles and interests of concerning parties need to be considered. Established DCRAs with specialized local knowledge and reach have the ability to lead local market development in own countries and new markets. GCRAs looking for market expansion, local knowledge and connections can help provide technical support, global expertise and access to international investors. There have been interests among GCRAs for involvement in the region and some established DCRAs notably in the Plus Three countries have their eyes on the regional and global markets. But the initiatives have been from individual CRAs on an individual basis, partly as a result of the fragmented markets and oligopolistic structure that limits profitability potential for new DCRAs as latecomers. An establishment of a RCRA with participation of DCRAs and GCRAs will accelerate the movement towards their more integrated relationship and continue market momentum that already exists in a regionally coherent way that benefits regional

market development.

Public institutions, including international organizations and local regulatory authorities, have the role in ensuring that CRAs interests are aligned and the RCRA plays a leading and complementary role in regional and local market development. Consistent with its objectives of enhancing DCRAs' capacity, quality of rating process and rating comparability in order to assist Asian Bond Market development and cross-border investment throughout the region, ACRAA can help coordinate and facilitate the participation of local and global CRAs in establishing the RCRA, possibly through a broad-based shareholding structure. ASEAN+3 members in the more developed markets such as China, Korea, Japan and Singapore can serve as initial funders. Sovereign ratings and other considerations necessary for credit risk adjustment to arrive at a regional rating scale by RCRA can be endorsed by the more established DCRAs and GCRAs and used effectively as an alternative regional benchmark. The rating and reporting processes and standards established by RCRA also serve as a regional reference for best practices accepted by international investors. Since most DCRAs are ACRAA members thus adhere to the ACRAA Code of Conduct, the harmonization of CRAs regulation or reporting standards is feasible by agreeing on how to adopt the IOSCO codes effectively with a particular emphasis on credibility of CRAs that are based on their independence, transparency and rating comparability. Therefore domestic and global investors who understand RCRA rating standards, methodologies and procedures will also have better understanding of credit ratings by DCRAs and enable them to better participate in the regional bond market development.

Chapter 2. CRA Markets in ASEAN+3 and Other Regions

I. Introduction

The evolution of local currency bond markets over the last decade has been one of the success stories of the Asian capital market. Growth in the ASEAN+3 local currency bond markets has been impressive. Outstanding issue volumes have risen by more than 300% since 2000, with government bonds having attracted considerable inflow from overseas investors. Nevertheless, much needs to be done from a regulatory, infrastructural and informational standpoint if Asia is to realise the potential of its fixed income markets by promoting increased growth, diversity and liquidity in its local currency bond markets. Regarding this, much also needs to be done if Asia is to develop dynamic cross-border investment among institutions and private investors, enhancing infrastructure within the region.

Credit ratings are a necessary accompaniment to bond issues. Most regulatory authorities require a credit rating for bond issuance while investment policies of some specific funds are dependent on credit rating limits. Therefore, the implicit corresponding requirement is that credit ratings should be subject to appropriate regulation since they provide investment information of public interest and for public use. The credit rating landscape post 2008 global financial crisis is characterised by regulatory reforms at the national and regional levels such as the revision of IOSCO's Code of Conduct Fundamentals, G-20 Declaration on Strengthening the Financial System that includes an oversight regime for Credit Rating Agencies (CRAs) whose ratings are used for regulatory purposes, U.S. SEC regulation amendments, and EU registration and regulation of CRAs. In Asia, the fragmented nature of regional credit rating market, however, means that any regulatory oversight that has been introduced is confined to the national authorities concerned. The increasing role of global regulatory changes and the continuing involvement of Global Credit Rating Agencies (GCRAs) with growing influence in domestic markets, therefore, become important factors to

be considered in the development of regional CRA markets.

This study discusses the present conditions of credit rating markets in ASEAN+3 region in addition to those in European and Latin America regions, and provides a perspective on the relative positions of domestic credit rating agencies (DCRAs) on the path towards regional harmonization.[6] These conditions provide an indication of the potential benefits of an accelerated rating harmonization process and the establishment of a regional credit rating system, in addition to how well DCRAs will be able to participate under such arrangement. A brief overview of credit rating system in the EU, Latin America and the Caribbean is given in the next section, followed by an overview of DCRAs in the ASEAN+3 region in Section 3 where the role of ACRAA in supporting regional DCRAs development is also discussed. Section 4 contains a more detailed description of DCRAs in major ASEAN markets.[7] Sections 5 to 7 present DCRAs' characteristics that are essential for their credibility and market acceptance in the context of regional credit rating harmonization and development of a regional credit rating system. Section 8 concludes with a discussion on how the regional credit rating system can be developed, principally through a Regional Credit Rating Agency (RCRA), in order to gain investors' acceptance and participation in the regional bond market development.

II. CRA Market Conditions in Other Regions

2.1 European Union CRA Regulation

The 2008 global financial crisis and the subsequent Euro crisis brought about a wave of regulatory changes in the European region. The European System of Financial Supervision created in 2009 consists of European Systemic Risk Board (ESRB) and three European supervisory authorities – the European Securities and Market Authority (ESMA) based in Paris, the European Banking Authority (EBA) based in London, and the European Insurance and Occupational Pensions Authority (EIOPA) based in Frankfurt. In 2009, the European Parliament and the Council of the European agree to formulate specific rules for CRAs

[6] *Generally defined as "convergence of various practices and rating principles across borders" in order to achieve a degree of comparability across rating agencies in terms of rating methodology, rating criteria, definitions, benchmarks and overall rating process (Imai,2004).*

[7] *Indonesia, Malaysia, The Philippines and Thailand*

operating in the EU with principal to protect investors and assure the stability of the financial market. The Regulation on CRA was adopted (Regulation No. 1060/2009) and was amended by the Regulation No. 513/2011. The combined regulations are now referred as the 'CRA Regulation'.

Following the introduction of CRA Regulation, the European Securities and Markets Authority (ESMA) was established as an independent EU authority. Founded on December 2009, ESMA is exclusively responsible for registration and supervision of the credit rating agencies (CRAs) in European Union. ESMA started its CRA supervisory competence on 1 July 2011. Starting with 5 registered CRAs at that time, there are now 32 registered and 2 certified CRAs form 13 countries inside and outside the EU as of March 2013 (Table 1). ESMA requires all registered and certified CRAs to provide historical rating information and statistics such as rating activities, default ratios and transition matrix to its central credit rating information repository (CEREP). CEREP is responsible for publishing rating activity and performance statistics of the CRAs by calculating aggregate statistics of both quantitative and qualitative data and disclose them on its website which is open to anyone and can be used for commercial purposes.

Table II-1: ESMA Registered and Certified CRAs

	Name of CRA	Country of residence	Status	Effective date
1	Euler Hermes Rating GmbH	Germany	Registered	16-Nov-10
2	Japan Credit Rating Agency Ltd	Japan	Certified	6-Jan-11
3	Feri EuroRating Services AG	Germany	Registered	14-Apr-11
4	Bulgarian Credit Rating Agency AD	Bulgaria	Registered	6-Apr-11
5	Creditreform Rating AG	Germany	Registered	18-May-11
6	Scope Credit Rating GmbH (formerly PSR Rating GmbH)	Germany	Registered	24-May-11
7	ICAP Group SA	Greece	Registered	7-Jul-11
8	GBB-Rating Gesellschaft für Bonitätsbeurteilung mbH	Germany	Registered	28-Jul-11
9	ASSEKURATA	Germany	Registered	18-Aug-11
10	Assekuranz Rating-Agentur GmbH	Germany	Registered	18-Aug-11
11	Companhia Portuguesa de Rating, S.A. (CPR)	Portugal	Registered	26-Aug-11
12	AM Best Europe-Rating Services Ltd. (AMBERS)	UK	Registered	8-Sep-11
13	DBRS Ratings Limited	UK	Registered	31-Oct-11
14	Fitch France S.A.S.	France	Registered	31-Oct-11
15	Fitch Deutschland GmbH	Germany	Registered	31-Oct-11
16	Fitch Italia S.p.A.	Italy	Registered	31-Oct-11
17	Fitch Polska S.A.	Poland	Registered	31-Oct-11
18	Fitch Ratings España S.A.U.	Spain	Registered	31-Oct-11
19	Fitch Ratings Limited	UK	Registered	31-Oct-11
20	Fitch Ratings CIS Limited	UK	Registered	31-Oct-11
21	Moody's Investors Service Cyprus Ltd	Cyprus	Registered	31-Oct-11
22	Moody's France S.A.S.	France	Registered	31-Oct-11
23	Moody's Deutschland GmbH	Germany	Registered	31-Oct-11
24	Moody's Italia S.r.l.	Italy	Registered	31-Oct-11
25	Moody's Investors Service España S.A.	Spain	Registered	31-Oct-11
26	Moody's Investors Service Ltd	UK	Registered	31-Oct-11
27	Standard & Poor's Credit Market Services France S.A.S.	France	Registered	31-Oct-11
28	Standard & Poor's Credit Market Services Italy S.r.l.	Italy	Registered	31-Oct-11
29	Standard & Poor's Credit Market Services Europe Limited	UK	Registered	31-Oct-11
30	CRIF S.p.A.	Italy	Registered	22-Dec-11
31	Capital Intelligence (Cyprus) Ltd	Cyprus	Registered	8-May-12
32	European Rating Agency, a.s.	Slovakia	Registered	30-Jul-12
33	Axesor SA	Spain	Registered	1-Oct-12
34	CERVED Group S.p.A.	Italy	Registered	20-Dec-12
35	Kroll Bond Rating Agency	USA	Certified	20-Mar-13

Source: ESMA

In November 2011 after two years of operation, ESMA evaluated registered CRAs performance by sending out a formal request for information regarding rating actions for three different classes (banks, sovereigns and covered bonds). Based on the information obtained from the CRAs, ESMA suggested that further formalization and disclosure of CRAs methodologies, policies and procedure including internal control is required and that CRAs

should monitor the adequacy of resources in terms of number of employees and expertise, within the context of market development and their impact on the organization, according to its view on CRAs activities in the areas subject to the examination as follows (ESMA, 2012).

2.1.1 CRAs Internal Processes

The new regulatory framework requires CRAs to increase the level of formalization of their activities, to follow more rigorous policies and procedures and to clearly allocate detailed roles and responsibility of the staffs. This includes 1) proper recording of the rating committee discussion to verify internally, as required by Article 8(2) of the CRA Regulation, that "thorough analysis of all the information that is available to it and that is relevant to its analysis according to its rating methodologies" has been made, and 2) consistent application of CRAs' rating methodologies (rigorous, systematic and continuous) as required by Article 8(3) of the CRA Regulation. As a result of the review, ESMA suggested that CRAs use a more rigorous and formalized approach to the organization and recording of core internal processes mainly in the activity of the Rating Committees and decision making within key internal meetings in order to improve control mechanism.

2.1.2 Transparency and Accuracy

According to Article 11.2 of the Regulation (EC) No 513/2011 on Credit Rating Agencies, ESMA has set up a Central Repository (CEREP) for publishing the rating activity statistics and rating performance statistics of CRAs. This is in response to market participants' indication that historical performance data presented by CRAs has not always been completed and that CRAs differ in their approach to collect and present data. CEREP creation is also in accordance with regulatory requirement to enhance transparency and to contribute to the protection of investor by providing information on the past performance of CRAs and about credit rating issued in the past (ESMA 2011). The role of CEREP is therefore to centrally collect data on credit rating issued by CRAs that are registered in compliance with the EU Regulation, on credit ratings that are endorsed by a registered credit ratings agency, and on credit ratings issued by CRAs that have been certified in compliance with the EU Regulation. In addition, CEREP will collect credit ratings issued in a third country by CRAs not certified or registered but belonging to the same group as a registered CRA on voluntary basis. CRAs are responsible for the accuracy and completeness of the data sent but subject to CEREP examination and request for correction and resubmission.

CEREP collects two types of raw data from the CRAs: (1) Rating data for corporate, sovereign or public finance, and structured finance rating, and (2) qualitative data such as explanation of the concept and definitions used by CRAs. Upon receiving data from CRAs, CEREP calculates performance and statistics for predefined periods of time in a harmonized manner and discloses them for public access through the CEREP's website. CEREP does not disclose any individual ratings information to the public but published only aggregated statistics that help promoting transparency and reducing the cost of information for both market participants and regulators.

2.1.3 Analytical Resource

CRA Regulation requires the CRAs allocate sufficient number of employees with appropriate knowledge and experience to its credit rating activities. Recital n. 31 of Regulation No 1060/2009 requires that CRAs should ensure that adequate human resources are allocated to the issuing, monitoring, and updating of credit ratings. In addition, point A(8) of Annex I of CRA Regulation requires that CRAs employ appropriate resources to ensure continuity and regularity in the performance of its credit rating activities. Based on its finding, ESMA suggests that CRAs monitor the adequacy of resources in terms of number of employees and expertise, within the context of market development and their impact on the organization.

2.1.4 Governance and Control Functions

The overall framework of the CRA Regulation relies on sound presence of internal control functions – auditing, compliance and internal review function – and focus on their accountability and independence. According to ESMA, CRAs should ensure that their internal control function comply with the CRA Regulation by continuously monitor the adequacy of resources (number of employees and expertise), and make sure that the relevant control functions effectively contribute to consistent credit rating methodologies. CRA Regulation assigned
specific duties to the Independent Directors to enhance oversight of the rating process. ESMA expects the Independent Directors to continue developing their role and involvement in CRAs' activities especially in the internal control function.

2.1.5 Disclosure of Methodologies and Presentation of Rating

In order for the users of credit ratings to make informed decisions, CRA Regulation requires credit rating agencies to disclose their rating criteria and methodology in a transparent manner. According to Section E, point 1.5 of Annex I of the CRA Regulation, a credit rating agency should disclose "the methodologies, and descriptions of models and key rating assumptions such as mathematical or correlation assumptions used in its credit rating activities as well as their material change." Recital n. 25 also specifies that "The level of detail concerning the disclosure of information concerning models should be such as to give adequate information to the users of credit ratings in order to perform their own due diligence when assessing whether to rely or not on those credit ratings."

Section D(2)(b) of Annex I of the CRA Regulation further requires that for each rating "the principal methodology or version of methodology that was used in determining the rating is clearly indicated, with a reference to its comprehensive description; where the credit rating is based on more than one methodology, or where reference only to the principal methodology might cause investor to overlook other important aspects of the credit rating, including any significant adjustments and deviations, the credit rating agency shall explain this fact in the credit rating and indicate how the different methodologies or these other aspects are taken into account in the credit rating."

2.2 CRAs in Latin America

In Latin America, there is no single regional regulator that is responsible for CRAs registration and supervision. Credit rating agencies are required to register with the Securities and Exchange Commision (SEC) in their own country under its regulation. In a recent survey, there are mainly 13 credit rating agencies in the Latin America region (Table 2). Peru ranks first with respect to the number of CRAs, totalling 4, followed by Ecuador (2), Columbia (2), Chile (2), Uruguay (1), Mexico (1), and Costa Rica (1). Most of these are GCRA affiliates (Fitch, Moody's or Standard & Poor's). Some local CRA operate in several countries. Pacific Credit Rating, Inc. for example, has branches in Bolivia, Ecuador, El Salvador, Guatemala, Panama and Peru. HR Ratings in Mexico is also registered in the United States as a Nationally Recognized Statistical Rating Organization (NRSRO) and thus has a global

presence.

Table II-2: CRAs in Latin America

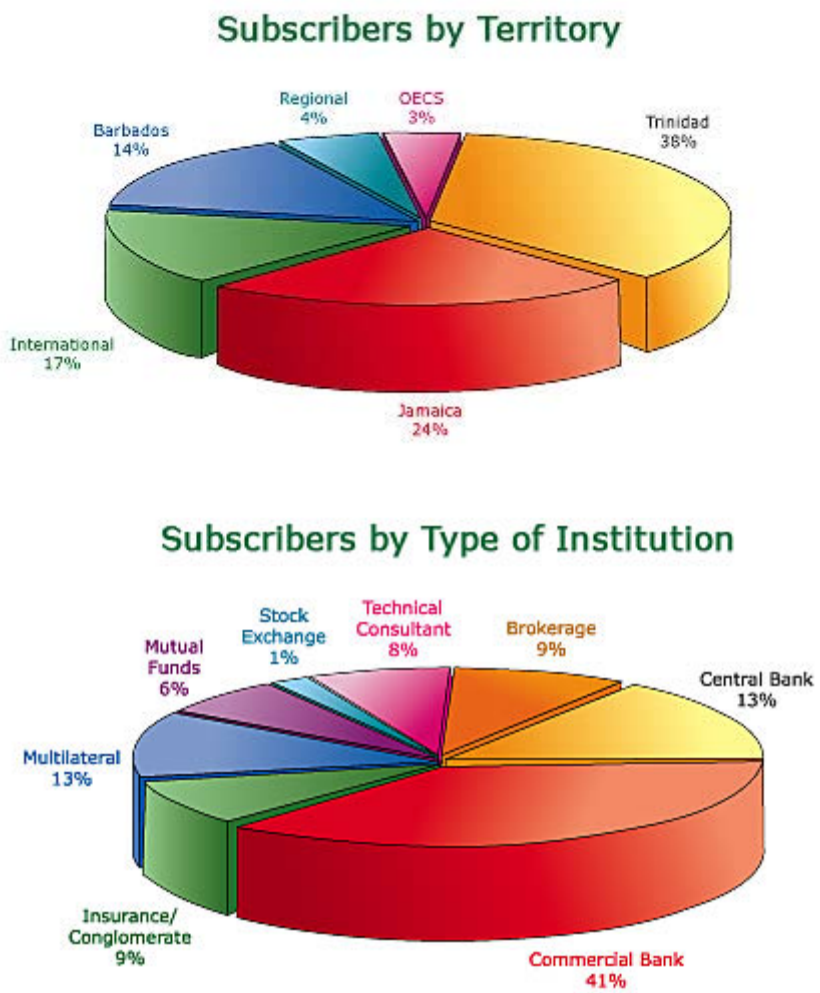
CRAs in Latin America	Description
1. Pacific Credit Rating	Pacific Credit Rating - or PCR - began in Peru but now serves a number of Latin American countries. Branches in PCR Bolivia, PCR Ecuador, PCR El Salvador, PCR Guatemala, PCR Panama, PCR Peru.
2. Apoyo & Asociados Internacionales S.A.C. [Support & Associates International SAC]	Apoyo is based in Peru and is an associate of Fitch Ratings. Services include local ratings for instruments and sovereign risk ratings.
3. Bank Watch Ratings	Bank Watch Ratings is based in Ecuador and is an affiliate of Fitch Ratings.
4. BRC Investor Services S.A.	BRC is based in Columbia and is an affiliate of Moody's Investor Service.
5. Calificadora de Riesgo	Calificadora de Riesgo are based in Uruguay and provide accurate risk assessment for investors.
6. Humphry's	Humphry's is based in Chile and was established in 1988.
7. Classy Asociados S.A. Clasificadora de Riesgo	Class & Asociados is based in Peru.
8. Duff & Phelps de Colombia, S.A., S.C.V	DCR Colombia is a Fitch associate.
9. Ecuability, SA	Ecuability SA is based in Ecuador.
10. Equilibrium Clasificadora de Riesgo	Equilibrium is based in Peru and is an affiliate of Moody's.
11. Feller Rate Clasificadora de Riesgo	Feller Rate is based in Chile and is a strategic affiliate of Standard & Poor's.
12. HR Ratings de Mexico, S.A. de C.V	HR Ratings are based in Mexico and have a large base in international support. It aims to provide transparency on the Mexican financial market.
13. Sociedad Calificadora de Riesgo Centroamericana, S.A. (SCRiesgo)	SCRiesgo are based in Costa Rica and provides risk rating for companies and projects in the region.

2.3 The Caribbean Region

In the Caribbean region, Caribbean Information and Credit Rating Services Limited

(CariCRIS) was established as the world's first regional credit rating agency in 2004 as a result of cooperation among 19 members from 23 economies in the Caribbean region in order to support the development of regional capital markets. CariCRIS formation was supported by feasibility studies that indicated the benefits of having a collective regional debt market with substantial economic size, cross-border financing and progressive regulatory regime. CRISIL Limited, India acted as the technical consultant during its formation. CariCRIS has a diversified shareholding structure which limits the influence of individual shareholders or shareholder blocks, meaning that its ownership would not coincide with any single market. The Board of Directors includes representatives from multilateral and regulatory institutions. The Rating Committee is totally independent from shareholders and the Board of Directors.

Figure II-1: CariCRIS Subscribers



Source: CariCRIS

CariCRIS offers national and regional scale (foreign and local currency) ratings to fill in the gap left by GCRAs' global scale that are typically capped by sovereign ratings. Since sovereign ratings of the Caribbean are comparatively low at BBB or below, the non-sovereign counterparts are inevitably compressed towards the lower end of the global scale leaving little variations for investors to differentiate risks at the regional level. Thus CariCRIS's role is to facilitate investors' risk identification and diversification, and act as a regional credit rating agency that provides transparent, independent, and unbiased risk assessments thereby enhancing credibility, acceptability and investors' access. The development of CariCRIS also supports regulatory authorities in increasing investor protection and market discipline and assists local authorities in infrastructure policy formulation and financial sector regulation. CariCRIS's services include credit ratings to debt issued by sovereigns, private and public companies, banks and financial institutions, private credit assessment, and risk management and training. However its revenue from rating income and other services (USD 0.7 million, as of March 2012) is still below total operating expenses (USD 1.0 million).

III. Asia's Local CRAs

The development of ASEAN+3 early domestic credit rating agencies (DCRAs) in Japan and Korea during 1980s, followed by those in emerging markets (such as Indonesia, Malaysia and Thailand) during the early 1990s, has preceded respective countries bond market development. The past decade also saw rapid growth of Asian bond market with local currency (LCY) bond outstanding for ASEAN+3[8] in 2011 of USD 18.4 trillion (around USD 15 trillion in sovereign bonds and USD 3 trillion in corporate bonds; Table 3)[9] growing more than three-fold over 15-year period from USD 5 billion in 1996. In terms of regional distribution, Japan's share of the market was 70% of the total value followed by China 18%, Korea 7% and ASEAN-6 (Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam) 5%.

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[8] *Excluding Cambodia, Lao PDR, Myanmar and Brunei*

[9] *USD 5.7 trillion excluding Japan; USD 3.8 trillion in government bonds and USD 1.9 trillion in corporate bonds*
Source: AsianBondsOnline

China with five currently accredited CRAs that are Association of Credit Rating Agencies in Asia (ACRAA) members, in particular, saw the amount of its government bond outstanding rising over 16-fold and corporate bond rising 300-fold since 2000. As of June 2012, the amount of LCY bonds outstanding was USD 3.5 trillion (USD 2.6 trillion government and USD 0.9 trillion corporate). In 2008, around 13% of corporate bonds were rated by the CRAs. In Japan, two out of three

Table III-1: Local Currency Bond Outstanding (USD Billions)

Size of LCY Bond Market in USD Billions

	2000		2011	
Market	**Government**	**Corporate**	**Government**	**Corporate**
Japan	3,499	1,053	11,556	1,152
Korea	122	233	510	719
China	199	3	2,540	852
Hong Kong	14	47	91	78
Indonesia	51	2	93	16
Malaysia	36	33	158	106
Philippines	21	0	67	10
Singapore	25	20	118	71
Thailand	26	5	182	43
Vietnam	0	0	15	2
Total	3,993	1,396	15,331	3,049

Source: AsiaBondsOnline

DCRAs were registered NRSROs and thus have global reach and expertise (Japan Credit Rating Agency, Ltd. – JCR, and Rating and Investment Information, Inc. – R&I[10]). The other agency was Mikuni & Co., Ltd. with extensive reach on Japanese firms and operating under an investor–pay model.[11] Larger DCRAs in one country inside or outside the ASEAN+3 region often provide technical assistance to the more recent DCRAs in other countries. Korea's Seoul Credit Rating & Information, Inc. (SCI), for instance, has a technical cooperation with JCR since 2000. Among the other three established DCRAs in Korea, only National Information and Credit Evaluation, Inc. (NICE) is owned locally and has cooperation with Dagong of China and R&I of Japan. The others, Korea Investor Services, Inc. (KIS) and Korea Ratings Corporations (KR), belong to Moody's and Fitch respectively.[12]

[10] *R&I withdrew its NRSRO registration in November 2011 but remained registered with Japan Financial Services Agency since September 2010.*

[11] *Yamori, N., & Nishigaki, N. (2006). Credit Ratings in the Japanese Bond Market. Japanese Fixed Income Markets: Money, Bond and Interest Rate Derivatives, pp. 257-281.*

[12] *An evaluation of relative performance among these Korean DCRAs is provided in Ferri, G., Kang T.S., Lacitignola P.,& Lee, J.Y. (2009). Foreign Ownership and the Credibility of National Rating Agencies: Evidence from Korea. Paper presented at*

Table 4 gives a listing of these Plus Three DCRAs.

Table III-2: Domestic CRAs in Plus Three countries

Country		ACRAA Members	Name	Acronym	Year of est.	Shareholding Structure
China	1	✓	China Chengxin Int. Credit Rating Co., Ltd	CCXI	1992	Joint venture between China Chengxin Credit Management (51%) and Moody's (49%)
	2		China Chengxin Rating Co., Ltd		2012	Fully owned by China Chengxin Credit Management
	3	✓	China Lianhe Credit Rating Co., Ltd.	Lianhe	2000	Joint venture between Lianhe Credit Information Service (51%) and Fitch Ratings (49%)
	4	✓	Dagong Global Credit Rating Co., Ltd.	Dagong	1994	Fully domestically-owned
	5	✓	Shanghai Brilliance Credit Rating & Investors Service Co., Ltd.	SBCR	1992	Fully domestically-owned
	6		Pengyuan Credit Rating Co., Ltd.	Pengyuan	1993	Fully domestically-owned
Japan	1	✓	Japan Credit Rating Agency, Ltd.	JCR	1985	Fully domestically-owned by local financial institutions
	2		Rating and Investment Information, Inc.	R&I	1998 through merger of Nippon Investor Service, NIS and Japan Bonds Research Institute, JBRI (est. 1985)	Fully domestically-owned by local financial institutions (NIKKEI Group as its majority shareholder)
	3		Mikuni & Co., Ltd.	Mikuni	1975	
Korea	1	✓	Korea Investors Service, Inc.	KIS	1985	Moody's (50% + 1 share) KIS Info (50% - 1 share)
	2	✓	Korea Ratings Corporation	KR	1983	Fitch Ratings (73.55%)
	3	✓	National Information & Credit Evaluation, Inc.	NICE	1987	Vanda Pte, Ltd 14.93% KTB Asset Management 14.57% Employee Stock Ownership 9.83% Tokyo Shoko Research 6.88% Woori Bank 6.83% Hana Bank 4.56% National Agricultural Cooperative 2.99% Shinhan Bank 2.78% Others 36.63%
	4	✓	Seoul Credit Rating& Information, Inc.	SCI	1992	SP Partners (19.19%)

Source: Bank of China (Hong Kong) (2011), originally Wind Information, E Fund Management (HK) Co., Limited; Yamori N., Nishigaki N., Asai Y. (2006); Ferri, G., Kang T.S., Lacitignola P.,& Lee, J.Y. (2009); Company websites

Table III-3: Domestic CRAs in major ASEAN markets

Country		ACRAA Members	Name	Acronym	Year of est.	Analysts	Types of Rating	Others Services	Number of Rated Entities
Indonesia	1	✓	PT Pemeringkat Efek Indonesia	P.T. Pefindo	1993	Corporate Rating Division (6) Municipal Rating Division (2) Financial Institutions Rating Division (5) Equity and Index Valuation Division (3)	Corporate and debt instrument ratings	Mutual Fund Services, Pefindo25 equity index, equity valuation, industry report, economic updates, credit information relating to debt capital markets	436 solicited ratings (as of October 2012)
	2	✓	PT ICRA Indonesia	ICRA Indonesia	1991	2	Corporates, banks and financial institutions, claim paying abilities and debt instruments including ABS	Research	8 companies (as of October 2012)
	3		PT Moody's Indonesia (formerly PT Kasnic Credit Rating Indonesia)	Moody's Indonesia	1997	12	Banks, insurers, securities companies, mutual funds, Islamic debt, corporate bonds, RMBS, ABS, asset-backed commercial paper, future flow transactions, CDOs, CLOs, CMBS, municipal bonds and medium-term notes.	Research	43
Malaysia	1	✓	Malaysian Rating Corporation Berhad	MARC	1995	Board of Commissioners (6) Rating Committee Members (8) Syariah Advisory Panel (4) Rating Team (4)	Corporate debt, issuer, structured finance, Islamic capital market instruments, financial institution, corporate credit, insurer financial strength, Islamic financial institution governance, sovereign issuer credit	Research and training	683 ratings (cumulative, as of December 2012): 400 corporate debt; 60 project finance; 168 structured finance; 1 sovereign debt; 2 sovereign credit strength; 23 financial institution ratings; 6 issuer ratings; 15 corporate credit ratings; and 8 insurer financial strength ratings
	2	✓	RAM Rating Services Berhad	RAM	1990	49 (as of 2011)	Local and foreign corporates, financial institutions and insurers, government-linked and other public-financed entities, project finance, sukuk, structured finance, including ringgit-denominated foreign issues	Consultancy, training, research, credit information	860 (1,919 cumulative ratings, as of January 2013)

Country		ACRAA Members	Name	Acronym	Year of est.	Analysts	Types of Rating	Others Services	Number of Rated Entities
Philippines	1	✓	Philippine Rating Services Corporation	PhilRatings	1985	8	Corporate, Banks, Financial Institutions, Government Institutions, Local Government Units, Insurance Companies	Research	39 (as of October 2012)
	2		Credit Rating and Investor Services Philippines, Inc.	CRISP	2008	5	Bond issuers and debt instruments in real estates, food and beverage, and energy sectors, Local governement financing	Investment Risk Assessment Training Industry Research	4
Thailand	1	✓	TRIS Rating Co., Ltd	TRIS Rating	Found in July 1993, Splited into TRIS Rating in June 2002	Research&Development 4 Staffs CRA 15 Analysts 4 Head 4 Support Staffs	TRIS Rating: 1. Credit Rating Services (Company rating, Issue rating, Short-term securities, Structured finance, Hybrid securities, Local government, Government-related entities) 2. Information Services	TRIS: 1. Performance Evaluation Consulting 2. Enterprise Risk Management Consulting 3. Performance Improvement Consulting 4. Good Corporate Governance and Corporate Social Responsibility Consulting 5. Internal Audit and Quality Assessment Report (QAR) Consulting 6. Survey and Business Research Service	102 (as of November 2012): 1 structured finance, 30 financial institutions, 66 corporates, 5 government related entities

Source: Company websites and reports

Within ASEAN, where LCY bond market saw a four-fold increase in both corporate and government segments since 2000, there are still relatively few DCRAs present. Major markets are Malaysia, Thailand and Singapore with two, one and no DCRAs respectively. Vietnam which has a corporate bond market also largely relies on global CRAs. Vietnamnet Credit Rating Centre (VCRC) was established in June 2005 but discontinued its operation in after less than

one year due to small credit rating market and lack of accurate information from banks and government agencies. Table 5 provides information on ASEAN CRAs' businesses. Like some of the Plus Three DCRAs, many of these ASEAN DCRAs maintain relationship with the GCRAs either through shareholding or technical service agreements. RAM Rating Services Berhad (RAM) has interestingly embarked on a transition towards becoming a GCRA in its own right by recently providing ratings based on its Global and ASEAN rating scales.[13] The following subsections review DCRAs in ASEAN market in more details and attempt to assess their characteristics in order to ascertain their ability to serve growing local markets relative to the GCRAs. In particular, possible advantages of regional harmonization and the establishment of a Regional Credit Rating Agency (RCRA) are examined. These subsections are divided according to the characteristics identified in the Asian Bankers Association study since 2000 (ABA, 2000) as being critical for the credibility of DCRAs in gaining investors acceptance within any framework towards harmonization of credit rating practices.[14] The study together with subsequent studies by the ADB[15] led to the publication of ADB Handbook on International Best Practices in Credit Rating (ADB, 2008) for which the current ACRAA Code of Conduct (ACRAA, 2011) is based on.

ACRAA was established in 2001 with the help of the ADB to represents 15 DCRAs in Asia and began its operation on 1 January 2002. Current membership has increased to 30 and spread across 13 Asian countries.[16] Its objectives focus on promotion of 1) exchanges of ideas, experiences, information, knowledge and skills to enhance DCRAs capabilities and provision of reliable market information; 2) adoption of best practices and common standards to ensure

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[13] *RAM (2013b). RAM takes major step to become global rating agency. RAM Press Release, 21 January 2013. And RAM (2013a). Credit FAQs: Global and ASEAN Ratings Explained. RAM Criteria & Methodology, January 2013.*

[14] *Namely, Independence, Transparency, Accuracy and consistency of ratings, Quality of analysis, and Timeliness and effectiveness of rating actions. These characteristics are referred to in the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies (IOSCO, 2008).*

[15] *Including a follow up study in 2004, ADB. (2004). Development of Regional Standards for Asian Credit Rating Agencies: Progress & Changes. Asian Development Bank.*

[16] *The 13 ACRAA member countries are Bangladesh; India; Indonesia; Japan; Kazakhstan; Korea; Malaysia; Pakistan; People's Republic of China; Philippines; Sri Lanka; Taipei, China; and Thailand.*

high quality and comparability of credit ratings; 3) the development of Asia's bond markets and cross-border investment throughout the region. Thus ACRAA objectives are consistent with the credibility enhancing characteristics of DCRAs that will be discussed in the subsequent subsections. The correspondence between ACRAA Code of Conduct and these characteristics is given in Annex 1. In addition, to the extent that some elements of the Code of Conduct (which are based on the articles of IOSCO code) are consistent with laws and regulations by each country's regulatory authorities, the implementing guidelines become a binding commitment from member DCRAs in the respective country. In Japan, for example, a recent IMF's assessment (IMF, 2012) found that all CRAs whose ratings are used for regulatory purposes are registered with Japan Financial Services Agency (FSA) and subject to periodic reporting and inspections in line with IOSCO's principle.[17]

ACRAA's objectives are pursued through joint training workshops, best practices dialogues, as well as conferences with regulatory authorities and participation in various activities. As an action program for ACRAA, *'Rating Harmonization'* is the effort to make the credit ratings of all member DCRAs comparable as a basis for investment decisions. ACRAA has three committees under the *'Capacity Building Initiative'* , namely, Training Committee, Best Practice Committee, and Regulatory Relationship Committee that work under two main objectives: for joint training workshops and for best practices dialogues. Research studies commissioned by the committees point to the necessity of having high standards of corporate governance, accounting policies and practices, transparency in disclosures and adequacy of regulatory oversight (Choudhury, 2004) that subsequently feature in ACRAA Code of Conduct for DCRAs. The harmonization challenge is for the DCRAs in different stages of development, rating methodologies[18], national market conditions, accounting standards and regulatory frameworks to work together for market integration and regional development interest as a whole.

3.1 ASEAN DCRAs

[17] *CRA recognition criteria include six elements: Objectivity, Independence, International Access/Transparency, Disclosure, Resources and Credibility. Japan FSA, for example, has taken administrative action against Standard and Poor's as a result of violations related to its credit rating announcement, monitoring and information disclosure, by requiring the company to submit periodic reports on preventive measures (FSA, 2012).*

[18] *Some of which are derived from those of different GCRAs, principally, Moody's, Standard and Poor's, and Fitch.*

This section provides background profiles of the major ASEAN DCRAs listed in Table 5. Further details concerning their credibility enhancing characteristics in relation to those of the Plus Three DCRAs are also discussed in the subsequent sections.

Indonesia

3.1.1 PT. PEFINDO (PT Pemeringkat Efek Indonesia)

Incorporated on December the 21st, 1993, PT Pemeringkat Efek Indonesia, or PT. PEFINDO in short, was the first credit rating agency in Indonesia that was established through the initiative of BAPEPAM (Indonesia's Capital Market Supervisory Board) and Bank Indonesia (the Central Bank) under the requirement that all commercial papers held or traded by banks need to have credit ratings. PEFINDO was structured as a private limited liability company owned by institutional shareholders. At the date of establishment, joint owners were 99 financial institutions with major shareholders (above 5%) as follow:

Figure III-1: PEFINDO's initial shareholding structure

SHAREHOLDERS	% of ownership
Dana Pensiun Bank Indonesia	25.56%
Bursa Efek Jakarta	18.00%
Dana Pensiun Pertamina	10.34%
Taspen	6.00%
Danareksa Sekuritas	5.10%

Source: PT. PEFINDO Credit Rating Indonesia Ltd.

As of 2011, PEFINDO shareholders comprised of domestic financial institutions, major pension funds, banks, insurers, Indonesia Stock Exchange (IDX) and securities companies, and two state-owned banks (see Table 6). Despite its purely domestic outlook in terms of the company's shareholding structure, PEFINDO has, from its early days, received technical support from the Standard & Poor's Corporation (S&P). For instance, PEFINDO rating process was adopted from S&P established methodologies. PEFINDO's directors and analysts also attended periodical trainings, workshops and courses organized by S&P. Apart from having S&P as its affiliate, PEFINDO is also a member of ACRAA and actively involves with ACRAA activities.

Table III-4: ASEAN DCRAs Shareholding Structure

Country		ACRAA Members	Name	Acronym	Year of est.	Shareholding Structure		
						Public	Private	GCRAs
Indonesia	1	✓	PT Pemeringkat Efek Indonesia	P.T. Pefindo	1993	3.5% State-Owned Banks (2)	96.5% Other domestic institutions: 20% Indonesia Stock Exchange 46.7% Pension Fund (26) 23.1% Securities Companies (56) 6.7% Insurance Companies (7) (as of December 2011)	
	2	✓	PT ICRA Indonesia	ICRA Indonesia	1991			99% owned by ICRA Limited (a subsidiary of Moody's
	3		PT Moody's Indonesia (formerly PT Kasnic Credit Rating Indonesia)	Moody's Indonesia	1997			Moody's Investor Service Inc.
Malaysia	1	✓	Malaysian Rating Corporation Berhad	MARC	1995		Domestically registered major life and general insurance companies, stockbrokers and investment banks (29)	
	2	✓	RAM Rating Services Berhad	RAM	1990		90.2% Domestically registered major banks and financial institutions (28)	4.9% Fitch Ratings Limited 4.9% Standard and Poor's (McGraw-Hill Asian Holdings (Singapore)
Philippines	1	✓	Philippine Rating Services Corporation	PhilRatings	1985		70% Motan Corporation 30% CIBI Foundation	
	2		Credit Rating and Investor Services Philippines, Inc.	CRISP	2008			
Thailand	1	✓	TRIS Rating Co., Ltd	TRIS Rating	Found in July 1993, Splited into TRIS Rating in June 2002	(TRIS Corp.) 13.52% Government Savings Bank 5% Ministry of Finance	76.48% Domestic Financial Institutions: 45.33% Commercial Banks 13.34% Stock Exchange of Thailand 7.81% Finance/Securities Companies 5% Mutual Fund Management Cos 5% Insurance Companies	5% Standard and Poor's (McGraw-Hill Asian Holdings (Singapore) Pte. Ltd.)

Source: Company websites and reports

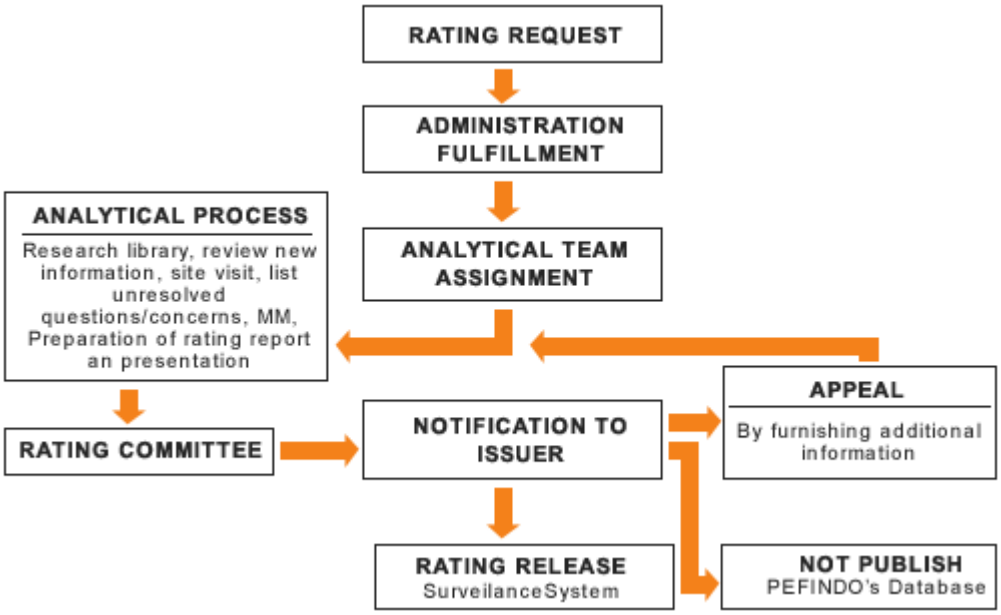
Apart from rating services, the company's related businesses include mutual fund services, PEFINDO25 index of small and medium enterprise stocks, corporate governance scoring, industry report and economic updates. Rating is its main focus, for which its rating products could be divided into 2 types: company rating and debt instrument rating. Company rating, also called 'General Obligation' (GO) rating or an issuer rating, reflects the overall credit worthiness of a company, which do not take into account the nature and provisions of the debt security, its standing in bankruptcy proceedings or liquidation, statutory preferences, the creditworthiness of the guarantors, insurers, or other forms of credit enhancement supporting the company. On the other hand, Debt Instrument rating reflects the creditworthiness of an obligor to timely meet its financial commitments. These could be a specific debt bond rating for long-term debt period (more than 5 years), medium term note (MTN) for 1-3 year period, or Commercial Paper (CP) and Promissory Notes (PN) for short-term period (below 1 year).

Since its inception until October 2012, the company has provided solicited ratings for 436 rated entities. For corporate sector, for instance, PEFINDO covers three major risk assessments: industry risks (i.e. cost structure, barriers and competition of the market), business risks (varied depending on Key Factors of Success of the market), and financial risks (i.e. financial policy, capital structure, cash flow protection, financial flexibility). Each risk type is assessed similarly based on the analyses of five key risk factors: 1) the industry's growth and stability 2) revenue and cost structures 3) barrier to entry and competition within the industry 4) regulation and de-regulation, and 5) financial profile of the industry. Nevertheless, there exists a slight distinction between the sets of key analytical factors used for the assessment of corporate business profile which could vary from one firm to another, depending on the so-called Key Success Factors (KSF) of certain industries. In some cases, a rating decision is influenced mostly by financial measures, while in other cases, a company's rating is more influenced by the firm's business profiles and fundamentals. There were no explicit explanations for the proportions of quantitative factors against those of qualitative factors that were integrated into the company's rating methodology, although PEFINDO maintains its commitment that its rating decisions would always reflect the balance of different factors, strengths and weaknesses included.

PEFINDO's typical rating cycle, which lasts for approximately within 30 working days, is illustrated in the diagram below. The process, under an issuer pay model, begins as a

response to a formal request from the issuing company. Information request from the company includes 3-5 years of the company's audited financial statements, several detailed questions and operational data as listed in PEFINDO's standard questionnaire depending on the sector, and some other documents such as prospectus, information memo, etc. Following the widely accepted norm, the rated entities possess the right to approve whether the result will be published.

Figure III-2: PEFINDO's Rating Process



Source: PEFINDO website

Assigning ratings specifically within the Indonesian context, PEFINDO ratings are characterized by the utilization of the 'id' prefix as the abbreviation of 'Indonesia'. PEFINDO's rating scale also resembles those of its S&P affiliates, with only one difference on the scale of selective default, idSD rating that ranges between idCCC and idD. This idSD grade would be assigned to a company that has failed to pay one or more of its due financial obligations. Despite the payment failure, this SD rating is to be assigned when PEFINDO believes that the obligor has merely selectively defaulted on some particular issue or class of obligations, yet, would continue to pay on time for its other obligations.

3.1.2 PT ICRA Indonesia (ICRAIndo)

Compared to PEFINDO, ICRA Indonesia is a much younger domestic credit rating agency in Indonesia. Almost two decades after Pefindo incorporation, ICRA Limited, an Indian CRA, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange, decided to have its subsidiaries in the country. Subsequently ICRA Indonesia obtained its operating license from Bapepam-LK - the Capital Market and Financial Institution Supervisory Board on September 14, 2010. As a subsidiary, it is 99 percent owned by ICRA Ltd, with its mother company, in turn, an associate of Moody's investor service. ICRA Ltd. also has Moody's Investor Service as its largest shareholder.

Due to its affiliation, ICRAIndo receives technical know-how from Moody's. This could perhaps most visibly be reflected in its adoption and modification of ICRA Ltd.'s Code of Conduct, which is in turn supported by a Technical Services Agreement entailing Moody's provision of high-value technical services, research capabilities as well as access to Moody's global research base to ICRA Ltd. Nevertheless, it is explicitly stated by ICRAIndo that the Code of Conduct has been adjusted to comply with the applicable regulations in Indonesia.

Characterized as a typical DCRA, ICRAIndo's ratings are designed to address the relative credit risks within Indonesia, and not adapted to any rating comparison among instruments across countries. Compared with other DCRAs, ICRAIndo operates in a much smaller manner with merely three members in its Board of Directors and two analysts. Principally through the accumulated experiences of its parent ICRA Ltd., ICRAIndo offers its Indonesian market with services including credit rating, grading and investment information. For its rating services, ICRAIndo offers credit ratings to a wide range of issuers including manufacturing companies, banks and financial institutions, infrastructure sector companies, service companies, municipal bodies, non-banking finance companies, small and medium sector entities, asset backed securities. Nonetheless, given its new position in the Indonesian market, it has only rated 8 companies thus far.

ICRAIndo operates on an issuer-pay model and therefore its rating process starts when an issuer submits the signed agreement. Apart from the information the issuer handed in as rating requirements, ICRAIndo also relies on secondary sources of information provided by its own Research Division. Upon its completion of assessment which normally takes up to 30 working days, the 'Rating Report' is presented to the Rating Committee which is the final authority for ratings assignment before passing on to the top management for acceptance. The report is used only if the issuer finds the rating acceptable.

3.1.3 PT Moody's Indonesia (formerly PT Kasnic Credit Rating Indonesia)

Founded in May 1997, the Jakarta-based PT Moody's Indonesia was formerly recognized as Kasnic Credit Rating Indonesia. Prior to Moody's affiliation accounting for 99% stake, Kasnic Credit Rating Indonesia was previously owned by PT. Kasnic Indotama (70%) and Fitch (30%). Operating as a credit rating agency, its activities involve the provision of ratings and credit opinions on issuers and debt instruments, such as banks, insurers, securities companies, mutual funds, Islamic debt, corporate bonds, residential mortgage-backed securities, asset-backed securities, asset-backed commercial paper, future flow transactions, collateralized debt obligations, collateralized loan obligations, and commercial mortgage-backed securities, as well as municipal bonds and medium-term notes.[19]

PT Moody's Indonesia rating methodology is primarily concentrated on financial and operational risks. Unlike other two Indonesian domestic credit rating agencies, PT Moody's Indonesia is not a member of ACRAA.

Malaysia

3.1.4 RAM Rating Services Berhad

RAM Rating Services Berhad was established in November 1990 as the Nation's first credit rating agency of its kind by Bank Negara Malaysia with assistance from CRISIL through trainings of analysts during its inception. RAM is well recognized as world's leading sukuk rating public limited company. RAM is an ACRAA member and owned by domestic financial institutions (90.2%), Fitch ratings (4.9%) and Standard and Poor's (4.9%). As of 2011, RAM operates with the expertise of 49 experienced analysts in total.

As of the end of January 2013, after the introduction of its Global and ASEAN scale ratings, RAM has rated more than 860 companies, accounting for 1,919 bonds and sukuk issues worth close to $261 billion since 1991.[20] It has rated ringgit and sukuk bonds issued by over 20 foreign companies, most of which are from South Korea, Japan, Singapore, Hong Kong, Indonesia, Kazakhstan and Gulf Cooperation Council countries (GCC). Outside the Malaysian territory, RAM Ratings (Lanka) Limited, another subsidiary of RAM Holdings

[19] *http://investing.businessweek.com/research/stocks/private/snapshot.asp?privcapId=31208587*

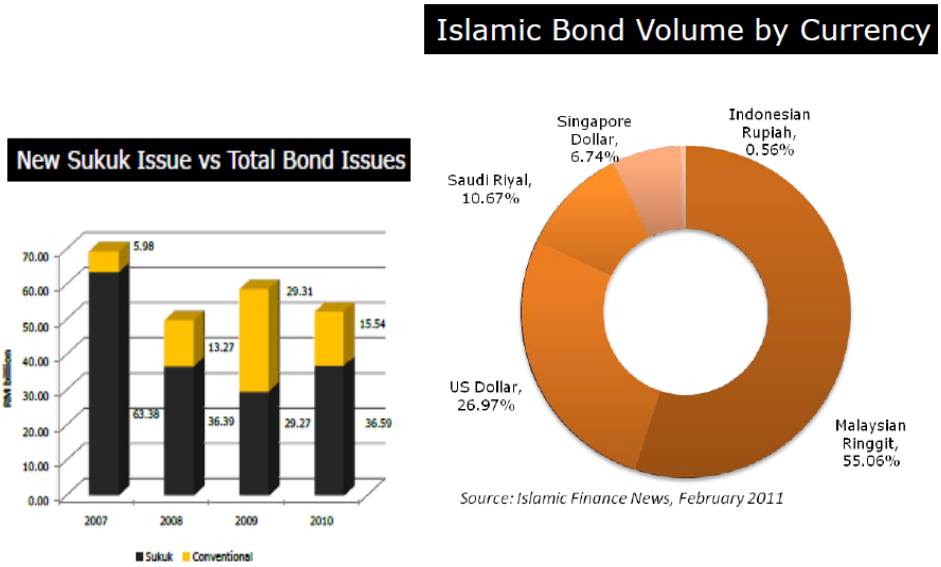
[20] *RAM (2013b). RAM takes major step to become global rating agency. RAM Press Release, 21 January 2013.*

that was formed in 2005, operates in Sri Lanka and is also an ACRAA member.

Also following the issuer-pay model, RAM provided both solicited and unsolicited ratings. Each rating requires around 4 to 6 weeks from the day of receipt of mandate and/or information until a decision is made by the Rating Committee. Any initial ratings would take up longer time than annual surveillance. Domestically, RAM's clients range from public listed companies, small and mid-sized organizations, financial institutions, large-scale enterprises and conglomerates to government-linked corporations and multinationals. However, on 21 January 2013, RAM Ratings has turned global by debuting its Global and ASEAN rating scales attracting more foreign issuers and investors that aim to compare and measure companies for their relative credit worthiness.[21] The new rating scales are intended to provide an option for domestic companies that wish to expand regionally and globally and give a benchmark and an indication how companies fare in terms of credit standing against their ASEAN or global counterparts. RAM stated that its decision is largely in response to the demand of the ASEAN-region investors and issuers for diversity in opinions. The move was also aimed to promote the Islamic bond market known as sukuk market in Malaysia as well as globally. Apart from its rating activities, RAM also offers other services including consultancy, trainings, research and credit information.

[21] *Ibid.*

Figure III-3: Islamic Sukuk Market



Source: RAM Rating Services Berhad

3.1.5 Malaysian Rating Corporation Berhad (MARC)

Kuala Lumpur-based Malaysian Rating Corporation Berhad (MARC) was incorporated as a public limited liability company in October 1995 prior to its official launch on September 5th 1996. MARC's shareholders comprise of major life and general insurance companies (46.5%), stockbrokers (26%), discount house (2%) and investment banks (25.5%) operating in Malaysia. The company is recognized by Bank Negara Malaysia and Securities Commission as an External Credit Assessment Institution (ECAI) under Basel II and as a bond rating agency regulated under the Guidelines on the Registration of Credit Rating Agencies issued by the Securities Commission on 30 March 2011. In addition to the core credit rating business, it also offers economic and fixed income research reports and training.

As of January 2013, it has rated 860 companies on corporate debts, project finance and structured finance including Islamic capital market instruments, asset-backed securities, as well as financial strength ratings of financial institutions and insurance companies. MARC provides both solicited and unsolicited ratings, the latter of which are public information ratings on a no-fee basis to support ratings on obligations relying on support mechanisms such as bank guarantees, parent company guarantees and state government guarantees. Its

corporate rating methodology comprises of business risk analysis, financial risk analysis, consideration of management and other qualitative factors and issue structure and terms, in which detailed information on indicators, ratios, and the analytical focus are identified for each analysis type and for a particular industry category under consideration. MARC requires approximately 7-8 weeks in delivering ratings, and depending on the circumstances, the assigned ratings might be placed on MARCWatch subject to upgrading, affirmation or downgrading. Apart from MARC's established Code of Conduct, the company adheres to many others policies such as whistleblowing, personal investment and trading of securities and analytic firewall policies that, it believes, are for the company, customers as well as investors' best interests.

Thailand

3.1.6 TRIS Rating

Under the promotion of Thailand's Ministry of Finance and the Bank of Thailand, the Industrial Finance Corporation of Thailand acted as the key institution in establishing 'Thai Rating and Information Services Co., Ltd' or 'TRIS' in July 1993 with the purposes to evaluate creditworthiness of debt securities and to assist investors in decision-making. TRIS was then approved as Thailand's first credit rating agency by the Office of the Securities and Exchange Commission (SEC) and started the credit rating business on July 27, 1993.

In June 2002, TRIS Rating Co., Ltd or 'TRIS Rating' was separated from its parent company, 'TRIS', and operated as an independent firm to supervise the credit rating business in comparison to TRIS that oversees the consulting services business. TRIS Rating is wholly owned by TRIS (99.99 percent). A shareholding

Table III-5: Domestic Shareholding Structure of 'TRIS', parent company of TRIS Rating [22]

Government Sector:	
Government Savings Bank	13.52%
Ministry of Finance	5.00%
Private Sector:	
Commercial banks**	45.33%
Stock Exchange of Thailand	13.34%
Finance and Securities companies	7.81%
Mutual fund management companies	5.00%
Insurance companies	5.00%
International Agency:	
McGraw-Hill Asian Holdings(Singapore)Pte.Ltd	5.00%

Source: TRIS Rating

structure of TRIS as of March 2012, comprises of 18.52 percent ownership from public sector, 75.48 percent ownership from private sector (commercial banks -- the largest shareholder accounts for 45.33 percent), and 5 percent ownership from the international agency. Standard & Poor's group (S&P) acquired 5 percent stake in TRIS in November 2011. TRIS Rating received technical assistance in credit rating methodology from S&P along with various trainings from ACRAA where TRIS Rating was a co-founding member.

TRIS Rating offers two main services. Its primary business is credit rating services while the other is information services. It only rates local-currency denominated debt instruments but under a variety of types including basic corporate debt instruments (secured and unsecured debentures), structured finance issues (project finance and guarantee debentures), and securitizations.

The rating methodology is largely subjective with no exact weighting scales between

[22] *Within 45.33 percent of the commercial banks' shareholding, TMB Bank PLC accounts for 15.30 percent of TRIS Corporation Ltd. (TRIS). TMB Bank PLC is 26 percent owned by Thailand's Ministry of Finance.*

quantitative and qualitative factors. Nevertheless, TRIS Rating compares company's profile to TRIS Rating's Rating Analysis Methodology Profile (RAMPs) of other companies that have already received ratings. It takes approximately six to eight weeks for the completion of the rating process given that there is sufficient information available.

TRIS Rating uses issuer-pay model as a credit rating model where it provides only solicited rating since the accumulation of essential and sufficient information is the major component in achieving accurate ratings. Rating fees are categorized by types of rating. Fees on company ratings are based on the asset size of the latest reviewed or audited consolidated financial statements while fees on issue ratings are derived from basis points of bond issuance.

Ratings assigned by TRIS Rating cannot be compared with those assigned by international credit rating agencies as TRIS Rating rates local currency bonds under the national scale rating system which does not address either direct sovereign risks of the government or foreign exchange rate risks. In addition, Thai sovereign rating is assigned AAA, the highest rating by TRIS Rating whereas it is rated BBB+ by S&P and BBB by Fitch Ratings.[23] Differences in sovereign rating yield different ceilings of rated issues.

In Thailand, there are two credit rating agencies which are accredited by the SEC, i.e., TRIS Rating and Fitch Ratings (Thailand). However, only TRIS Rating is recognized as a local credit rating agency since Fitch Ratings (Thailand) is an affiliation of Fitch Ratings. Nevertheless, there exists a certain extent of market segmentation among the two credit rating agencies. According to an interview with TRIS Rating, TRIS Rating mainly provides ratings to Thai corporations while Fitch (Thailand) primarily issues ratings to Thai banks.

The Philippines

3.1.7 PhilRating

The 'Philippine Rating Services Corporation' or 'PhilRatings' is the pioneer domestic credit rating agency found in 1985. It is entirely-owned by private sector, i.e., 70 percent owned by Motan Corporation and 30 percent owned by CIBI Foundation. It covers issuer ratings, short-term ratings, and long-term ratings. PhilRatings uses issuer-pay model and conducts solicited rating as well as private rating for exclusive use by specific parties and

[23] *Source: Thailand Sovereign Rating by Major Rating CRAs; the Public Debt Management Office Thailand. Accessed on November 23, 2012.*

entities such as local government units and insurance companies.

The rating methodology encompasses a wide range of quantitative and qualitative factors, however, there exists no exact formulae or specific standard sets of ratios. The rating process carries around four to six weeks after the submission of completed information. Nevertheless, the actual time-frame depends on size and complexity of the issuer or issue. The formal-basis monitoring process requires quarterly updated information. Moreover, it is mandatory to meet with company's management at least once a year as long as there is an outstanding credit rating.

The rating fee is paid upfront and depends on the amount of time and effort needed to complete a credit rating. Issuer ratings fees depend on asset size whereas those of issue ratings rely on the amount to be issued. PhilRatings is regulated by the Philippines Securities and Exchange Commission. It is also a founding member of ACRAA.

3.1.8 CRISP

Credit Rating and Investors Services Philippines Inc. or CRISP was established in 2008. It is not a member of ACRAA. It rates bond issuers and debt instruments covering real estate, food and beverage, as well as energy industries. Types of issues and rated institution are short-term issues, long-term issues, issuer, structured finance, real estate investment trust (REIT), and local government financing. CRISP rating committee and analysts are associated with Asian Institute of Management. Some are former employees of S&P and Moody's. CRISP is also an accredited rating agency regulated by the Philippines Securities and Exchange Commission.

From the above description of DCRAs in major ASEAN markets, there are thus relatively few established DCRAs present in the region. There are also relatively few newcomers in the rating business since the established DCRAs, most of which were formed during the 1980s and 1990s, have gained expertise and position in their respective domestic market. Most of established DCRAs are now members of ACRAA. The next few sections consider CRA characteristics that are essential for gaining further investors' acceptance. Many aspects of these characteristics have been incorporated into the ACRAA Code of Conduct to a certain extent.

3.2 Independence

Independence features in many parts of ACRAA Code of Conduct, notably independence of rating assignment from all sources of compensation and related businesses throughout the rating process and for all its analysts and employees involved (Annex 1). According to the Code of Conduct, the definition of potential conflict of interest can be specific to each DCRA, and it is recommended that DCRAs' Codes of Conduct also apply to their Boards of Directors. In addition, the general code adopted from IOSCO also refers to independence of rating action from potential political or economic effects or otherwise.

Almost all ASEAN DCRAs listed here provide information on the members of their rating committees and boards of directors. Thus market participants can make a certain level of assessment on any potential conflict of interest. DCRA's Code of Conduct can provide some assurance on independence of its analysts.

In addition to relevant regulations on credit ratings in Plus Three countries[24], Plus Three DCRAs provide their own Codes of Conduct which contain policies regarding independence and avoidance of conflicts of interest in accordance with their national regulations and IOSCO principles. Most of them are also ACRAA members and thus their Codes are similar and adhere to ACRAA Code of Conduct. China Dagong, for example, is generally devoted to provide independent, objective, fair, transparent, on-time and forward-looking credit information, and has Codes concerning avoidance of conflicts of interest by its employees, rating charges and separation of different businesses (firewall policies), in particular.

More importantly however, DCRAs have to demonstrate their independence from political or business influence since information on such issue as majority shareholding can lead to presumption, correctly or not, about the credibility of their rating actions. Thailand and the Philippines, for example, are affiliated with domestic government, public institutions and/or regulator[25]

(Table 6) due to their formation at an early stage of development. Other DCRAs

[24] *The regulatory agencies in charge of supervising CRAs in Plus Three countries are People's Bank of China (PBOC for issuing regulation), China Securities and Regulatory Commission (CRSC for bond exchange supervision) and National Development and Reform Commission (NDRC for enterprise bonds) in China; Financial Services Commission (FSC), Financial Supervisory Service (FSS) and Korea Financial Investment Association (KOFIA) in Korea; Japan Financial Services Agency (FSA) and Securities Exchange and Surveillance Commission (SESC) under the new IOSCO consistent CRA registration control and inspection system in accordance with the revised Financial Instruments and Exchange Act (FIEA) and Cabinet Office Ordinance in Japan. Source: ADB (2012). ASEAN+3 Bond Market Guide.*

[25] *18.52 percent of TRIS Corp., the parent company of TRIS Rating, is owned by the public sector (13.5 percent Government Savings Bank and 5 percent Ministry of Finance), and 30 percent of PhilRatings belongs to CIBI Foundation, Inc., a private not-for-profit credit information corporation established by the Central Bank of the Philippines, the Securities and Exchange Commission of the Philippines, and the Financial Executives Institute of the Philippines (FINEX).*

Table III-6: ASEAN DCRAs Corporate Rating Methodology

Country		ACRAA Members	Acronym	Year of est.	Affiliation	Tech Assit	Rating Duration	Methodology (Corporate)	Data Sources
Indonesia	1	✓	P.T. Pefindo	1993	S&P	S&P	30 days	Risk assessment based on industry risk, business risk and financial risk (corporate sector) including comparative analysis against similar competitors in the same industry and inter-industry analysis	Audited Financial Statements, Financial Projection, Prospectus, Information Memorandum, Annual Reports, business activities and other important information on the companies, Holding companies, Affiliates and Subsidiaris and company's Group in general
	2	✓	ICRA Indonesia	1991	Moody's	Moody's	30 days	Cash flow, business and financial risk analyses including assessment of promoters/management quality and competitive position	Direct business information, company visit, management's plans, outlook, competitive postions, funding policies and research from secondary sources
	3		P.T. Moody's Indonesia	1997	subsidiary of Moody's Indonesia (BVI) Ltd.	subsidiary of Moody's Indonesia (BVI) Ltd.	n/a	Moody's methodology with an emphasis on operational and financial risks	Moody's
Malaysia	1	✓	MARC	1995	none	none	6 weeks	Business and financial risk analyses, management and other qualitative factors, issue structure and terms	Preliminary research, company information, management meetings
	2	✓	RAM	1990	S&P Fitch	CRISIL	4-6 weeks	Industry, business, financial risk analyses and analysis of management quality	Business information on industry, operation and supporting statistics, financial information, principal terms and conditions of the issue, and management meetings on performance, prospects and plans
Philippines	1	✓	PhilRatings	1985			4-6 weeks	Business and financial risk analyses	Business and economic information including management and strategy, financial information and asset quality
	2		CRISP	2008	none	none		Industry, business, financial risk analyses and analysis of management quality	Audited financial statements, feasibility studies, historical and projected market share, management meetings, field visit
Thailand	1	✓	TRIS Rating	1993	S&P	S&P	6-8 weeks	Industry, business, financial risk analyses	Financial statements, site visits, management/audit committee meetings on track-record, teamwork, past successes and failures, vision, creditability and transparency

Source: Company websites and reports

have a largely diversified shareholder base but still concentrated mostly on domestically registered financial institutions which not only can be potential investors in the domestic market but also the issuers of rated securities themselves. Though the proportion of the shareholding held by a particular public or private institution is relatively small, it is still difficult for investors to evaluate the credibility of CRAs' ratings with respect to political independence and independence of ownership, particularly when looking from a regional perspective. In addition, since most DCRAs operate under the issuer-pay model, there is an incentive for DCRAs to give into issuer's rate shopping by awarding higher rating than otherwise in order to gain rating business in some countries where there are intense competition, including from the GCRAs or their affiliates.

Given national differences in rating standards and practices, rating harmonization across the region is thus important for investors' confidence in ratings assessed by the DCRAs. Another possible solution to ensure independence at the regional level is the provision of alternative benchmark ratings, possibly on a regional rating scale[26], by an independent body such as a Regional Credit Rating Agency (RCRA) whose rating standards are recognised regionally and internationally.

3.3 Transparency and Rating Methodology

ACRAA Code of Conduct also contains several elements related to DCRAs transparency that reflect their rating process, rating methodology, rating information and potential conflicts of interest (Annex 1). The Code of Conduct requires transparency of the rating process whereby rating policies, procedures, methodologies and criteria are well-defined and published, Rating Committee's discussion is documented and its decisions are subjected to a clearly described review or appeal process. All rating actions and assignments (along with information about DCRA's historical performance data) are disclosed, unsolicited ratings are distinguished, conflicts of interest are defined and published, and rating and non-rating fees are disclosed. DCRA's own Code of Conduct itself, including Code of Ethical Conduct applicable to its employees and board members, should be available publicly along with any changes and description on how these will be implemented and enforced.

Most ASEAN DCRAs listed in Table 5 publish rating process, timeframe and rating methodologies across issue types with varying details. Descriptions of corporate rating

[26] *So that sovereign and political risks, among other country-specific factors, have been taken into account.*

methodologies are broadly similar among DCRAs and involve industry, business and financial risk analyses, and analysis of management quality (Table 8). The data source used by DCRAs include information from meetings with company's managements and/or site visit on competitiveness position, future plans and outlooks, in addition to the examination of audited or non-audited financial statements and information from secondary sources. DCRAs thus have greater access to assess issuer's characteristics and utilize local knowledge and connections. Thailand TRIS Rating, for example, describes its solicited issuer-pay rating process which includes information gathering, analysis, rating committee meeting, rating announcement and monitoring on its official website with specified timeframe. The rating methodologies are classified into different types of rating issues and institutions[27] together with details of each quantitative or qualitative factor under consideration but without exact weighting scale between these factors or exact benchmarks for the quantitative factors.

Despite their similarity in the types of analysis being conducted, the actual rating methodologies used by DCRAs are different and not explicitly stated in all cases. For many DCRAs these are influenced by the ownership of or affiliation with GCRAs with different rating definitions and methodologies (Table 9).

Table III-7: DCRAs Affiliation with GCRAs

	S&P	Moody's	Fitch
Ownership	Taiwan: TRC	Korea: KIS Indonesia: ICRA	Korea: KR
Affiliation	Malaysia: RAM (4.9%) Thailand: TRIS (4.9%) Indonesia: Pefindo	China: CCXI (49%) Indonesia: ICRA	China: Lianhe (49%) Malaysia: RAM
Technical Assistance	China: Shanghai Brilliance Indonesia: Pefindo Malaysia: RAM Thailand: TRIS	China: Dagong Global Indonesia: ICRA	Malaysia: RAM
Methodology Similarity	Thailand: TRIS	China: CCXI, Dagong Korea: KIS Indonesia: ICRA	China: Lianhe Korea: KR Malaysia: RAM

Source: Company websites and reports

In order to increase their regional presence, GCRAs have deepened their involvement in

[27] *Short term rating, corporate, local government, government related entity, bank, securitization, hybrid securities*

the region and transferred technical expertise that in turn improves DCRAs' capacity. Plus three DCRAs also have technical cooperation among each other. In Korea, for example, NICE has Japan R&I and China Dagong Rating as partners in credit assessment. Korea SCI is also partnered with Japan JCR (Mitsui, 2009). ASEAN DCRAs are still in the process of gaining their expertise and expanding their rating capabilities in order increase their appeal to wider investor base however. A recent survey of issuers and investors in Malaysia indicated that professional bodies, banks, bond issuers and institutional investors still disagree that DCRAs communicate effectively with investors and issuers on issuer's performance, and that either investors or issuers understand the methodologies employed by the DCRAs (Mat Radzi and McIver, 2012). Thus there is room for improvement on transparency and rating methodology so that information provided by DCRAs becomes meaningful for issuers and investors and increases their confidence and usage of DCRAs' ratings.

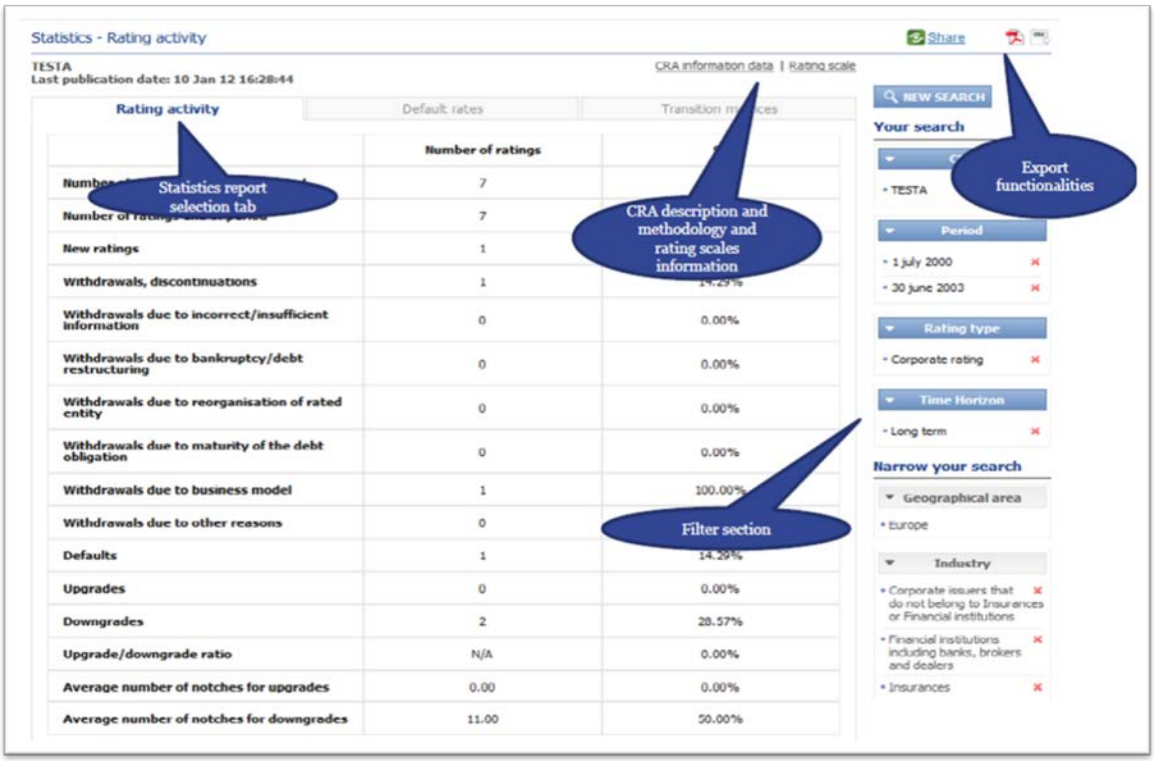
In the European Union (EU), the EU Security Market Authority (ESMA) requires registered CRAs whose ratings are used in the EU to provide rating information and statistics such as rating activities, default ratios and transition matrix to its central credit rating information repository (CEREP) which is open to anyone and can be used for commercial purposes. Even though, unlike the EU, there is no supra-national body in ASEAN+3 region to establish uniform region-wide rules and regulations and such regulatory gaps are to be addressed by the ASEAN+3 Bond Market Forum (ADB, 2012), a common CRA registration and reporting system for DCRAs in the region at the standards and contents which are useful for investors' assessment, for example, will help enhance ratings transparency and evaluation at the regional level. A RCRA can take the lead by adopting reporting standards and level of transparency that ensures sufficient understanding and confidence of investors. The Caribbean RCRA, CariCRIS, discussed in Section 2.3 is an example where benchmark ratings are intended to support greater information disclosure, better corporate governance and improved access to publicly available expert analysis (CariCRIS, 2005).

3.4 Accuracy and Consistency of Ratings, Quality of Analysis and Timeliness of Rating Actions

As mentioned in the beginning section, ASEAN+3 DCRAs are at different stages of development hence the relative rating performance between the more established DCRAs that manage to maintain their relative standing in the respective market and the smaller late comers are likely to differ. The regional market is also fragmented with most ratings done at

the national level under an oligopolistic market structure making intra-regional comparison and evaluation of

Figure III-4: ESMA's CEREP Database



Source: ESMA Central Repository (CEREP)

credit ratings difficult. ACRAA's rating harmonization program aims to achieve comparability among DCRAs in terms of rating methodology, rating criteria, definitions, benchmarks and overall rating process that will facilitate cross-border investment. ACRAA Code of Conduct also emphasizes transparency and timeliness of ratings disclosure that include a consistent and uniform default definition, and publication of a default and transition study with annual default rates for each rating category, 3-year average cumulative default rates and 1-year transition rates with guidance on the calculation method (ACRAA, 2011). This is because historical default studies with clear default definition, publication of rating policies, methodologies and practices, and databases for information disclosure and comparison are identified as determinants of credit ratings comparability and demonstrate elements of common standards among DCRAs. As outlined by the ADB (ADB, 2006), rating comparability is seen as a necessary first step in the Asian Bond Market Initiative's (ABMI) agenda to build tools for cross-agency and cross-border comparison of ratings, and compile

rating methodologies and databases of all ratings issued by agencies and of regulatory support measures across the regulatory environments of DCRAs.

Table III-8: TRIS Average One-Year Corporate Transition Rates (1994 – 2011)

Ratings	No. of Sample	AAA	AA	A	BBB	BB	B	C	D	Cumulative Withdrawals
AAA	14	78.57%	21.43%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	2
AA	81	1.23%	91.36%	6.17%	0.00%	0.00%	0.00%	0.00%	1.23%	7
A	307	0.00%	3.26%	93.81%	2.61%	0.00%	0.00%	0.00%	0.33%	25
BBB	285	0.00%	0.00%	7.02%	87.37%	2.11%	0.70%	0.00%	2.81%	25
BB	14	0.00%	0.00%	0.00%	14.29%	71.43%	0.00%	0.00%	14.29%	8
B	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	50.00%	50.00%	-
C	1	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	100.00%	-
Total	**704**									67

Source: TRIS Rating (2012)

Table III-9: PEFINDO One-Year Corporate Rating Transition Rate (1996 – 2010)

Ratings	No. of Sample	idAAA	idAA	idA	idBBB	idBB	idB	idCCC	idD	NR
idAAA	18	88.89%	5.56%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	5.56%
idAA	106	3.77%	84.91%	6.60%	0.00%	1.89%	0.00%	0.00%	0.94%	1.89%
idA	383	0.26%	8.88%	82.77%	2.09%	0.78%	0.00%	0.00%	3.39%	1.83%
idBBB	319	0.00%	0.63%	14.11%	66.46%	4.70%	1.25%	1.88%	7.84%	3.13%
idBB	65	0.00%	0.00%	0.00%	20.00%	21.54%	6.15%	4.62%	30.77%	16.92%
idB	23	0.00%	0.00%	0.00%	8.70%	13.04%	34.78%	4.35%	30.43%	8.70%
idCCC	19	0.00%	0.00%	15.79%	47.37%	10.53%	10.53%	5.26%	10.53%	0.00%
Total	**933**									

Source: PEFINDO (2011)

Table III-10: S&P Average One-Year Asia Corporate Rating Transition Rates (2000 – 2011)

Ratings	No. of Sample	AAA	AA	A	BBB	BB	B	CCC	CC	C	SD,D,R	Withdrawals
AAA	47	91.39%	6.53%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	2.08%
AA	416	0.69%	92.64%	2.57%	0.00%	0.00%	0.28%	0.00%	0.00%	0.00%	0.00%	3.82%
A	998	0.00%	1.32%	90.74%	1.86%	0.24%	0.34%	0.00%	0.00%	0.00%	0.00%	5.50%
BBB	1143	0.00%	0.00%	3.78%	82.50%	3.43%	0.00%	0.00%	0.00%	0.00%	0.00%	10.29%
BB	821	0.00%	0.00%	0.00%	6.41%	78.58%	4.61%	0.00%	0.13%	0.00%	0.11%	10.17%
B	465	0.00%	0.00%	0.00%	0.00%	8.34%	73.13%	2.17%	0.56%	0.00%	1.94%	13.86%
CCC	61	0.00%	0.00%	0.00%	0.00%	0.00%	16.61%	57.04%	5.56%	0.00%	7.66%	13.14%
CC	18	0.00%	0.00%	0.00%	0.00%	0.00%	12.50%	15.63%	35.42%	0.00%	14.58%	21.88%
SD,D,R	53	0.00%	0.00%	0.00%	0.00%	0.00%	1.39%	5.93%	2.78%	0.00%	29.65%	60.26%
Total	4022											

Source: Calculation from CEREP statistics. Retrieved on 5 February 2013.

Table III-11: Moody's Average One-Year Asia Corporate Rating Transition Rates (2000 – 2011)

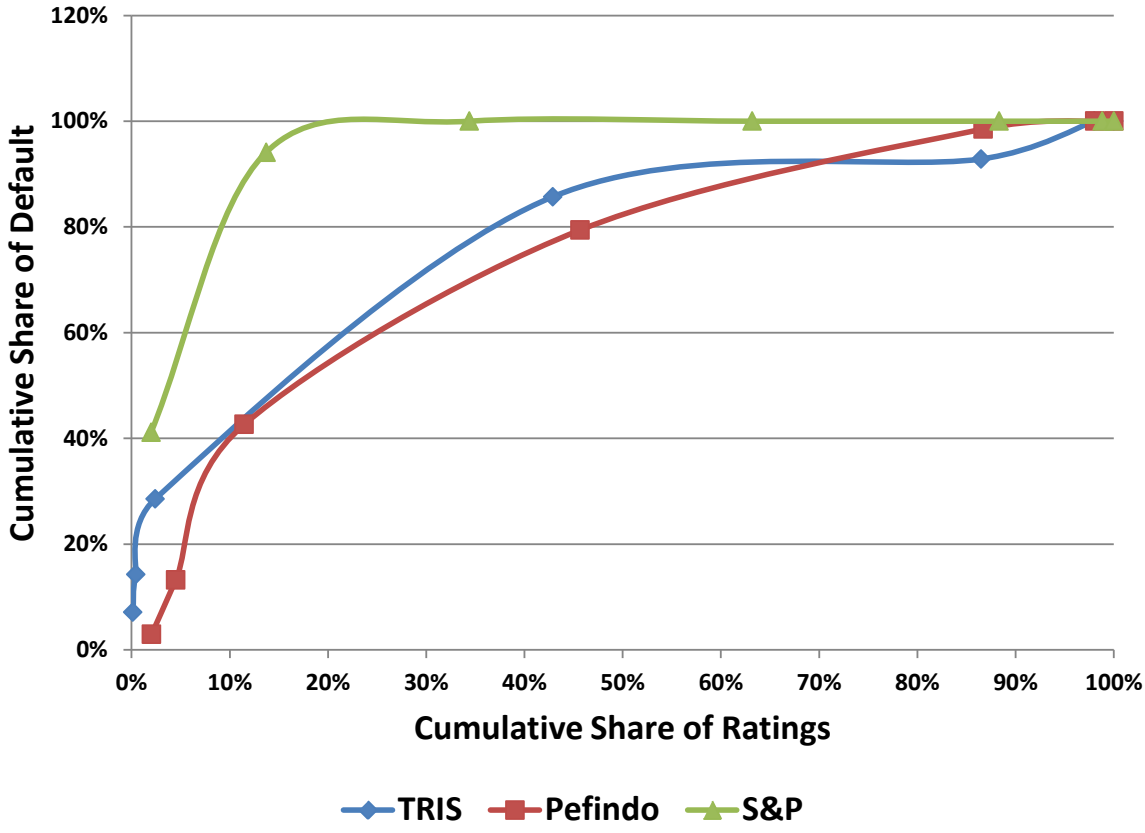
Ratings	No. of Sample	Aaa	Aa	A	Baa	Ba	B	Caa	Ca	C	Default	Withdrawals
Aaa	45	85.24%	8.93%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	5.83%
Aa	364	1.68%	90.70%	5.09%	0.00%	0.00%	0.21%	0.00%	0.00%	0.00%	0.00%	2.32%
A	1036	0.00%	1.50%	87.91%	4.15%	0.13%	0.26%	0.00%	0.00%	0.00%	0.00%	6.04%
Baa	1073	0.00%	0.00%	5.20%	83.70%	1.42%	0.10%	0.08%	0.00%	0.00%	0.10%	9.41%
Ba	391	0.00%	0.00%	0.00%	12.77%	69.20%	5.31%	1.08%	0.67%	0.18%	1.49%	9.31%
B	198	0.00%	0.00%	0.00%	0.33%	10.86%	67.38%	4.68%	1.45%	0.00%	3.71%	11.60%
Caa	30	0.00%	0.00%	0.00%	0.00%	0.00%	15.61%	42.06%	3.70%	0.00%	11.11%	27.51%
Ca	19	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	36.67%	0.00%	0.00%	63.33%
C	2	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	50.00%	0.00%	50.00%
Total	3158											

Source: Calculation from CEREP statistics. Retrieved on 5 February 2013.

Most ASEAN DCRAs that are ACRAA members have thus provide historical default studies that allow investors' use of the information in order to evaluate their investment and structure their exposure, in addition to evaluate DCRAs rating performance. Table 10 and 11, for example, show one-year long-term corporate rating transition matrices for Thailand's TRIS (1994-2011) and Indonesia's PEFINDO (1996-2010) respectively that are obtained from their corporate default and rating transition studies. Table 12 and 13 also show similar transition matrices for S&P and Moody's that are obtained by calculating average one-year transition probabilities over the 2000-2011 period from annual transition rates for their long-term corporate ratings in Asia. The annual rating statistics are available at ESMA's CEREP database. Transition rates along the diagonal of the transition matrix indicate the probabilities that issues in the static sample remained in the same rating category throughout the period, whereas off-diagonal entries in a particular row show the likelihood of an upgrade or downgrade from the referenced row rating category to another rating as indicated in the reference column.

If the S&P transition matrix (Table 12) is used as a benchmark for comparison, TRIS's (Table 10) and PEFINDO's (Table 11) ratings are notably more volatile at the BBB category and below, having smaller percentages of ratings on the diagonal entries and much more variability of rating transitions to other categories, in the case of PEFINDO, indicating lower rating performance (i.e. more frequent changes of ratings possibly due to more reactive ratings as opposed to predictive or 'through the cycle' ratings). Although the 'A' and 'BBB' categories for the DCRAs have large numbers of observations (around 300-400 for each rating category cumulatively over the sample period), there are small numbers of sample at the highest and lowest rating grades. TRIS has 18 observations cumulatively for AAA category, 14 for BB and 3 for categories below BB. PEFINDO has 18 observations for the idAAA class, 65 for idBB and 42 for other grades below). S&P's transition matrix contains information from greater number of observations (almost 4000, counted and sum each year from annual information available in the EU CEREP database on a static pool basis) due to greater number of ratings for Asia region as a whole, whereas those of the two ASEAN DCRAs have less number of observations (704 for TRIS and 933 for PEFINDO) due to fragmented nature of the markets.

Figure III-5: Cumulative Accuracy Profiles



Source: Calculation based on data from TRIS Ratings (2012), PEFINDO (2011) and CEREP database

Figure 6 shows Cumulative Accuracy Profile (CAP) plots for S&P and the two DCRAs where default information is approximated from their respective transition matrices. The CAP plots show cumulative shares of default (vertical axis) for each rating category from lowest rating to highest rating (horizontal axis). The plot for S&P is closest to an ideal curve where most defaults occur with lowest rating categories. The 'accuracy ratio', ratio of the area between the CAP curve and the 45-degree line to the total area above the 45-degree line, can also be calculated. The calculated ratios for the CRAs are derived here from their corresponding 'average defaulter position', Moody's measure of ordinal rating performance (Moody's, 2011) which shows average shares of ratings above default for defaults that occur in all rating categories. Thus a higher average defaulter position, like the accuracy ratio, indicates better rating performance. The calculated accuracy ratios for S&P, TRIS and PEFINDO are 88.42%, 52.27% and 49.12% respectively and the corresponding average

defaulter positions are 94.21%, 76.13%, and 74.56% respectively. In practice, if a RCRA can provide region-wide coverage of benchmark ratings then the information provided by the RCRA can be used to assess the accuracy of its rating relative to those of GCRAs, for example. And subsequently similar comparison for the assessment of DCRAs, given that the numbers of ratings have significantly increased as a result of greater comparability, once the market is harmonized and has a regional scale benchmark to compare against.

Since most ASEAN DCRAs are ACRAA members and thus adhere to the ACRAA Code of Conduct, the harmonization of CRAs regulation or reporting standards is feasible by agreeing on how to adopt the IOSCO codes effectively with a particular emphasis on credibility of CRAs that are based on their independence, transparency and rating comparability. This will help domestic and global investors to better understand credit ratings by DCRAs and enable them to better participate in the regional bond market.

IV. Conclusion and Recommendation

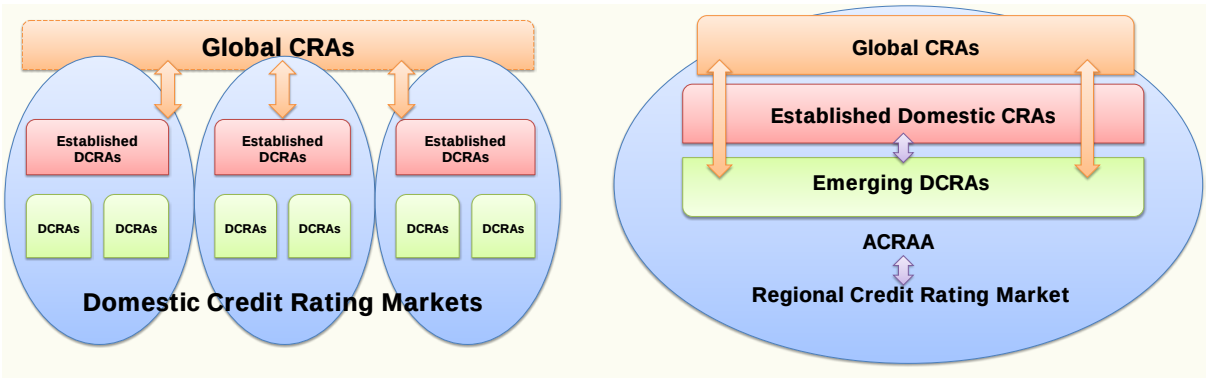
Given the present conditions of ASEAN+3 CRAs, there are potential benefits in terms of regional credit market integration and expansion for greater investors' access and investment opportunities through accelerated rating harmonization process and the establishment of a regional credit rating agency (RCRA). The resulting recognition of rating standards and practices as well as alternative regional benchmark ratings under internationally recognized rating standards of an independent RCRA can lead to significant improvement in DCRAs' credibility enhancing characteristics (Independence, Transparency, Accuracy and consistency of ratings, Quality of analysis, and Timeliness and effectiveness of rating actions) necessary for gaining investors' acceptance.

A regionally coherent credit rating market development such as one that follows the establishment of a RCRA will consist of practical measures for implementation such as the utilization of an alternative/common regional scale, a regulatory system for CRAs registration and reporting, support for DCRAs capacity building, and agreement on essential best practice and monitoring. There is currently a gap between services provided, on the one hand, by GCRAs with limited capacity in terms of number of employees and analysts to cover greater number of regional issuance, and on the other hand, services by DCRAs that are limited to their respective country coverage. Thus an independent regional CRA, that leverages on the expertise of GCRAs and greater local reach of DCRAs as well as coordination and

facilitation from ACRAA, and financial and technical resources from international organizations under a roadmap for market acceptance would facilitate regional bond market development by improving regional comparability, coverage and market access.

In order to effectively create a regional credit rating system that is able to facilitate cross-country and cross-currency issuances in the context of intra-regional investments as well as outward investment in other regions by local firms, the roles and interests of concerning parties need to be considered. Established DCRAs with specialized local knowledge and reach have the ability to lead local market development in own countries and new markets. GCRAs looking for market expansion, local knowledge and connections can help provide technical support, global expertise and access to international investors. There have been interests among GCRAs for involvement in the region and some established DCRAs notably in the Plus Three countries have their eyes on the regional and global markets. But the initiatives have been from individual CRAs on an individual basis, partly as a result of the fragmented markets and oligopolistic structure that limits profitability potential for new DCRAs as latecomers. An establishment of a RCRA with participation of DCRAs and GCRAs will accelerate the movement towards their more integrated relationship and continue market momentum that already exists in a regionally coherent way that benefits regional market development.

Figure IV-1: Present and Future Regional Credit Rating Systems



Public institutions, including international organizations and local regulatory authorities, have the role in ensuring that CRAs interests are aligned and the RCRA plays a leading and complementary role in regional and local market development. Consistent with its objectives of enhancing DCRAs' capacity, quality of rating process and rating comparability in order to assist Asian Bond Market development and cross-border investment throughout the region,

ACRAA can help coordinate and facilitate the participation of local and global CRAs in establishing the RCRA, possibly through a broad-based shareholding structure. ASEAN+3 members in the more developed markets such as China, Korea, Japan and Singapore can serve as initial funders. Sovereign ratings and other considerations necessary for credit risk adjustment to arrive at a regional rating scale by RCRA such as regulatory risks, transferability and convertibility risks, and parent-subsidiary links, etc., can be endorsed by the more established DCRAs and GCRAs and used effectively as an alternative regional benchmark. The rating and reporting processes and standards established by RCRA also serve as a regional reference for best practices accepted by international investors. Since most DCRAs are ACRAA members thus adhere to the ACRAA Code of Conduct, the harmonization of CRAs regulation or reporting standards is feasible by agreeing on how to adopt the IOSCO codes effectively with a particular emphasis on credibility of CRAs that are based on their independence, transparency and rating comparability. Therefore domestic and global investors who understand RCRA rating standards, methodologies and procedures will also have better understanding of credit ratings by DCRAs and enable them to better participate in the regional bond market development.

Near-term measures to support the establishment of a RCRA include:

1) Gathering interest from potential CRA shareholders/members with initial public sector financial support to build up market reputation and credibility;

2) Arrangement among GCRAs and established DCRAs with capacity to evaluate sovereign risk to provide a common/alternative regional rating scale (as already done individually by GCRAs like S&P and established DCRAs like RAM rating, for example); 3) Market sounding/book building exercise to pool potential issuers and assess investors' demand through the support of shareholder members (DCRAs in local market and GCRAs in international market); and 4) Leverage information required for in-depth rating process from local sources through DCRAs and leverage surveillance capability and technical expertise of international organizations like ADB, AMRO and the IMF.

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