

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

March 2013
Institute for International Monetary Affairs

1. International Discussion on the Credit Rating Agencies (CRAs)

After the Enron's collapse and the Lehman Shock, the main topics of international discussions on CRAs have been concentrated on (1) Independence of the CRA and Conflicts of interest, (2) Oligopoly, (3) Credibility of the rating method and data on structured finance and (4) Over-dependence on CRAs. Over-dependence on CRAs was considered to amplify pro-cyclicality in the market. The Financial Stability Board published the principles for reducing reliance on CRA rating in 2010. The argument of over-dependence is, however, rooted mainly on the experience of inappropriate practices in the US and European financial markets. This argument should be carefully interpreted in Asia, where the financial markets are still premature and the major challenge is how to develop CRAs.

2. Credit Ratings in Asia: Japan and ASEAN countries

There is no significant difference in rating methodologies in Japan and ASEAN. CRAs in Japan first evaluate the default risk and then evaluate the recovery risk for individual obligations. The analysis of the issuer's default risk forms the base of the assessment and determines the issuer's general capacity to fulfill all of its financial obligations. Credit rating process in Japan starts with a request for credit rating then goes through request for submission of data to analyze, interviews and interacting with the management of the issuers, rating committee, informing issuers of ratings decisions, and review of the credit rating.

The rating methodologies of the ASEAN-based CRAs comprises of business analysis – which includes industry analysis, business diversification, competitive position, etc. and financial analysis – which covers profitability, funding structure, etc. Rating process follow almost the same as in Japan.

3. Regional Credit Rating Agencies in Europe and Latin America

In Europe there is no region-wide credit rating agency. But the discussion of region-wide regulations has started as a result of the global financial crisis in 2008. Now the European Securities and Market Authority are given full authority to supervise credit rating agencies.

In Latin America, there is the regional credit rating agency in the Caribbean region.

Stakeholders in CariCRIS are local financial institutions, central banks, and regional development bank and the rating committee is independent from both shareholders and management.

It should be noted that the high degree of economic and systematic integration in this region was behind the foundation of the CariCRIS Harmonizing corporate legal systems and accounting standards would be an important precondition to assigning region-wide credit ratings.

4. Analytic discussions and policy recommendations of the IIMA

4.1 Introduction of National Scale Ratings by global credit rating agencies

Although bond markets in emerging countries are a closed universe, where market activities are conducted mainly by local entities, global credit rating agencies (GCRAs) are attempting to enter into those markets as economies of those countries develop. National scale ratings (NSRs) are rating products strategically designed by such GCRAs to penetrate domestic markets.

NSRs are defined as relative scale of creditworthiness within a credit universe of each market. Although GCRAs officially explain that NSRs are neither comparable with global scale ratings nor with NSRs of other countries, they are being recognized among not a few investors to function as credit references that links domestic credit universes and the global credit universe. It is important to know a certain number of high credit local companies are forming a credit universe of the Asian regional market and GCRAs has started providing NSRs, which has potential to be evolved to a comparable measure.

4.2 Commercial banks' capacity to conduct horizontal comparison of risk assessment

In Asia, where bank finance is still a major financial intermediary, region-wide commercial banks have its own internal rating system in a regionally comparable way. They analyze quality of their loan assets by combining information of macro economies and each corporate client which they are privileged to access.

The detail of methodology is not disclosed but two things should be noted: (a) region wide comparison of corporate credit is possible by scrutiny of each individual company's information and (b) a large number of potential rating targets are emerging in Asia. They may be known among local lenders in each individual universe. But they are not recognized as a group which is ready to form a region wide credit universe. Possibly they would become targets of "regional scale ratings" and this group of companies should be made use of in creating new schemes that could improve the comparability of local credit ratings in Asia.

4.3 Policy recommendations

(1) A guidebook for basic rating methodologies and rating criteria

To help DCRAAs across the region develop rating methodologies and criteria that will make their ratings more comparable, it is proposed that a project be undertaken to develop a guidebook on common basic rating methodologies and basic rating criteria. The guidebook could establish minimum standards for the credit rating process and transparency in this process and should address different industries and sectors in separate chapters.

(2) Convergence of accreditation criteria for CRAs

ASEAN+3 could convene a forum for regulators to look at best practices and develop a set of minimum standards in the region for the accreditation of CRAs.

(3) Convergence of financial standards and regulations

Comparability of credit ratings across markets won't be promoted without convergence of financial reporting standards and disclosure rules. Such measures would be best undertaken within a broader regional framework.

(4) An official information website viewing credit information of issuers

Our core policy recommendation is to create a common credit information website on which (a) bond issuers, initiated by local credit rating agencies or securities houses can upload their corporate information for promotion of their IR, (b) investors can access information of ratings in NSRs and credit information of issuers and (c) CRAs can provide their ratings to the issuers. The exchange of those information takes place on this same site so that all parties can recognize a regional credit universe in a visualized way. The information of this website is collected, processed and provided on standardized templates so as to urge standardization of input information and regulations behind it.

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

Instead of historical default data, this scheme uses current corporate information as a clue to overcome the problem of incomparability of NSRs. By using such information, investors can examine for themselves the level of national scales by comparing issuers' ratings with their corporate information. This scheme requires such a proactive but very basic engagement of self-examination of investors to improve the comparability of NSRs.

5. Analytic discussions and policy recommendations of the AKI

5.1 Necessity of regulatory harmonization

There are variations in the manner of licensing and supervision DCRA in the region. In the light of these diverges there is a need for harmonization of regulatory frameworks in order to enhance harmonization of credit ratings of various DCRA in various jurisdictions.

5.2 Feasibility of a regional credit rating agency

The proposed establishment of a regional credit rating agency (RCRA) in Asia is premised on addressing the inadequacies of the current DCRA in exploiting its potential contributions in the development of the bond market in the region. However, the idea of RCRA, though it is well-intentioned, is confronted with difficult challenges including major institutional, technical and reputational constraints, inadequate mechanisms in the exchange of credit information, variability of standards used in financial reporting, thinness of the actual market for the viability of the enterprise, the question on governance structure as well the regulatory framework that will oversee the regional entity.

5.3 Alternative choice – System of Mutual Recognition of Credit Rating (SMR)

Despite these limitations on the practicability of establishing a RCRA, there are several avenues that may be pursued some of the constraints. The option of establishing a System of Mutual Recognition of Credit Rating (SMR) among regulatory agencies has some prospects.

What may be pursued is the route of accreditation of DCRA in various jurisdictions. This may require that regional bodies like ACRAA and ASEAN Bond Market Forum (ABMF) will have an active role not only in the accreditation process but in overcoming some of the limitations. The accreditation of DCRA may be given by ACRAA based on a certain criteria accepted globally and applicable regionally. The association can also address the institutional, technical, reputational constraints of DCRA through its programs that harmonize standards, procedures, methodologies, quality of human resources, and code of ethics.

5.4 How to establish System of Mutual Recognition of Credit Rating (SMR)

In a System of Mutual Recognition of Credit Rating (SMR), there is a need to strengthen provisions on investor protection, creation of independent institutions, and enforcement

of expected code of conduct for parties involved in cross-border investment. These are already discussed in the ABMF but such discussions should also include credit ratings agencies.

ASEAN+3 member countries should re-examine some of the region's regulatory frameworks that have been recognized by the European Securities and Markets Authority as equivalent to the EU regulatory framework on credit rating agencies.

5.5 Policy recommendations

Specific recommendations include among others are:

- (1) To recognize the potential of ACRAA as a major instrument in promoting cross border investments and in enhancing the Asian bond market.
- (2) For governments, regulators, and regional financial institutions to encourage and support the Ratings Harmonization Programs of ACRAA such as training program for capacity building, default data study and enforcement of the ACRAA's code of conduct Fundamentals.
- (3) To establish a System of Mutual Recognition of Credit Rating in ASEAN+3.
- (4) To move closely coordinate the work of ABMF, ABMI, ACMF, and ACRAA in harmonizing standards and practices in credit ratings.
- (5) To pursue parallel efforts of harmonizing regulatory frameworks in aid of enforcing an effective system of oversight over regional financial markets.
- (6) To promote the establishment of at least one DCRA in every ASEAN country and towards this end, to enlist the participation of ACRAA.
- (7) To restore the ABMI Task Force on Working Group on Credit Ratings and include ACRAA as member.
- (8) To fund and conduct a study on a Final Concept and Implementations Plan for a Systems of Mutual Recognitions of Credit Ratings for ASEAN +3.