

THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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Meeting Paper 8-A **Proposals on Promoting the Development of Credit Rating Agencies in the Region**

Office of the Advisory Group Chair

- PURPOSE** For consideration.
- ISSUE** Proposals on Promoting the Development of Credit Rating Agencies in the Region
- BACKGROUND** Credit rating systems can play an important role in promoting cross-border investment in local currency bonds across the region. Given high-quality credit ratings for bond issues that can be compared across markets with a sufficient level of reliability, investors can be encouraged to expand their bond investments in the region. This will significantly contribute to the development of local currency bond markets,
- PROPOSAL** Recommend that APEC Finance Ministers endorse a project to develop a regional guidebook on common basic rating methodologies and basic rating criteria for key industries and sectors with the collaboration of the Association of Credit Rating Agencies in Asia; convergence of accreditation criteria for CRAs across markets; and convergence of financial standards and regulations to facilitate comparable credit ratings across markets.
- DECISION POINT** Endorse the recommendation.

ENHANCING THE POTENTIAL OF CREDIT RATING AGENCIES TO FACILITATE CROSS-BORDER INVESTMENT IN LOCAL CURRENCY BOND MARKETS

This year, the Advisory Group revisited its previous work on credit rating agencies in light of the new developments in the region's bond markets, including the growth of the region's credit rating industry.

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

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

- Domestic CRAs (DCRAs) are the dominant industry players in the region's emerging local currency bond markets. Divergent rating practices among DCRAs across the region, which to a large extent are also due to differences in the local environment, pose a serious problem for cross-market comparability. Major areas of divergence include default definitions, rating principles, frequency of rating reviews, transparency of rating methodology and criteria, standard of disclosure in rating reports and timeliness in rating actions.
- The local ratings currently used by DCRAs for domestic bonds are based on relative scales and not on absolute scales that are used in global ratings, which are meant to be comparable across markets. These local ratings represent relative ranking of creditworthiness within a particular market and are intended for use by investors in relation solely to their exposure to this market. This problem is exacerbated by the wide divergence among sovereign ratings of economies in the region, on which the local scale ratings are based.
- Local currency bond markets across the region differ in terms of levels of development, financial reporting standards, disclosure practices, legal and regulatory regimes and legal protection for investors. Consequently, it is very difficult for investors without a clear understanding of these differences to use credit ratings to compare the riskiness of financial instruments across these markets.
- Investors have yet to develop sufficient trust in ratings issued by most emerging market DCRAs in the region, many of which have been only established in the 1990s or later. Global credit rating agencies have accumulated more than a century of performance experience over a number of economic cycles in the advanced markets behind them. In contrast, DCRAs in the region's emerging markets are still very much in the process of developing robust and proven methodologies, as their markets and instruments have not yet been in existence for a sufficiently long period and much relevant data is not yet available.
- While local currency bond markets will need a robust and trusted credit rating industry in order to grow, the development of the credit rating industry in most of the region's

emerging markets, including its viability as a business and ability to attract and retain talent is, in turn, dependent on the growth of these markets.

Addressing these challenges in a way that supports sound market mechanisms will involve a long-term evolutionary process, whose direction is still difficult to discern at this point, given the still early stage of development of financial markets and cross-border financial cooperation and integration processes and structures within the region. As the value of CRAs to investors lies in their independence to rate according to each one's stated criteria and methodology, it is important to carefully design interventions by government and public institutions in promoting the development of the credit rating industry, so as to enable CRAs to retain such independence.

Market competition is also important in promoting a healthy industry and the continuous development and enhancement of rating methodologies and practices that will benefit investors and issuers. For this reason, it is important that measures to promote robust credit rating systems with increased cross-border investment in the region's local currency bonds in mind be designed to allow a natural evolution of the market for credit ratings, while creating conditions that would be conducive to this market's development.

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

Development of a guidebook for basic rating methodologies and basic rating criteria for selected industries and business sectors

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

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

- A conference to identify, select and prioritize the industries and business sectors for which methodologies and criteria are to be developed.
- Compilation of published methodologies and rating criteria of ACRAA members in these industries and sectors for comparative study.
- A series of workshops, each one featuring a number of the selected industries, to focus on updating of basic knowledge of and current developments in each selected industry and sector, describing the nature and peculiarities of each industry and sector, their products and services, their markets and competition and their regulatory environment. Industry and sector experts will be invited to make the presentations with a view to making comparisons across markets. These workshops would address three principal questions:
 - What are the key drivers of viability and profitability of companies operating in the industry or sector?

- What is the nature and peculiarities of the business risks specific to the industry or sector, and how are these translated into credit risks?
- How are these business and credit risks mitigated or avoided?
- The output of the workshops and the published methodologies and criteria collected from ACRAA members would be used to draft a Guidebook on Basic Rating Methodologies and Basic Rating Criteria.
- The guidebook would be reviewed by a panel and editorial board including ACRAA members and relevant experts, finalized in a conference and presented for adoption by ACRAA members. It will be published, disseminated and also promoted for adoption by other DCRAAs in the region.

Promoting convergence of accreditation criteria for CRAs across emerging markets in the region

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

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

Promoting convergence of financial standards and regulations to facilitate comparable credit ratings across markets

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