



The Advisory Group on APEC Financial System Capacity-Building

A Public-Private Sector Initiative

Document: AGFSCB 27-015
Draft: **FIRST**
Source: ABAC Vietnam
Date: 25 February 2007
Meeting: Seattle, USA

First Meeting 2007

28 February 2007

The Grand Hyatt Seattle (Menzies Suite, 6th Floor)
Seattle, U.S.A.

AGENDA ITEM 4.1

PAPER 4.1-C

Summary of a Conference on Promoting the Development of the Credit Rating Industry in the Asia-Pacific Region

ABAC Vietnam

SUMMARY OF INTERNATIONAL CONFERENCE ON “PROMOTING THE DEVELOPMENT OF CREDIT RATING INDUSTRY IN THE ASIA - PACIFIC REGION”

Hanoi, June 12, 2006

I. Executive Summary:

Credit rating agencies (CRAs) are of vital importance in our financial systems today. Sustainable economic development requires the presence of well-designed and developed credit rating mechanism, apart from other conditions. Credit rating service is also of vital importance to SMEs, since the formation of the industry shall greatly improve their access to financing, thereby contributing to overall economic growth.

The conference on “Promoting the Development of Credit Rating Industry in the Asia - Pacific Region”, co-organized by the Asian Bankers Association (ABA), APEC Business Advisory Council (ABAC), Vietnam Chamber of Commerce and Industry (VCCI) and Vietcombank, aims at highlighting the boost that CRAs provide to growth and development, which falls very much in line with the work the ABAC is currently undertaking. Valuable outcomes of this conference shall be considered in the ABAC’s report to APEC’s Finance Ministers Meeting this September.

As indicated by the presenters, the regional capital market has been growing rapidly, particularly in East Asia, whilst financial integration is being accelerated. To further develop the regional capital market, promoting information disclosure is seen as an important measure, in which development of regional credit rating industry will play a key role. The presenters also identify key necessary conditions for development of regional credit rating industry. *Firstly*, the regional market for credit rating services must be of sufficient scale. *Secondly*, CRAs must be able to operate independently. *Thirdly*, the regulatory framework must be adequate and enforceable. *Fourthly*, the professionalism of CRAs needs to be built up and continually strengthened. *Besides*, the expansion of a network of domestic CRAs should be signified. Simultaneously, rating activities among domestic CRAs in the region should be harmonized. *Finally*, there must be a regional organization to establish and enforce “Common Best Practices and Norms”.

The participants then make some policy recommendations for the development of regional credit rating industry. To begin with, the market perception of credit ratings should be properly strengthened. Besides, the environment, both economic and regulatory, for rating activities in the region should continue to be improved. Training provision, particularly by the countries with more experience in developing CRAs, is also critical to enhance technical competence and expertise of credit rating analysts. Efforts to liberalize the capital markets are of equivalent importance to accelerate regional integration of capital market and to expand the market for credit rating activities. Meanwhile, the network of domestic CRAs should be built up, with special attention to consolidating the linkage between the members. Finally, the role of continuing study on common rating practices, methodologies and policies among domestic CRAs should not be under-estimated.

II. Conference Outcomes

As implied by its theme, this international conference seeks to provide participants with deeper knowledge of credit rating in the Asia - Pacific. Among the variety of contents, the key issues addressed at the conference include the significance of credit rating industry, the trend in credit rating development in the Asia - Pacific, and the conditions to develop regional credit industry and policy recommendations.

1. Significance of credit rating industry

Credit rating can be defined in a number of ways. Most popularly, it is seen as the determination of “credit risk” inherent in a specific security, where the risks may include, but not limited to, country risk, sector risk and enterprise risk. As a source of forward-looking information, the significance of credit rating service by professional agencies can be justified on some grounds.

Firstly, since such rating implies the inherent credit risks of security issuers, information asymmetry between the issuers and investors can be reduced. To have a security rated, potential issuers have to supply necessary information about their financial situations. Such information is in aggregate processed more efficiently and accurately by the CRAs, which usually have sufficient scale and expertise to provide compiled and useful credit information about issuers to a large number of investors. Meanwhile, the information supplied by issuers can be compiled by CRAs into some simple grades, thereby preserving information confidentiality for the issuers. Moreover, the ratings can be made easily comparable, which provides investors with some assessment of alternative investment choices.

Secondly, in doing so, credit rating agencies contribute significantly to the enhancement of transparency and efficiency in the capital market. More information internal to the issuers is combined in credit rating process, and thus, the requirement of credit ratings in issuing securities generally promotes transparency in the market. At the same time, as credit ratings reduce information asymmetry between issuers and investors, it facilitates more efficient channel of funds at the aggregate level.

The experience of India indicates that as CRAs gradually gained public awareness and acceptance, demand for their services has been growing, even for instruments that are not required to be rated by regulations. Such growth was exhibited in all aspects, from volume and extent of coverage, to type of issuers, number of issuers and sectors. It has also been found that the yields are generally more closely aligned with credit ratings.

2. The trend in credit rating development in the Asia - Pacific

Local currency bond market in the region, particularly in the East Asia, continues to expand rapidly - with substantial improvement in width, depth and market infrastructure - which gives rise to the increasing demand for credit rating services. Numerous studies (eg. by ABA, PECC, ADB and ABAC) and measures have been implemented to promote further development of regional bond market. As the development trend of such market is expected to continue, the outlook for credit rating industry is relatively positive.

On the other hand, the high net savings ratio in the region also results in the large portion of funds being channeled to the regional capital market. Meanwhile, the firms in the region seem to rely more on bank finance than other debt instruments. There has also been a recent trend away from USD

financing as the only form of debt available for developing market countries. In the context of information asymmetry as a major obstacle to financial intermediaries and savers to find the right investment in the region, credit rating emerges as an important and effective solution.

Another factor contributing to the positive outlook of credit rating development in the Asia – Pacific is the integration of regional financial markets. There has also been an emergence of a regional bond market where bonds issued in Asian currencies can be freely invested in and traded by both domestic and foreign participants.

Over the last 5 years, global CRAs have started entering local markets in the region. They have contributed to the setting up of local credit rating counterparts, and encouraged local analyst participation for international transactions. Such rating service is also applied to other debt instruments such as bank loans, other long term contracts, etc., rather than just to bonds. Yet across the region, ratings are yet to be comparable. The development of regional credit rating industry is also difficult due to the lack of harmonized regimes, such as in financial reporting, insolvency laws, etc.

3. Conditions to develop regional rating industry and policy recommendations

Certain conditions need to be met for effective development of regional credit rating industry (CRI). *Firstly*, the regional market for credit rating services must be of sufficient scale, with sustainable development trend. Under this prerequisite, the CRAs will enjoy a more favorable operating environment, with higher potential of achieving economies of scale – apart from higher probability of making profits.

Secondly, the value of credit rating service to capital market development can only be consolidated on the ground of its independence. Otherwise, credit rating process may be influenced by the issuers to the extent that the assigned grade is misleading. Such misleading results are detrimental because once the ratings are judged by investors to be too inaccurate and incredible, it is hard or almost impossible to build up investor confidence again.

Thirdly, the presence of an adequate and enforceable regulatory framework should be signified for the development of CRI. On the one hand, adequate regulations are required to keep the above-mentioned independence from being intentionally abused by the CRAs and the issuers. On the other hand, in the early stage of development of CRI, the role of regulatory framework may prove to be vital since it helps to create a market demand for rating services via mandating the credit ratings upon issuance of securities. The regulations are also necessary to ensure that the issuers provide as accurate information as possible, and that the CRAs do not use such information for other private benefits.

Fourthly, the professionalism of CRAs needs to be built up and continually strengthened. With their role, the CRAs should fully acknowledge the importance of providing an accurate score, for the benefits of users as well as for the sustainable development of credit rating industries in the region. Besides, skills and expertise of these agencies need to be strengthened so that they can produce better forward-looking credit rating score.

A *fifth* condition, apart from those general conditions, for development of regional CRI is the expansion of network of domestic CRAs. Ideally, there should be at least one domestic CRA in each country in the region, since the local CRAs are often better than the international counterparts at accessing to local credit information sources. Also, the local market may be insufficient to support fully-owned operations by international CRAs. With the number of countries in the region, there can

exist a unique CRI in the region. As emphasized by the Association of Credit Rating Agencies in Asia (ACRAA), developing local CRAs effectively is the first building block to regional CRI. However, the domestic CRAs must meet certain minimum qualifications of operations, to assure competence and integrity across the region.

For the development of regional CRI, another necessary condition is harmonization in ratings among domestic CRAs in the region. This requirement implies more than the adoption of the same rating symbols by domestic CRAs. Harmonization here means that the CRAs in the region employ substantially the same methodologies, with established criteria, though there might be some appropriate variations to take into account differences in industry characteristics. In addition, qualified rating analysts must also be present to consistently apply the rating methodologies and criteria.

Finally, countries in the region should agree on the foundation of regional organization with the institutionalized role of establishing and enforcing “Common Best Practices and Norms”. These will serve to benchmark the domestic CRAs, one against the others, to help establish the pattern and enforce observance of high service standards, and to be the instrument for facilitating ratings harmonization.

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Having stated those necessary conditions, participants at the conference have made some policy recommendations to develop regional CRI. The first and foremost of them is to strengthen proper market perception of credit rating services. Specifically, credit ratings should be accepted to the extent of an information source only; it should not be misconstrued as the statement of fact, of whether the issuers will *definitely* default or not.

Besides, countries in the region need to make both unilateral and cooperative efforts to improve the environment for regional credit rating activities. The code of conduct for CRAs should be carefully revised and enforced, perhaps on the basis of the Code of Ethical Conduct by the ACRAA. Regional regulatory framework should simultaneously be strengthened, to consolidate the independence of CRAs on the one hand and to better adjust the regulations on corporate governance, accounting standards and accountability, etc. on the other hand.

In addition, provision of training by the more advanced countries is critical, so as to build up and enhance technical competence of credit rating analysts in the region. This need is even more pressing in the countries without established domestic CRAs like Vietnam. Training provision is also important in the sense that it promotes the dialogues between different countries, thereby facilitating the harmonization of rating activities across the region.

In developing the regional credit rating industry, liberalization of capital market is another important measure. This is expected to promote regional integration of capital markets, as well as the development of each and every capital market. Meanwhile, it also contributes to the expansion of market for regional credit rating activities. In particular, capital market liberalization is also important in that it imposes pressures on domestic CRAs to develop.

Cooperative efforts of involved countries are required to develop a domestic CRA network in the region. Special attention should be paid to the countries currently without any qualified CRA in operation. The fact that different countries are at different stages of capital market development

should also be considered carefully, to allow for and gradually reduce the difference in organizations and practices of CRAs in each country. To enhance the linkage between CRAs, both domestic and international coordinating mechanisms need to be designed and applied.

Furthermore, continued study should be undertaken to identify common rating practices, methodologies and policies among domestic CRAs. The areas of research interest may include specific financial benchmarks, rating databases or other guiding factors used by domestic CRAs. This will facilitate deeper understanding of credit ratings, as well as common best practices of such activities in the region./.

The conference on “Promoting the Development of Credit Rating Industry in the Asia - Pacific Region” is co-organized in Hanoi, by the Asian Bankers Association (ABA), APEC Business Advisory Council (ABAC), Vietnam Chamber of Commerce and Industry, and Vietcombank. Participants to this conference come from a variety of government agencies, business and investors associations, enterprises, and international firms and organizations. Apart from the organizers, there are notable representatives from the State Bank of Vietnam (SBV), Central Institute for Economic Management (CIEM), Association of Credit Rating Agencies in Asia (ACRAA), Asian Development Bank (ADB), Fitch Ratings, Moody’s Investors Service and Golden Bridge Finance Group.

The conference is opened by some remarks of H.E. Mr. Tran Minh Tuan, Standing deputy governor of the State Bank of Vietnam. His remarks are followed by the keynote address by Mr. Mark Johnson - Deputy Chairman of Macquarie Bank and Chairman of ABAC Finance Working Group. The main part of the conference exhibits the discussions of rationale and necessary conditions for viable credit rating industry in the region, by the member of ADB, Moody’s Investors Service, Golden Bridge Finance Group, ABA, ACRAA, CIEM and Fitch Ratings. Mr. Hoang Van Dzung, the Chairman of ABAC 2006, then concludes the conference with some closing remarks, with particular emphasis on importance of and policy recommendations to promote a regional credit rating industry.