

**“ACRAA and Harmonization under Asian Bond  
Market Initiative”**

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## **ACRAA and Harmonization under Asian Bond Market**

### **Initiative**

One of the proposals identified in the ASEAN + 3 Asian Bond Market Initiative (ABMI) which was endorsed at the ASEAN + 3 Finance Ministers Meeting in Manila on August 7, 2003 is a need for strengthening the credit rating systems in Asia by developing and utilizing existing Asian domestic credit rating agencies (DCRAs) who are acquainted with the economic and social situations of Asia. And hence, they are able to issue fair and credible ratings, which will be accepted by international investors, for cross border international issuance by Asian borrowers. A fair and reliable credit rating system in the region would be important in laying the foundations essential for active regional bond markets in Asia.

This view was widely shared by various studies conducted by APEC and Asian Development Bank previously.

The general consensus and findings was that there was a need to enhance credit rating systems in Asia, primarily in areas of raising the standards and process and increasing the level of transparency among others.

#### 1. Performance of Asian DCRAs

Rating agencies play an important role in bridging the information gap between issuers and investors, providing a common yardstick for measuring credit risks and performing a key surveillance on monitoring function for investors. In emerging markets, they typically take on an additional role in promoting the development of bond markets through

education, information dissemination and research activities. Presently, there are about 30 DCRAAs operating in Asia including 6 in China.

Performance of Asian DCRAAs is assessed in the report of Asian Bankers Association (ABA) “Development of Regional Standards for Asian Credit Rating Agencies : Issues, Challenges and Strategic Options”.

It presents the results of a survey conducted to both international and domestic investors asking their views of Asian CRAs’ performance.

The key issues are as follows:

(1) Timeliness in rating actions

DCRAAs have a better understanding and insights of local companies and have better access to local information.

However, it does not mean that DCRAAs are capitalizing on this advantage. They suffer poorly in being timely with their rating actions. There is much more room for forward looking analysis that is ahead of the market sentiment.

(2) Accuracy of DCRAAs’ rating and quality of rating reports and analysis

An important criticism that has risen is that often, insufficient information is disclosed and that reports are more descriptive than analytical. It is not surprising that DCRAA rationales are purchased primarily as information sources and used as a counter check to see if any important points are missed by the investors’ own in-house research.

### (3) Credibility

The key opinion of many international investors is that DCRAAs are not credible. The absence of credibility means that DCRAAs are in a very weak position relative to the more credible international credit rating agencies (ICRAAs).

According to international investors, the credibility of DCRAAs can be significantly enhanced by improving four areas namely independence, transparency, accuracy of ratings, and quality of analysis.

## 2. Formation of Association of Credit Rating Agencies in Asia

In order to address those issues of Asian DCRAAs' performance and to promote adoption of common standards that ensure high quality and comparability of credit ratings throughout the region and eventually to contribute to the development of Asia's bond markets, the Association of Credit Rating Agencies in Asia (ACRAA) was organized on September 14, 2001, when the Articles of Association were adopted in an organizational meeting at ADB headquarters.

To date, ACRAA counts 19 credit rating agencies as members coming from the following countries as shown in the handout: Bangladesh (1); People's Republic of China (2); India (3); Indonesia (2); Japan (1); Korea (3); Malaysia (2); Pakistan (2); Philippines (1); Taiwan (1); and Thailand (1).

The key tasks that ACRAA can initiate are: (1) Developing cooperative efforts, (2) Setting common standards. You can see ACRAA's purposes in its Articles of Association (handout 1), namely

The essential first step in moving toward change or improvement is to initiate developing cooperative efforts, such as common training programs, analyst exchange programs, regional industry studies and so on.

Since the organization of ACRAA, about 3 years ago, its Training Committee has conducted five (5) training workshops which were all sponsored and funded by the Asian Development Bank (ADB). They are two (2) training workshops on Securitization, one on the Analysis of Banks, one on Infrastructure Project Finance and another on Claims Paying Ability Rating for Insurance Company.

All training workshops are typically attended by two representatives from each ACRAA member rating agency.

Training has brought about significant benefits not just from the added knowledge as imparted by the instructor or trainer but from the shared experiences of various participants from various countries when specific rating issues are examined in guided case studies or group discussions.

### 3. Harmonizing Credit Rating Standards and Practices

Today, I would rather discuss more about harmonization, as ACRAA's second task for harmonization of rating practices of DCRAAs in the region by developing common standards to make their credit ratings more comparable and easier for cross-border investors.

I suppose at the outset there is a requirement for a definition of the term, harmonization. It can be briefly defined as the "convergence of various practices and rating principles across borders". Harmonization, as an Asian-wide collective

effort, is a continuous dynamic process that summons us to seek to know and understand what different credit rating agencies do, how they do things, and why.

I ventured to say that for credit rating agencies, the end-goal of any harmonization process is to achieve a degree of comparability across rating agencies in terms of rating methodology, rating criteria, definitions, benchmarks and overall rating process.

This comparability is promoted by uniformity and consistency in rating policies, in disclosures, in communications and in a wide range of business practices.

I will be the first one to admit that there could be a better definition of harmonization, but what is essential for now is that we have a starting definition to direct ACRAA's early harmonization efforts. Our evolving practices will ultimately produce the appropriate definition.

Asian CRAs must cooperate with and talk to each other to bring about harmonization. However, harmonization is not an easy process. Even as we move towards a certain "commonality", differences are highlighted – such as the depth and sophistication of the capital markets in different countries.

Let me be more specific by citing some obstacles to harmonization.

- (1) Different sense of urgency on the part of DCRAAs. A desire to be independent, autonomous.
- (2) Different accounting standards being followed.
- (3) Different legal frameworks prescribing legal requirements.

- (4) Different levels of development of domestic capital markets.
- (5) Varying business cultures which prescribe expectations on disclosure and norms of behavior.
- (6) Different attitudes of Regulatory Authorities.
  - (1) When a DCRA is just very concentrated in establishing its credibility in the local financial market, and in generating enough business to cover its overhead, in an environment of keen competition, there just might not be enough incentive to spend time in harmonizing with other DCRA's. Also, there is always the desire for independence in the pursuit of credit rating. Indeed, some agencies will tell you there is no need for harmonization considering the differences in business practices and social culture from country to country. However, ADB has recently conducted the survey to update the study of "Development of Regional Standards of Asian Credit Rating Agencies" of year 2000 especially concerning the DCRA's' current views of harmonization and the 86% of the survey respondents of DCRA's still supported harmonization although there was some disagreement on the degree to which it should be attempted.
  - (2) Different accounting standards and different ways of accounting reporting also pose obstacles to harmonization. Credit rating depends heavily on audited financial statements and different accounting treatment of transactions can lead to different conclusions. For example, different

rules on capitalizing pre-operating expenses, or recognizing contingent liabilities can unduly distort the financial statements – and the credit evaluation process.

- (3) Different legal frameworks and different legal requirements can make harmonization difficult.

In a certain country, for example, debt securities issued by government corporations are exempt securities not requiring registration and approval by a Security Exchange Commission (SEC). Not having gone through the scrutiny of an SEC, these securities are difficult to compare with other debt issues.

Since these are exempt securities, they are not required to go through a credit rating process.

Different legal jurisdictions may require different levels and types of disclosures, and this gives rise to disharmonization.

- (4) The varying levels of development of domestic capital markets also pose obstacles to harmonization. The more developed the market, the more sophisticated the investors, the greater the demand for full and timely information, the higher the requirements for transparency and for accountability. It could be difficult to establish the same practices for DCRA's operating in different stages of capital market development when the usefulness or urgency of these practices cannot be equally appreciated.

- (5) Very much related to the level of capital market development is the business culture prevailing in a particular economy. The business culture describes the expectations on disclosure and norms of behavior, of what is acceptable or not acceptable. The expectations or lack of expectation of local capital market practitioners or even investors can be more influential and important than the good intentions of all DCRA's in the Asian region descending on the market in the name of harmonization.

Sad to say, in some undeveloped capital markets, the value of credit ratings is underestimated, and ratings are seen as just another additional cost to financial intermediation.

- (6) The different attitudes of national regulatory authorities also are potential obstacles to harmonization. Some regulatory authorities may prefer to be strict, others to be lenient, even indifferent, as regards such topics as transparency and reporting requirements, accreditation and imposing sanctions for violations of the law or its implementing rules.

Having said all of these, however, harmonization continues to be of current and pressing interest especially because of the mounting desire to promote the Asian bond market.

#### 4. The ACRAA Initiatives Promoting Harmonization

Under the Asian Bond Market Initiative, an important infrastructure in the harmonization process for credit rating agencies in Asia is our organization, ACRAA. ACRAA has taken steps that lead to the harmonization of credit rating process and practices in the Asian region. We do not explicitly call it “harmonization” but indeed what we are doing will lead to, sooner or later, common ways of doing things as we compare among ourselves what is good, what is better and what is best practice. As you notice, the idea of harmonization is embedded in our purposes of the Article of Association.

We have in ACRAA a “Best Practices” Committee and as the name describes, it is assigned the task of comparing the whole wide range of rating and business practices of member credit rating agencies with a view to identifying the similarity and differences in policies and rules, in approaches and norms of conduct.

Indicative of our cognizance of the high demands of trust and integrity in a very sensitive business, the first official action ACRAA undertook, through the Best Practices Committee, was to adopt a Code of Ethics and Code of Conduct, one addressed to the institution and another addressed to the practitioners.

In a move to get more specific towards possible harmonization, we have sponsored what we call Best Practices Dialogues to address some chosen specific issues, again to compare on thinking and determine why we follow certain policies or rules or practices.

We have conducted three (3) Best Practices Dialogue to date, covering topics of concern to rating agencies.

Such topics have included: code of ethics; code of conduct for rating agencies; communication of ratings; parent-subsidiary relationships; rating well-secured debt; meaning of default for debt securities; and factoring in governance practices into credit ratings. Similar to the training workshops, the dialogues promote the lively exchange of ideas and information on the “more practical side” of credit rating.

Aside from these “dialogue”, the Best Practices Committee of ACRAA has ably conceptualized and spearheaded the compilation of a Compendium of Best Practices, where each member-rating agency discloses its practices on 21 items such as : rating committee constitution; description of rating process and criteria; publication of default and transition statistics; policy on unsolicited ratings; policy on preserving confidentiality of privileged information; code of ethics; among others.

The Compendium is seen as an instrument for self-regulation among credit rating agencies and aids in focusing on what we think are key areas of concern.

##### 5. Moving Forward on Harmonization

Other projects are planned to promote a commonality of understanding, not only among ACRAA member-credit rating agencies, but among the users of credit ratings, as well. The Best Practices Committee, for example, is in the process of compiling a Glossary of Rating related Terms in an effort to standardize the meanings of key terms for

greater understanding among market participants. The definition of the word “default”, for example, has already been seen to vary from agency to agency and although convergence may be hard to achieve immediately, it is good to know and be aware of what the variations are in practice.

Other areas for harmonization seem endless : rating scales and definitions; the rating process; rating methodology and criteria; rating benchmarks; rating policies; rating databases; internal control procedures; default studies; and even report structures and format.

It is hard to picture where harmonization may bring us and to answer the questions: “To what extent is it possible? To what extent is it practical? To what extent is it helpful?” Through ACRAA we work towards harmonization, step by step, mindful of the benefits that it can bring. Harmonization should result in great acceptability, understanding, and use of ratings by issuers, investors and regulators.

It will promote a freer exchange and flow of information as credit rating agencies share financial benchmarks and rating data, without violating the “confidentiality of information” provision in our rating agreements. It should improve capital markets activity as market players become more confident and familiar with credit rating processes and what credit ratings mean. It is, therefore an important measure in developing a regional bond market and encouraging cross-border capital flows under the Asian Bond Market Initiative.

However, without great cooperation of governments and regulatory authorities concerned in the region, it is rather

difficult to overcome the obstacles to harmonization as indicated earlier.

In this sense, we earnestly hope that their strong support will be given to harmonization to achieve purposes of ABMI along with the private sector efforts.