

Would the Integration of Asian Financial Markets Benefit From Regional Rating Agencies?

by

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Presentation at ADB on 24 July, 2006

ADB Seminar Series on Regional Economic
Integration

Key Questions in Presentation – 1

- ❑ Why is the development and integration of financial markets in Asia progressing much more slowly than GDP growth and productive integration?
- ❑ Lack of a single currency/strong exchange rate agreement (though important) not only answer
→ we need to consider other factors
- ❑ We look at a particular infrastructure: Credit Rating Agencies (RAs) affecting issuers' access to financial markets & (with Basel II) also to bank credit

Key Questions in Presentation – 2

- As to Asian rating market structure, we show:
 - (i) density of national RAs (NRAs) and extensiveness of firm ratings is highest in Asia;
 - (ii) by specializing on rating smaller-sized/domestic-focused firms, NRAs complement (*rather than substitute*) the GRAs (Moody's, S&P, Fitch), who focus instead on the other firms
- But, current situation still suboptimal since rating quality is not entirely satisfactory:
 - (i) to give financial markets quality information on issuers, Asian NRAs need to improve their independence & reputation;
 - (ii) being based on country-specific scales, NRA ratings are little comparable across Asian countries, thus favoring segmentation rather than integration

Key Questions in Presentation – 3

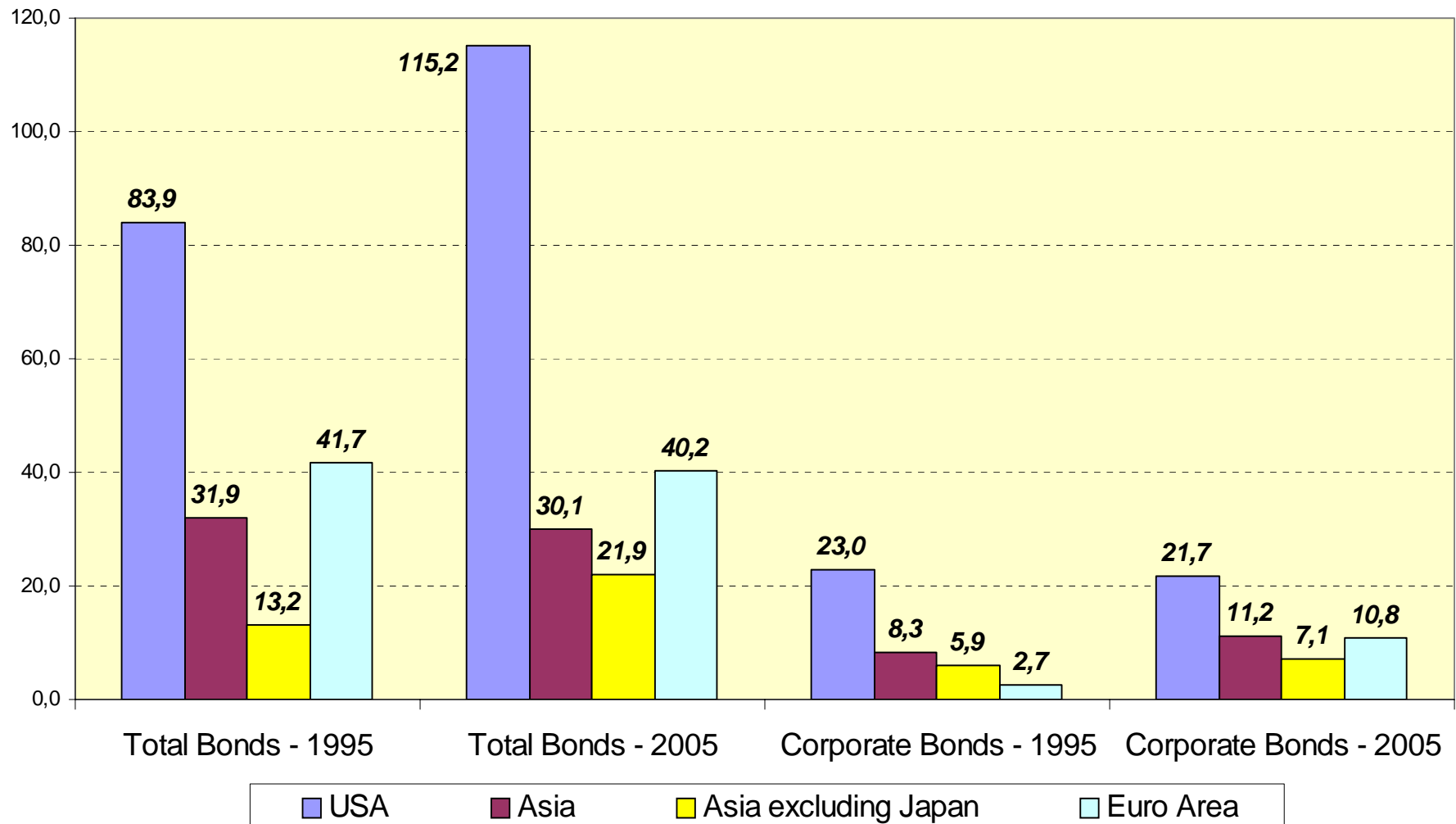
- We argue that Regional RAs (RRAs) would overcome current NRA limits, since:
 - (i) RRAs could be more independent since their ownership would not coincide with their market of operation and the larger regional market would give stronger incentives to be reputable;
 - (ii) RRAs would assign ratings based on a region-wide scale, thus favoring Asian financial market integration.
- Thus, RRAs can enhance Asian bond market development & integration
- ADB can help Asian RRAs' inception

Bond Mkt Development: Key for Asia

- ❑ The 1997-8 financial crisis highlighted the problem of bond market underdevelopment in Asia → corporate borrowers excessively dependent on bank finance
- ❑ Actions were taken to boost Asian bond market development, particularly for corporate bonds (e.g. ASEAN + 3 Asian Bond Market Initiative; ABMI)
... but progress has been limited, especially for corporate bonds (see fig 1)

Bond Market Size/GDP: 1995 vs. 2005

Figure 1 RATIO (%) OF PRIVATE BONDS OUTSTANDING TO GDP



Why Little Progress in Asia?

- ❑ Certainly, lack of a single currency/strong exchange rate agreement is important factor
... but even Europe, in spite of the Euro, did not rapidly converge to the US benchmark
→ we need to consider other factors
- ❑ We study Credit Rating Agencies (RAs)
... a key support to bond market functioning, particularly for corporate issuers

RAs Key to Capital & Credit Markets

- Ratings are an essential lubricant for financial markets by reducing information asymmetry of investors vis-à-vis issuers
- Unexpected rating changes affect level-volatility of bond-share price (Kliger & Sarig 2000) and credit default swaps (Hull et al. 2004); bond downgrades cause negative abnormal stock returns (Dichev & Piotroski 2001)
- RAs affect also credit markets with Basel II:
 - directly, for the limited number of rated borrowers of banks choosing the “standardized approach”;
 - indirectly, for the other banks, whose IRB models – to be validated by supervisors – need to be consistent with RAs’ methodologies (i.e. RAs are a benchmark for IRB validation)

Global vs. National RAs – 1

- *Looking at ratings in emerging economies:*
 - Asia has the largest number of ratings (fig 2)
 - GRAs' penetration is smallest in Asia where independent NRAs are strongest (fig 3)
 - GRAs seem to pursue a local-rooting strategy, moving from branches to subsidiaries (fig 4)
 - NRAs dominate in several emerging Asian countries (India, Korea, Malaysia, Thailand) and also in Japan (fig 5)

Figure 2

NUMBER OF RATINGS ACROSS REGIONS: EMERGING ECONOMIES

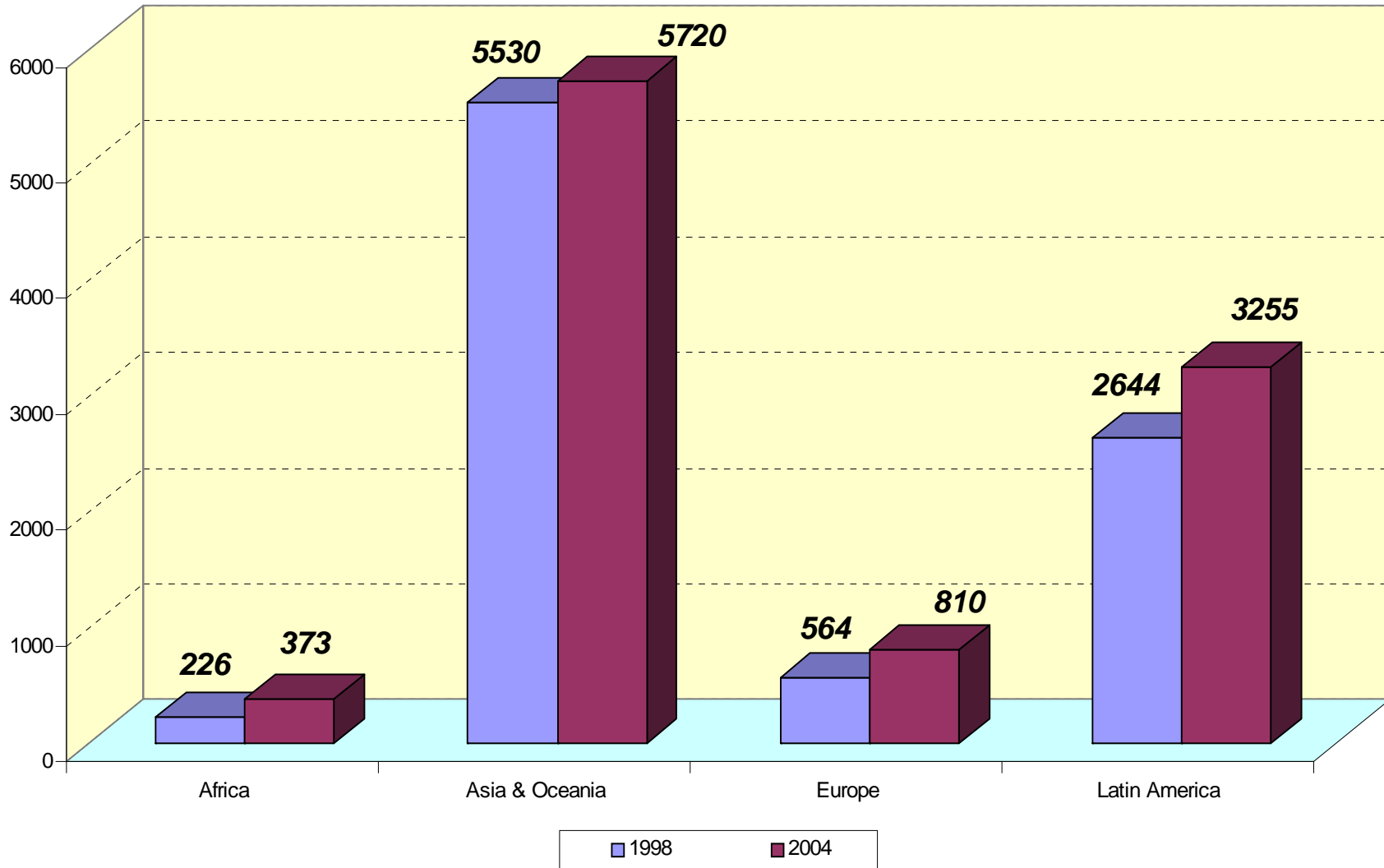


Figure 3

Share (%) of the Rating Market Held by NRAs

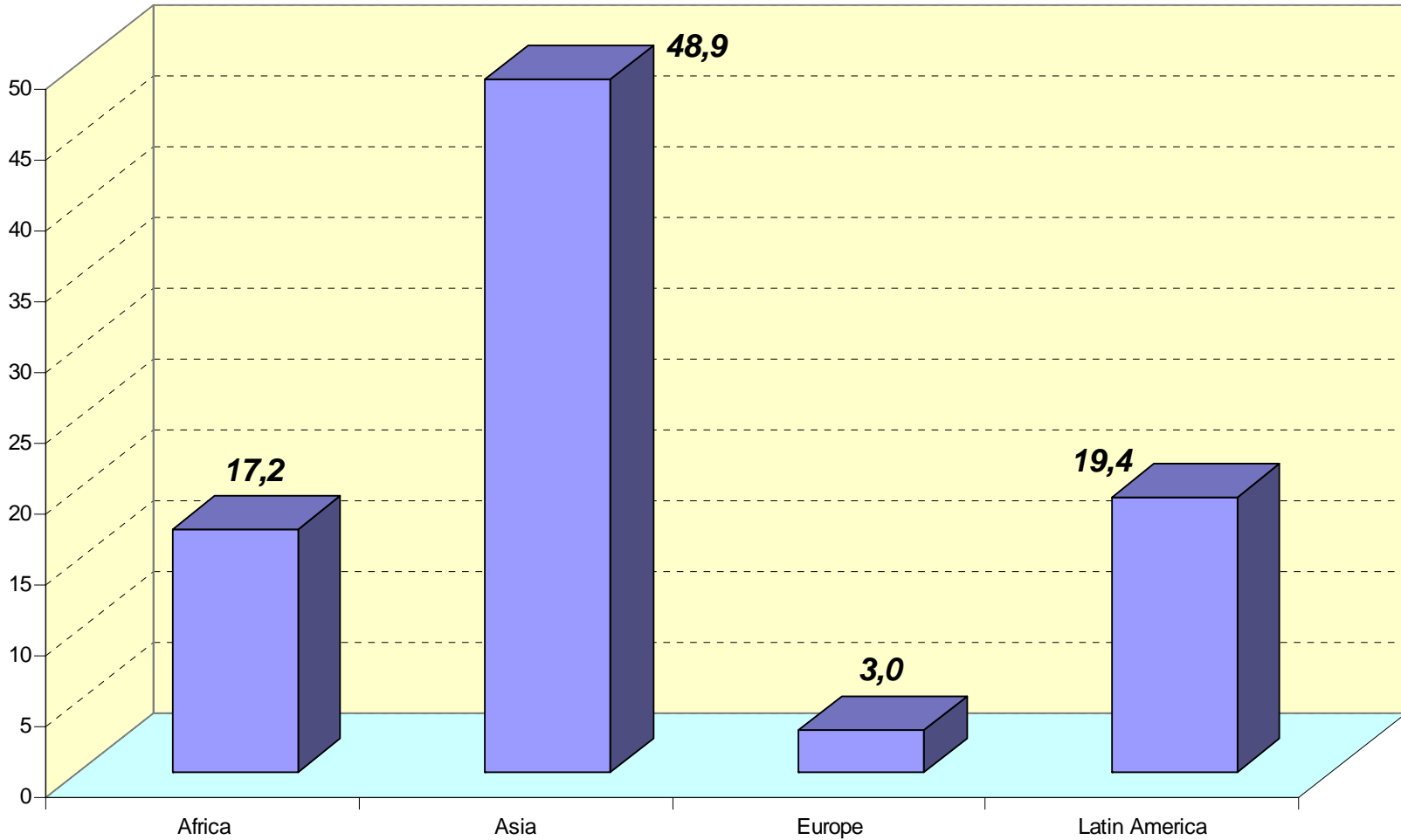


Figure 4

GCRAs' BRANCHES & SUBSIDIARIES VS. INDEPENDENT AGENCIES: EMERGING WORLD

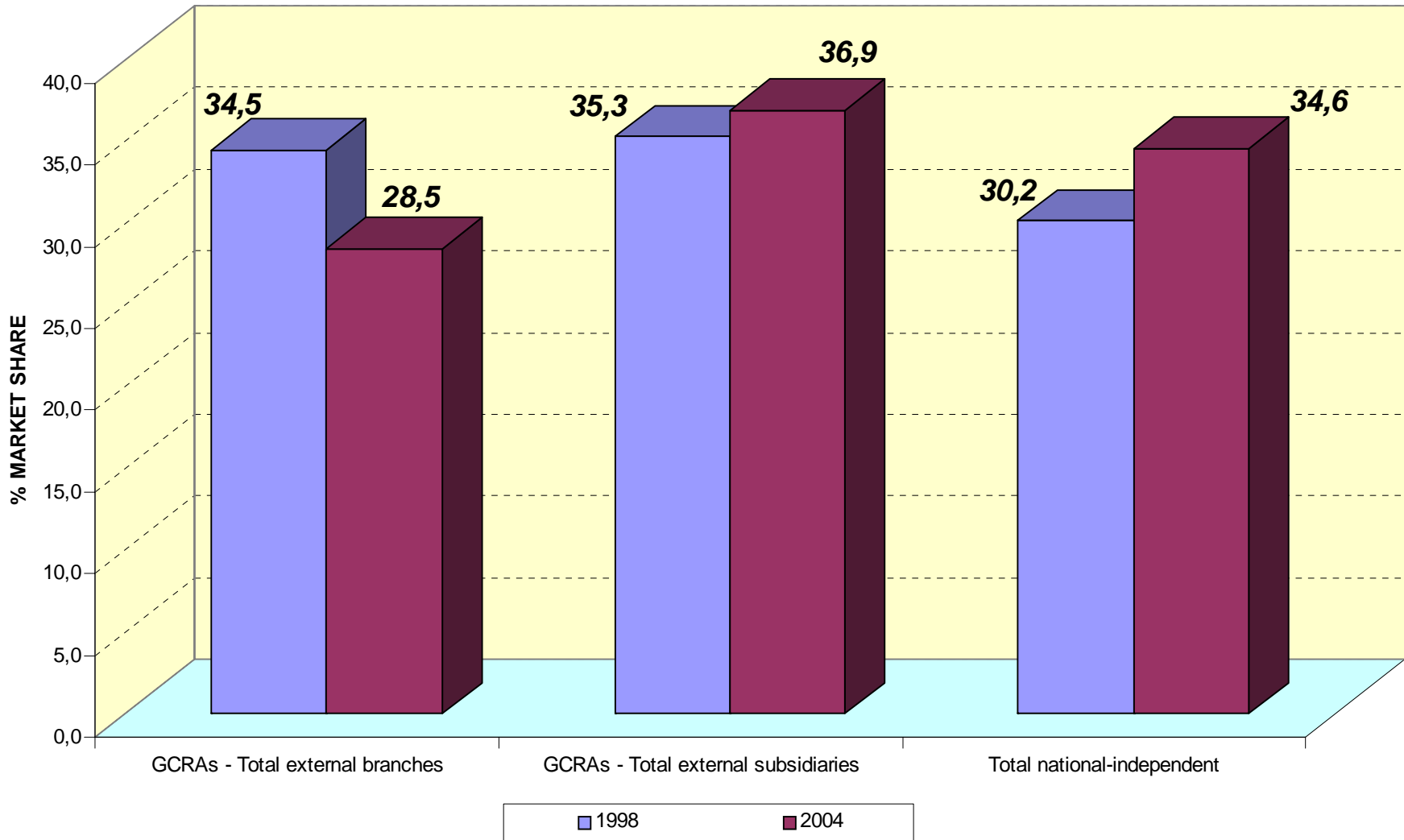
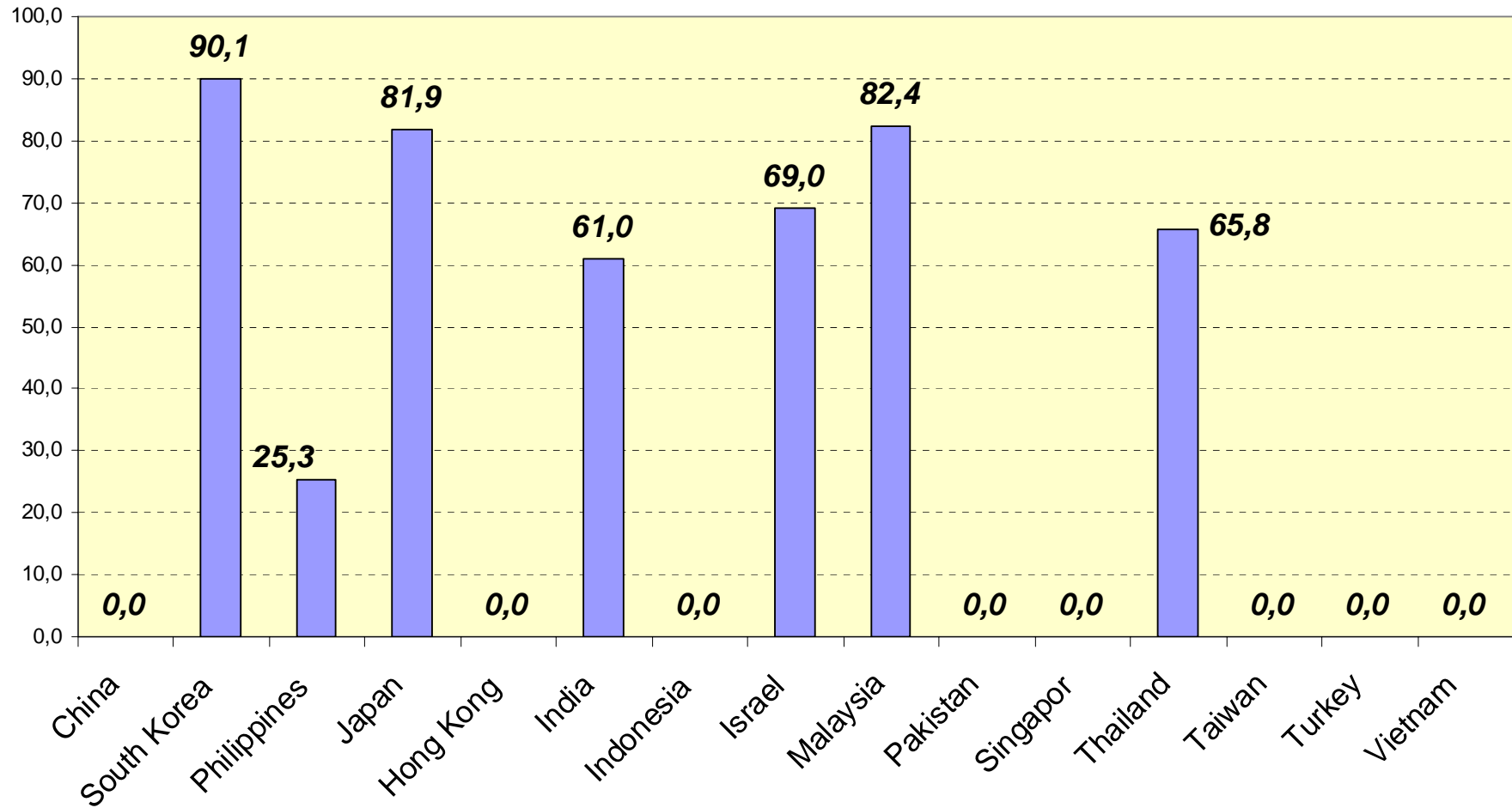


Figure 5

MARKET SHARE (%) OF NATIONAL RATING AGENCIES



Is There Value Added in NRAs?

□ Yes, because they seem to complement (rather than substitute) GRAs:

- NRAs specialize in rating more domestic-focused firms (fig 6);

- NRAs focus on smaller-sized companies (fig 7)

□ Thus, NRAs feed rating market (many Asian smaller-sized firms hold a rating only thanks to NRAs) → pre-condition to expand bond market ... no surprise the strong correlation between presence of NRAs & bond market development

Figure 6

Share (%) of Firms Listed Also Abroad

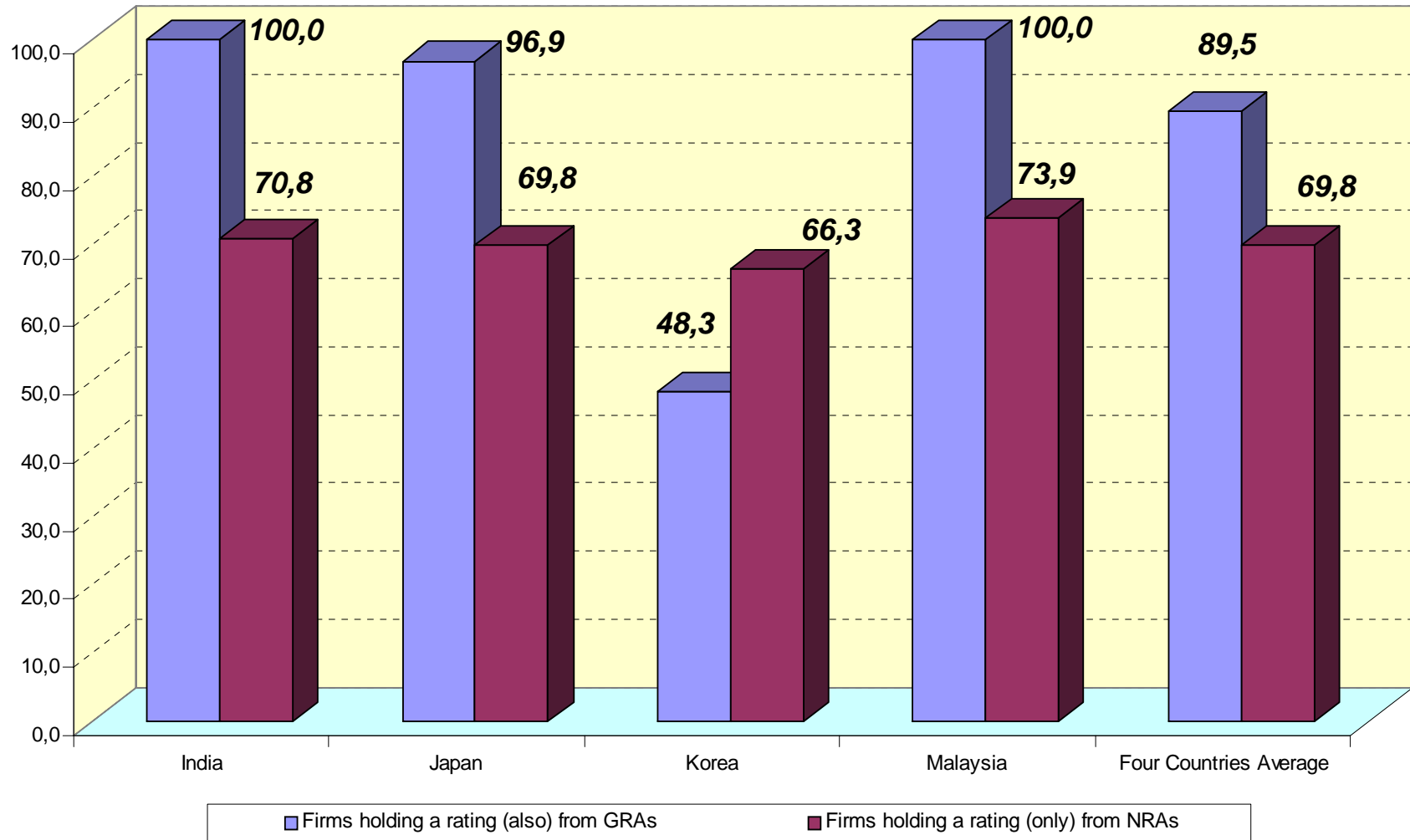
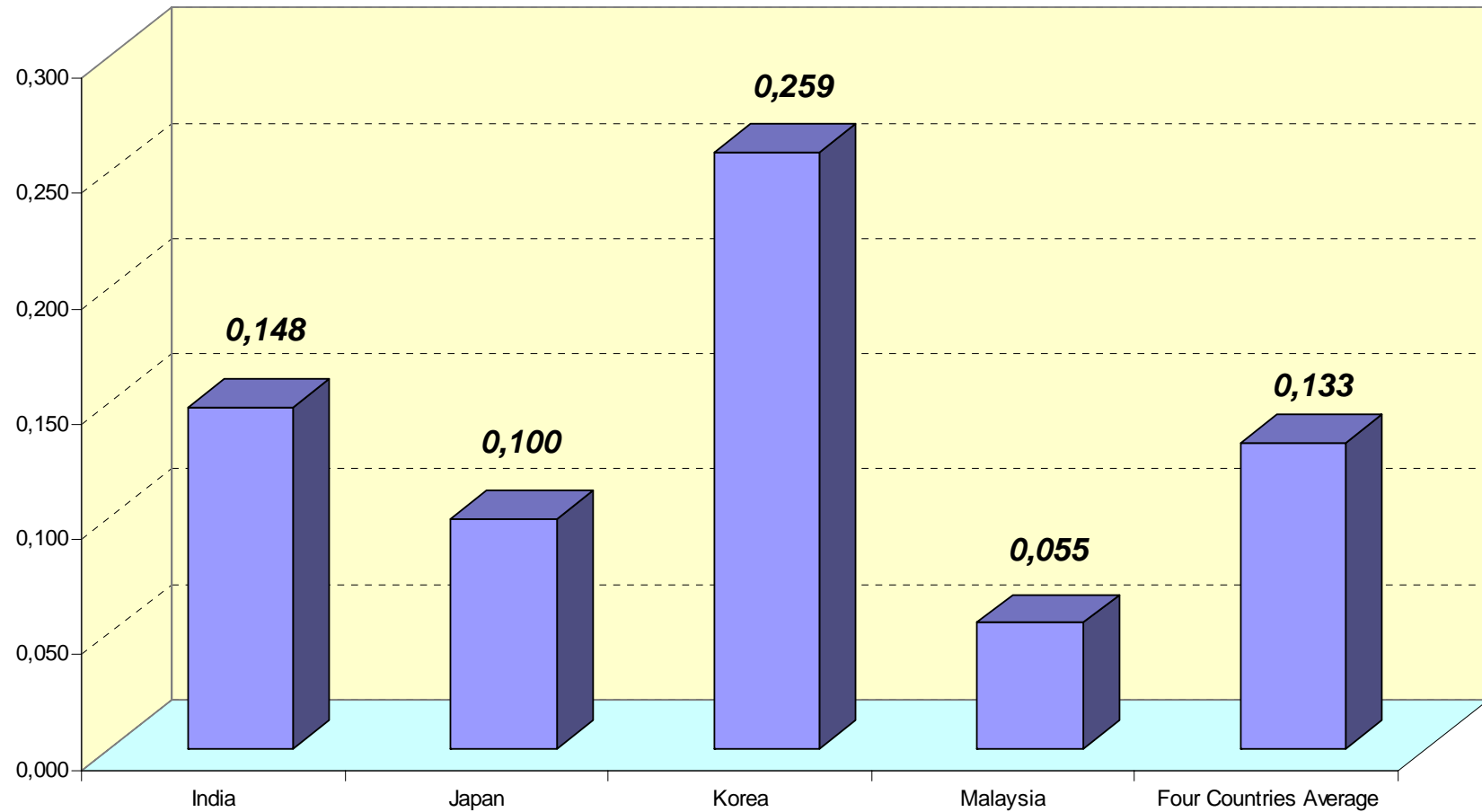


Figure 7

Relative size of firms holding a rating (only) from NRAs as a ratio to firms holding a rating (also) from GRAs



But Asian Situation Still Suboptimal

□ Two major problems with Asian NRAs:

- They need to improve independence & reputation
- NRA country-specific rating scales favor national segmentation (rather than regional integration) of the bond market

NRAs' Independence & Reputation

- Often regulation & practice weaken market-based discipline on NRA rating quality, e.g.:
 - lack of recognition of foreign RAs;
 - regulatory requirement that corporate bonds have more than 1 rating
- At times ownership & governance structure is not conducive to independence, e.g.:
 - when a bank holds a significant share in an NRA, the interest of the latter may be too closely aligned with bank shareholders;
 - possible conflict of interests in rating groups which generate a large share of the single NRAs' fees

NRA Country Specific Scale: e.g., Korea's NICE vs S&P (Ratings Always Higher)

Firm	Korean NRAs(NICE)	GRAs(S&P)
1	AA- ('06.6)	BBB-
2	AAA ('06.6)	A-
3	BBB-('06.5)	CCC
4	AA- ('06.5)	BBB-
5	BBB+ ('06.6)	BB-
6	AA ('06.6)	BBB-
7	AA('06.6)	BBB-
8	BBB+ ('06.6)	BB
9	AAA ('06.5)	A-
10	BBB+ ('06.5)	B+
11	A- ('06.2)	BB+
12	AAA ('06.5)	A
13	AA+ ('06.3)	BBB
14	AAA ('04.6)	A
15	AAA ('06.6)	A
16	AAA ('06.5)	A-
17	AAA ('05.7)	A-

Asia Needs Regional Rating Agencies – 1

- Regional RAs (RRAs) could overcome the current first NRA limit, since
 - (i) independence & reputation:
 - RRAs should be more independent [← their ownership would not coincide with any single national market of operation];
 - the larger regional market would give RRAs stronger incentives to be reputable [← more at stake]

Asia Needs Regional Rating Agencies – 2

□ RRAs could overcome the current second NRA limit, since

(ii) going beyond national rating scales:

- RRAs would assign ratings based on a region-wide scale, thus favoring Asian financial market integration [→ investors throughout Asia would be better able to compare issuers across countries → this would help create a truly region-wide bond market, well beyond the sum of the current national bond markets]

What Can ADB Do? – 1

□ A first possible ADB action to promote the foundation of RRAs in Asia:

- Support more thorough studies of NRAs' merits and limits, to make a stronger case for RRAs:
 - whereas in recent years several authors analyzed GRAs' working, only a few seminal papers study NRAs;
 - cursory evidence tells us that NRAs differ from GRAs:
 - (i) in some positive aspects (small firm focus, lower fees, more tailoring to local business practice); (ii) but also in some negative aspects (independence & reputation; rating scale);
 - the studies would possibly show that RRAs contribute to bond market development as they improve on NRAs by removing the cons while retaining the pros.

What Can ADB Do? – 2

□ A second possible ADB action to promote the foundation of RRAs in Asia:

- Encourage Asian countries to utilize Basel II as a unique opportunity to favor a market-driven development of RRAs in the area:
 - Basel II gives a prominent role to RAs & expand the ratings market;
 - this could give NRAs a chance to try becoming RRAs;
 - however, such an opportunity will materialize only if domestic bank regulators approve (qualified) NRAs from other Asian countries to issue ratings domestically;
 - that is, to promote RRAs, ADB should persuade national regulators to avoid precluding (Basel II related) entry to NRAs from other countries

What Can ADB Do? – 3

□ A third possible ADB action to promote the foundation of RRAs in Asia:

- Eventually sponsoring the merger of two or more Asian NRAs:
 - venturing into region-wide business operation requires large shoulders (at the beginning) for any NRA and the cost may be prohibitive if the service has to be supplied via greenfield investment;
 - the merger of two or more NRAs probably makes more sense;
 - ADB could assist in two ways: (i) as a third-party shareholder; (ii) facilitating the identification of the potential matching partners and the subsequent negotiations

In conclusion – 1

- Observing that the development and integration of financial markets in Asia is progressing too slowly, we addressed the role of Credit Rating Agencies (RAs), a key infrastructure for bond market development & (with Basel II) also for bank credit too
- As to rating market structure, we showed:
 - (i) density of national RAs (NRAs) and extent of firm ratings is highest in Asia;
 - (ii) by specializing on rating smaller-sized/domestic-focused firms, NRAs complement (*rather than substitute*) the Global RAs (Moody's, S&P, Fitch), who focus instead on the other firms

In conclusion – 2

- But, rating quality unsatisfactory, NRAs need:
 - (i) more independence & reputation;
 - (ii) avoid country rating scales (segmentation)
- Regional RAs (RRAs) to overcome NRA limits:
 - (i) RRAs more independent (ownership outside national boundaries) and more reputation incentive;
 - (ii) RRA ratings on a region-wide scale (integration)
- Thus, RRAs can enhance Asian bond market development & integration
- ADB can help nurture RRA in various ways