

New Basel Accord and Requirements for ECAI Recognition from Asian Developing Countries' Perspective

by

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Abstract

Observing that Basel II extends the impact of the rating agencies (RAs) from affecting companies' access to financial markets to influencing also companies' access to bank credit, this paper aims to assess the situation in emerging Asia. First, we look at the rating market structure and show that: (i) across the various continents, Asia – and particularly East Asia – exhibits the largest presence of national rating agencies (NRAs); (ii) NRAs seem to be complement rather than substitute of the global rating agencies (Moody's, S&Ps, Fitch; GRAs), since NRAs specialize in rating smaller-sized/domestic-focused companies while GRAs concentrate on rating larger-sized/internationalized companies. Second, focusing on Korea, we try to measure the quality of the ratings supplied by NRAs vs. GRAs, particularly weighing the relative accuracy and independence of judgment. Though decreasing of the recent years, NRAs appear to grant more generous ratings vs. GRAs. On one hand, this could indicate that Korean NRAs issue less independent judgments than GRAs. On the other, this could reflect a better quality of the companies rated by NRAs, which is suggested by the fact that the corporate default ratio for investment grade companies is slightly lower at NRAs vs. GRAs. Our main conclusion is that building on existing NRAs and further improving the quality of their judgment is paramount to expand financial markets but it is also key to secure emerging Asia a smooth transition in credit markets as Basel II is phased in.

JEL Classification: G2, G3

Keywords: Basel II, Bank Minimum Capital Requirements, Rating Agencies, Emerging Asia

1. Introduction

Basel II assigns a key function to External Credit Assessment Institutions (ECAIs) or Rating Agencies (RAs). RAs' assessment has both a direct role in the "standardized approach" and an indirect impact affecting the criteria to which Internal Rating Based (IRB) models must abide in order to be validated by the supervisory authority. Through the latter impact, RAs' judgment becomes even more prominent. If previously, a good rating affected only rated companies, by and large those issuing on financial markets, with Basel II also unrated companies will be influenced in their access to and cost of bank credit.

In view of the above, countries will benefit from having a network of RAs both well developed and able to perform the most accurate evaluation of domestic borrowers' creditworthiness. Attaining this may be problematic for developing countries. First, RAs are usually less expanded in developing countries than in rich countries. Second, many developing countries lack national or regional RAs (NRAs) and rely almost exclusively on the work of the three big US-based global RAs (Moody's, S&Ps, Fitch; we will label them GRAs), which: (i) may be less able/prompt than NRAs to understand national business practice differing significantly from the US standard – even though GRAs' assessment may be more independent than that offered by local RAs – global RAs might provide less accurate (possibly more conservative) ratings than NRAs could do; (ii) also thanks to their market power tend to charge higher fees than NRAs and, thus, fewer national borrowers – particularly the smaller-sized ones – are willing to ask for a rating and, for the reasons outlined above, this will not help the proper functioning of Basel II.

In this paper we try to assess the situation in Asia. We show that, on average, NRAs play a larger role in Asia than in any other part of the world – of course, excluding the US. Not all Asian countries have NRAs: among the medium-large sized emerging Asian countries, the share of NRAs is large only in Korea, Malaysia, Israel, Thailand and India. Next, analyzing the suppliers of ratings across companies, we demonstrate that NRAs specialize in smaller-sized and less internationalized entities, whereas GRAs tend to offer their services to larger and more internationalized companies. This confirms our a priori that NRAs provide a value added in terms of extending the supply of ratings to classes of companies which could otherwise be left unrated.

This judgment does not translate, though, in saying that the Asian situation is perfect. Indeed, it is quite possible that many of the numerous ratings offered by NRAs in emerging Asia are not as punctual and informative as they could be. To be sure, it is possible that some emerging Asian countries preserved their network of NRAs not only thanks to the underlying ability of their agencies, but also because of harder obstacles for GRAs to acquire them – something that the global did extensively in other areas of the world.

For this reason, focusing on Korea, in the paper we study whether NRAs are prone to give systematically “higher” ratings to local firms with respect to what is done by GRAs. This may be a problem particularly where GRAs have little business footing. In the Korean case, the “generous” ratings assigned by NRAs could limit the impact of Basel II, but local companies could be disadvantaged in their access to international financial markets because: (i) these companies do not have easy access to the trusted ratings of the GRAs, and (ii) the ratings assigned by NRAs may be disregarded by international investors. Instead, in those Asian emerging economies where GRAs have a solid business footing we might find two effects going in the opposite direction. On one hand, companies might suffer disadvantages because GRAs’ ratings are generally low, and this could deliver larger Basel II capital requirements irrespective of corporate performance (Ferri and Liu, 2002). On the other hand, the quality of existing NRAs’ ratings could improve over time as these agencies compete with the globally accepted best practices of the GRAs.

A further issue that arises even in the countries where GRAs have a solid operational base comes from the fact that the major business domain of ECAI activities is the credit rating of corporate bonds, not the corporate rating for bank loans. This derives from the fact that those companies able to issue corporate bonds are bigger firms mostly listed at the stock exchange. The problem is that the number of firms in need of credit ratings from ECAIs is all too small in Asian LDCs. This situation derives partly from the fact that the demand for credit ratings has often been created by government regulation promoting the process of issuing corporate bonds. As such, corporate managers treat ECAI ratings just as simply an “unavoidable cost” which should be expensed. This means ECAI ratings are not entirely recognized as the right way to enhance market efficiency therefore a firm could reduce its financing cost. This represents a cultural bias which should be dealt with.

In the case of Korea, the number of firms having decent credit ratings by ECAI (NRAs) is only 250 or so. This number tells us that even listed firms at KOSPI (some 800 are listed now) do not access ECAI credit ratings. As such, most of loans are just classified as unrated. Presumably, this is evidence that SMEs are frequently distanced from ECAIs. This could make the procyclicality problem – the fact that company ratings are (possibly excessively) downgraded during downturns – worse when a credit crunch hits the economy since SMEs are disproportionately dependent on bank loans. In addition, estimated PDs (probabilities of default) have often shown a weak power of recognition since there are no significant differences among investment grades (BBB or above). Accordingly, Korea’s Banking regulator seems to prefer the IRB approach over the “standardized” approach. Bigger banks with a large pool of loan screening officers will adopt the IRB approach. Whereas, small regional banks are scheduled to apply the “standardized”

approach. FSS will persuade regional banks to move to the IRB approach in due course. Finally, ECAIs have to extend their rating of firms down to SMEs located in small local cities so that regional banks can reliably depend on the rating outcomes by NRAs. Thus, it is necessary to present the due process/course in expanding rating market in the SME area.

Overall, it appears that some emerging Asian countries already have a relatively thick network of national agencies and don't need to build a new one. In view of Basel II, however, there is a need to expand the clientele and to improve the rating quality. Bearing in mind the large economies of scale in the rating business and of the fact that supranational RAs may be better able to issue independent assessment, emerging Asia might benefit by fostering some consolidation at the regional level of its RAs. Such consolidation could give rise to one or a few more solid regional-level RAs. This would probably allow Asia to reap the advantage of better cost efficiency and rating reliability building on institutions which maintain a strong focus on understanding the local business practice and have an incentive to seek expanding the rating market toward smaller-sized companies. In this sense, the benefit would not be limited to a smoother working of Basel II but would extend to providing a potential boost to financial market development at large.

The rest of the paper is structured as follows. In Section 2 we briefly discuss how Basel II amplifies the role of RAs by letting them affect companies not only in their access to financial markets but also in that to bank credit. Section 3 is devoted to assess the rating market structure in Asia by distinguishing NRAs from GRAs and studying whether and to what extent the two types of ECAI have a different specialization in terms of the companies they service. Then, mostly focusing on Korea, we try to measure the quality of the ratings supplied by NRAs vs. GRAs, particularly weighing the relative accuracy and independence of judgment (Section 4). At the end on the paper, Section 5 gathers our main conclusions and discusses policy implications for emerging Asia.

2. The Role of ECAIs' Ratings With Basel II

Basel II gives a prominent role to rating agencies (RAs). RAs' assessment has a direct role at those banks – generally the small-sized banks – opting for a “standardized approach”. At these banks, even though nothing changes for unrated borrowers with respect to Basel I, the capital requirement against rated borrowers has to be adjusted according to their rating. Nevertheless, RAs' assessment has an indirect – possibly even broader – impact also at those banks choosing to introduce their own Internal Rating Based (IRB) models. These IRB models will, in fact, have to be validated by the supervisory authority. In this respect, it is easy to presume that, to grant

validation, supervisors will require that the IRB model classifies those bank borrowers holding a public rating assigning them an IRB rating consistent with the one given to these borrowers by the RAs. Thus, IRB methodologies need to be coherent with RAs' ones for banks' rated borrowers. Furthermore, this indirect influence of the RAs will presumably extend to the whole clientele since IRB models will have to apply the same methodology to both rated and unrated customers.

Against this background, countries will benefit from having a network of RAs both well developed and able to perform the most accurate evaluation of domestic borrowers' creditworthiness. Two issues arise at this juncture for developing countries. To start with, in developing countries RAs are usually less expanded than in rich countries – especially the US, the country from which the rating tradition emanated. Furthermore, developing countries often lack national or regional RAs and rely almost exclusively on the work of the three big US-based global players (Moody's, S&Ps, Fitch). There are two reasons why this situation might be disadvantageous for developing countries. First, the global RAs may be less able/prompt than national or regional RAs to understand national business practice differing significantly from the US standard. For this reason – even though the global RAs' assessment may be more independent than that offered by local RAs – global RAs might provide less accurate (possibly more conservative) ratings than national or regional RAs could do. Second, also thanks to the market power element granted them by belonging to the short – and virtually closed – list of Nationally Recognized Statistical Rating Organizations (there is some regulatory advantage for the ratings issued by RAs belonging to the NRSRO list, held by the SEC), global RAs tend to charge higher fees than national or regional RAs. In turn, if national or regional RAs are missing, fewer national borrowers – particularly the smaller-sized ones – will be willing to ask for a rating and, for the reasons outlined above, this will not help the proper functioning of Basel II.

3. The Supply of ECAs' Ratings in Asia¹

But what is the situation in developing Asia? Although Asian countries differ in terms of their specific degree of coverage, national RAs do play a larger role in Asia than in any other part of the world – of course, excluding the US. The following figures – based on Financial Times Interactive data for Winter 2004 – exemplify this claim for the emerging world as a whole and also breaking down the information among the four large emerging areas: Africa, Asia and Oceania, Europe and Latin America. First, emerging Asia holds the largest number of ratings, a much larger

¹ This Section partly draws on Ferri and Licitignola (2006).

number than Africa, Europe and Latin America (figure 1).² Second, distinguishing between the ratings supplied by the global RAs – either through their own branches or through controlled subsidiaries – and those offered by national RAs confirms that the market share of the latter is largest in Asia (figures 2a, 2b, 2c, 2d). Besides that, something worth noting from these figures is the tendency for the national RAs to gain market share. At the same time, it is visible how global RAs reorganize from direct branches to controlled subsidiaries, a move that might signal a better organization to understand local business practice. Not all Asian countries have national RAs: among the medium-large size emerging Asian countries, the share of national RAs is considerable only in Korea, Malaysia, Israel, Thailand and India (figure 3); in addition the share is large also in Japan. In particular, NRAs' coverage is most significant in Japan, Korea, Malaysia and India.

Specifically, Japan has three rating agencies: two of them are relatively well structured (Japan Credit Rating Agency, JCR; and Japan Rating and Investment Information, R&I) and a third one is less structured (Mikuni). Korea features four NRAs, beside some activity by JCR and R&I: Korea Investment Service (KIS), Korea Rating (KR), National Information and Credit Evaluation (NICE) and AM Best. Malaysia has two NRAs: Malaysian Rating Corporation Berhad (MARC) and Rating Agency Malaysia (RAM). In India there are three NRAs: Investment Information and Credit Rating Agency (ICRA), Credit Rating Information Services of India (CRISIL) and Credit Analysis & Research (CARE). None of these several Asian NRAs, yet, can be considered regional because their business is mostly tied to their nation of origin (only JCR and R&I have some business out of their nation of origin). Though, these Asian NRAs originated recently (none of them was established before 1985), in these countries they issue numerous ratings compared to GRAs and they are very active also in revising previously issued credit ratings.

Differently from the US tradition, NRAs in Japan originated with a strong support from regulation. Ratings were a necessary tool to obtain regulatory approval to issue bonds. After 1985, many Japan corporate bonds were required to have a minimum credit rating in order for the issue to be approved. While this requirement was abolished in January 1996, other regulatory obligations remained tied to credit rating.

² The list of countries refers to emerging economies only. Africa includes: Botswana, Burkina Faso, Cameroon, Egypt, Gambia, Ghana, Kenya, Lesotho, Liberia, Malawi, Morocco, Mozambique, Nigeria, Senegal, South Africa, Tunisia. Asia and Oceania includes: Azerbaijan, Bahrain, Bangladesh, China, Fiji Islands, Georgia, Hong Kong-China, India, Indonesia, Iran, Israel, Jordan, Kazakhstan, Korea (South), Kuwait, Kyrgyzstan, Lebanon, Macau, Malaysia, Mauritius, Mongolia, Oman, Pakistan, Papua New Guinea, Philippines, Qatar, Saudi Arabia, Singapore, Sri Lanka, Taiwan-China, Thailand, Turkey, Turkmenistan, United Arab Emirates, Vietnam. Europe includes: Belarus, Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Greece, Hungary, Latvia, Lithuania, Moldova, Poland, Portugal, Romania, Russia, Slovak Republic, Slovenia, Ukraine. Latin America includes: Argentina, Barbados, Belize, Benin, Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, Suriname, Trinidad & Tobago, Uruguay, Venezuela.

Some of the Asian NRAs are owned, at least in part, by consortia of financial institutions (e.g. ICRA is mainly owned by Indian banks; RAM is owned by 49 financial institution) which may receive credit ratings of their own from the controlled NRA and may also have important business relationships with borrowers that receive ratings from the controlled NRA in turn. This ownership structure – probably stemming from the need to rely on private sector assistance in developing credit analysis – poses potential conflicts of interests, which should require greater efforts to ensure the integrity of the rating process.

Based on the scant literature addressing this issue, the growing coverage of NRAs may be a positive signal because the market appears to take into account both NRA and GRA ratings when pricing securities. For instance, Packer (2000) shows that a combination of NRA and GRA ratings predicts spreads on securities secondary market trading more accurately than any of the two classes taken separately.³ JCIF (2001)'s survey finds that, in the opinion of Japanese corporations, NRAs do not differ from GRAs in terms of market influence and recognition but NRAs get a strong minus as regards global activity while they are reputed somewhat better than GRAs in terms of: (i) placing more importance on factors relating to Japanese business practice (industrial specialization); (ii) providing more persuasive reasons as to the level of the assigned rating and/or of the subsequent changes (rating fairness) (Figure 4).

In addition, various authors have pointed out that the quality of GRAs' ratings is lower in emerging economies than in developed countries. First, GRAs have been accused of acting too late in revising their ratings in emerging markets. For instance, looking at the 1997-98 Asian crisis, Bongini et al (2002) find that stock prices and ratings did not outpace backward looking balance sheet information to assess bank fragility. By the same token, Reinhart (2002) and Sy (2004) show that sovereign downgrades in emerging countries follow (rather than lead) currency crises even though they do better at predicting defaults. According to Reinhart (2002) this is consistent with the view that currency instability raises the country's default risk. Second, other authors have charged GRAs of acting pro-cyclically in emerging economies. Specifically, it is argued that late recognition of problems may lead GRAs to downgrade emerging countries (both sovereigns and companies) excessively vis-à-vis what deserved by their fundamentals, thereby possibly exacerbating cycles and downturns in emerging countries. Macro evidence on this is provided by Monfort and Mulder (2000), Mulder and Perrelli (2001), Ferri, Liu and Stiglitz (1999), Kaminsky

³ Shin and Moore (2003) seem to contrast Packer's evidence as they find a systematic bias upward for the two Japanese rating agencies (JCR and R&I) and show the bias cannot be explained by keiretsu belonging. However, when they estimate a rating determination equation the discriminating power of the Japanese RAs as measured by the adjusted R² is no lower than for Moody's or S&P.

and Schmukler (2002), Kräussl (2003) and Reisen and von Maltzan (1999).⁴ Third, it has been pointed out that, in emerging economies, GRAs' ratings of private entities are too much linked to sovereign ratings so that sovereign downgrades cause firm-level downgrades (that are sticky to sovereign upgrades instead) via a "domicile effect" (Nickell et al. 2000), exerting also a negative impact on the cost of capital for emerging economies' private sector, a negative effect which will only be amplified by the new Basel II criteria (Ferri, Liu and Majnoni, 2001). Fourth, some authors have shown that the quality of private ratings is lower in emerging economies: e.g. Ferri and Liu (2003) find that firm specific risk dominates/sovereign risk is negligible for developed countries' firms while the opposite holds for emerging countries. Furthermore, there is some evidence that the lower quality of their ratings in emerging countries may be explained by the fact that GRAs under-invest in those countries. Vis-à-vis developed countries, GRAs seem to assign fewer analysts for emerging countries' sovereigns (absolute under-investment) and emerging countries' firm ratings is positively related to the number of analysts while the opposite holds for developed countries' firms, suggesting relative under-investment in emerging countries (Ferri, 2004; Ferri and Liu, 2005).

Thus, issuers may benefit obtaining ratings both from GRAs and from NRAs. Possibly, NRAs' judgment on issuer reliability places a larger weight on the local environment and business practice, which depends on idiosyncratic aspects of the specific country. On the contrary, GRAs may be keener to use standardized rating criteria for all issuers in the world, regardless of local business practice, and this could sometimes deliver an under-estimation of issuers' creditworthiness. Indeed, studying the case of Japan, Packer (2000) documents that the ratings assigned by NRAs are, on average, 3.5 notches higher than GRA ones. However, he also shows that, this notwithstanding, NRA ratings are more related to rated companies' financial ratios than GRA ratings.

There is a basic intuition behind the argument that NRAs may be an important factor to promote financial market development as well as to help a smooth phasing in on Basel II. The intuition runs as follows. Financial markets will develop more strongly and Basel II will be least disrupting/most effective if, *ceteris paribus*, a country enjoys a large number of rated companies. The availability of more rated companies will, in fact, improve the information available to intermediaries and investors. In turn, market failures depending on information asymmetries will be reduced and financial markets will be boosted by expanding both demand and supply. Indeed, nourishing NRAs can be key to increasing the number of rated companies in the country. This is

⁴ However, Mora (2004) questions some of this evidence for the East Asian crisis pointing to rating stickiness (in line with a conservative hypothesis, Löffler, 2004); while Hu et al. (2004) suggest that sovereign ratings were insufficiently conservative before the Asian and Russian crises.

because the presence in the country of the three big players (Moody's, S&P, Fitch, the global rating agencies; GRAs) may be not enough. By and large, the GRAs tend to specialize in the top rank of companies, i.e. the country's companies which are larger/more internationalized. In part, this depends on demand: larger/more internationalized companies are more inclined to get a rating from the GRAs as this rating will be more reputed in the international financial markets, where they may wish to issue debt. For another part, however, GRAs may chose to rate larger/more internationalized companies because these are the typical companies they do business with all over the world. By the same token, NRAs are likely more cost effective – and charge lower fees – at rating smaller/less internationalized companies, whose assessment depends more on getting local – often soft – information and understanding the local business practice. All in all, it appears that GRAs might have a comparative advantage in rating larger/more internationalized companies while NRAs might have a comparative advantage in rating smaller/less internationalized companies. This configures the possibility that GRAs and NRAs, rather than engaging in fierce competition across the board, might largely be complementary and specialize in different clientele. If so, a country lacking NRAs will have fewer rated companies and, consequently, less developed financial markets.

Now we try to verify whether, in fact, NRAs are more specialized in domestic-focused corporations. We investigate this hypothesis using rating data for Japan, Korea, India and Malaysia for listed non financial corporations only. We consider all issuers obtaining a rating either from GRAs or from NRAs or from both. In addition, we consider issuers' size along with as a proxy of their degree of internationalization. We measure issuers' size as the mean total asset in 2002. As a proxy for a company's degree of internationalization we distinguish whether a company is listed in a foreign stock market, beside being listed on its own domestic market. Naturally, one could think of many alternative ways to capture internationalization but our proxy is particularly valuable to convey that form of internationalization which could make GRA ratings more appealing. A firm which is also listed abroad is, in fact, the best potential candidate to issue securities in the international market and, as such, the most interested in obtaining a GRA rating, well recognized by global investors.

Among the companies obtaining a rating (also) from GRAs the share of companies listed also internationally is significantly larger than among companies receiving a rating only from NRAs. In India and Malaysia this share is 100.0% for the former group and, respectively, 69.1 and 77.4 for the latter group (Figure 5). The two figures for Japan are, respectively, 94.6 and 69.3%. only in the case of Korea we find the opposite: respectively, 48.3 and 65.2%.

The difference between GRAs' clientele and NRAs' one is even more blatant when we look at company size. The average size of the companies obtaining a rating only from NRAs is much smaller than that of those companies receiving a rating (also) from GRAs. The ratio of the average size of the former group to the average size of the latter group is 5.5% in Malaysia, 9.7% in Japan, 12.8% in India and 25.9% in Korea (Figure 6).

Our evidence on Asia, thus, supports the view that GRAs and NRAs do specialize in rating different clientele. In other words, there seems to be a division of labor between GRAs – specializing in larger-sized/internationalized companies – and NRAs – concentrating on smaller-sized/domestic-focused companies. Consequently, this evidence supports the view that the presence of NRAs may boost the extent of rated companies in a country and, through this, favor financial market development as well as a smooth phasing in of Basel II.

4. The Quality of ECAIs' Ratings in Asia: Focusing on Korea

According to the evidence above, some emerging Asian countries are in a good position among the emerging areas of the world in terms of endowment of national RAs. This judgment does not translate, though, in saying that the Asian situation is perfect. Indeed, it is quite possible that many of the numerous ratings offered by national RAs in emerging Asia are not as punctual and informative as they could be. To be sure, it is possible that some emerging Asian countries maintained their network of national RAs not only thanks to the underlying ability of its agencies, but also because of harder obstacles for global RAs to acquire them – something that the global did extensively in other areas of the world.

For this reason, we want to study whether NRAs are prone to give systematically “higher” ratings to local firms with respect to what is done by GRAs. This might be a problem particularly where GRAs have little business footing. In these Asian countries, the “generous” ratings given by NRAs would limit the impact of Basel II, but local companies could be disadvantaged in their access to international financial markets because: (i) these companies do not have easy access to the trusted ratings of the GRAs, and (ii) the ratings assigned by NRAs are disregarded by international investors. Instead, in those Asian emerging economies where GRAs have a solid business footing we might find two effects going in the opposite direction. On one hand, companies might suffer disadvantages because GRAs' ratings are generally low, and this could deliver larger Basel II capital requirements irrespective of corporate performance (Ferri, Liu and Majnoni, 2001). On the other hand, the quality of existing NRAs' ratings could improve over time as these agencies compete with the globally accepted best practices of the GRAs.

A further issue that arises even in the countries where GCRA have a solid operational base comes from the fact that the major business domain of ECAI activities is the credit rating of corporate bonds, not the corporate rating for bank loans. For those able to issue corporate bonds are bigger firms mostly listed at the stock exchange. The problem is that the number of firms that needs credit ratings from ECAI is all too small in Asian LDCs. This situation derives partly from the fact that the demand for credit rating has often been created by government regulation promoting the process of issuing corporate bonds. As such, corporate managers treat RAs' ratings just as simply "unavoidable cost" that should be expensed. This means RAs' ratings are not recognized as the right way to enhance market efficiency therefore a firm could reduce its financing cost. This represents a cultural bias which should be dealt with.

In the case of Korea, the number of firms having decent credit ratings by RAs is only 250 or so. This number tells us that even listed firms at KOSPI (some 800 are listed now) cannot access to the credit ratings by RAs. As such, most of loans are just classified as "unrated". Presumably, this is evidence that SMEs are frequently distanced from RAs. This could make the pro-cyclicality problem worse when a credit crunch hits the economy since SMEs are disproportionately dependent on bank loans. In addition, estimated PDs (probabilities of default) have often shown a weak power of recognition since there are no significant differences among investment grades (BBB or above). Accordingly, Korea's Banking regulator prefers IRB approach to the "standardized" approach. Bigger banks with large pool of loan screening officers will adopt the IRB approach. Whereas, small regional banks are scheduled to apply "standardized" approach. FSS will persuade regional banks to move to the IRB approach in due course. Finally, RAs have to extend their rating of firms down to SMEs located in small local cities so that regional banks can reliably depend on the rating outcomes by RAs. Thus, it is necessary to present the due process/course in expanding rating market in the SME area.

Table 1

Probability of Default

(%)

	'98	'99	'00	'01	'02	'03	'04	'05
Total	7.49	1.51	1.45	2.03	1.79	1.06	3.00	1.2
Investment grade	0.00	0.00	0.00	0.52	0.00	0.00	0.00	0.00
Speculative grade	18.11	4.76	3.87	4.89	4.85	3.81	15.11	6.77

source: Korea Financial Supervisory Services.

To further develop the above arguments, we will now focus on a more detailed analysis of the performance of Korean NRAs comparing it, where appropriate, to the performance of GRAs operating in Korea.

4.1. Credit Rating Performance of Korean NRAs

The credit rating performance (or the quality of ratings) of NRAs is often assessed in terms of their Annual Probability of Default, Transition Matrix, and Average Cumulative Default Rate (CDR).

The annual Probability of Default of Korean NRAs improved considerably in recent years. The default ratio of rated firms was 1.20% in 2005, down from 3.00% in 2004 (Table 1). This mainly reflects the improvement in debt servicing capacity of firms due to economic recovery. In addition, the improvement was driven by the evolution of the defaults of the speculative grade companies while the default rate was constantly nil over the observed years for investment grade companies. Nevertheless, it has to be pointed out that the 2005 improvement should not be overstated in as much 2004 – with its 15.11% default rate for speculative grade companies – was the most negative year since the 1998 crisis – when the default rate for these companies reached 18.11%.

The notion that there was some progress in 2005 is, however, supported also by the evidence that the ratio of credit ratings sustainability (Transition Matrix) of Korean NRAs improved too. It is worth reminding that the Transition Matrix is the share of firms which maintain the same credit ratings throughout the year. This share rose sharply from 2004 to 2005 (Table 2a). Furthermore, it can be observed that the improvement was recorded in each individual rating class (Table 2b).

Table 2a

Transition Matrix

	2004	2005
Investment grade	71.62% ~86.67%	81.01% ~93.98%
Speculation grade	38.27% ~ 53.45%	56.67% ~ 61.64%

source: Korea Financial Supervisory Services.

Though partly reflecting the ongoing economic recovery, at the same time, the improvement suggests that Korean NRAs have become increasingly more conservative in their credit assessment. However, this ratio was still low vis-à-vis comparable ratios by S&P or Moody's, indicating that credit ratings by Korea's NRAs are not sufficiently stable yet. This is also consistent with the existence of an upward bias of credit ratings by domestic RAs (Table 3).

Table 2b

Transition Matrix (2004 & 2005)

(%)

2004		End of year grade							
		AAA	AA	A	BBB	BB	B or lower	D	WR*
Beginning of the year grade	AAA	86.67							13.33
	AA	6.85	73.97	2.74					16.44
	A		8.95	72.63	3.16				15.26
	BBB			9.46	71.62	1.8			17.12
	BB				12.35	38.27	2.47	13.58	33.33
	B or lower				5.17	1.72	53.45	17.24	22.41

2005		End of year grade							
		AAA	AA	A	BBB	BB	B or lower	D	WR*
Beginning of the year grade	AAA	93.98							6.02
	AA	2.35	81.18						16.47
	A		6.7	75.6	1.44				16.27
	BBB			10.13	81.01				8.86
	BB				11.67	56.67	1.67		30
	B or lower						61.64	12.33	26.03

source: Korea Financial Supervisory Services,

* Withdrawal of Ratings

As expected, the average Cumulative Default Rate (CDR) tends to get larger for lower ratings over the same lapse or for longer lapses over the same ratings (Table 4).

Table 3

Comparison among S&P, Moody's and Korean RAs
(during the year 2005)

(%)

	Investment grade				Speculative grade	
	AAA	AA	A	BBB	BB	B or lower
S&P	88.20	87.16	87.24	84.13	75.74	59.87
Moody's	89.90	87.89	88.12	84.72	76.68	67.60
Korean RAs	92.77	76.69	73.18	71.94	56.46	52.30

Source: Korea Financial Supervisory Services.

Table 4**Annual Average CDR****(%)**

Grade		1 st year	2 nd year	3 rd year	4 th year	5 th year	6 th year	7 th year
Investment grade	AAA, AA	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	A	0.00	0.00	0.12	0.12	0.12	0.12	0.12
	BBB	0.16	0.40	0.68	1.42	2.05	2.05	2.05
Speculative grade	BB	3.94	6.64	8.54	9.38	9.77	10.17	10.60
	B or lower	12.77	15.63	17.68	17.68	17.68	17.68	17.68

Source: Korea Financial Supervisory Services.

For a given lapse of comparable ratings, the ratio of Korean NRAs is lower than those of S&P and Moody's (Table 5). This suggests that firms of relatively better quality tend to be rated in Korea. Indeed, even less than one-third of listed firms at KOSPI gain access to the credit ratings by NRAs.

Table 5**Comparison of Average CDR among S&P, Moody's and Korean RAs****(%)**

		1 st year	2 nd year	3 rd year	4 th year	5 th year	6 th year	7 th year
Investment grade	Korea RAs	0.07	0.19	0.37	0.76	1.11	1.11	1.11
	S&P	0.11	0.32	0.56	0.89	1.24	1.59	1.91
	Moody's	0.08	0.23	0.44	0.69	0.93	1.16	1.38
Speculative grade	Korea RAs	6.44	9.18	11.12	11.74	12.01	12.28	12.56
	S&P	5.05	10.32	15.33	19.61	23.12	26.20	28.90
	Moody's	5.15	10.42	15.43	19.77	23.49	26.70	29.48

4.2. Selected Issues

The most frequently-asked single question to the credit rating experts in Korea is: "By how much will the existing ratings already assigned by Korean NRAs be lowered with the introduction of Basel II?" (Jung and Yang, 2006). This shows a clear evidence that market participants in the credit rating market recognize the lenient rating behavior of Korea RAs for local Korean firms. The core factor behind this leniency is the lack of independence of Korean NRAs. Specifically, a number of issues need to be addressed in order to enhance the independence of NRAs in Korea. Obviously, in fact, the less independent NRAs may be more likely to result in the upward bias of credit ratings by domestic RAs.

(1) Ownership and Governance Structure

To ensure the independence of NRAs, the Act of Credit Information Utilization and Protection specifies regulatory ceilings on the ownership stake held by certain types of institutions. For example, member companies of the large business groups and financial institutions are only allowed to hold an ownership stake of less than 10%. Even within these ceilings, however, it is quite possible that the interests of NRAs are too closely aligned with those of their financial institution shareholders to preserve the independence of NRAs. For instance, one of the credit agencies (Korea Ratings Inc.) tends to rate a disproportionately high share of securities underwritten as lead institution by the Korea Development Bank which happens to be a major shareholder of the company (Lee and Park, 2005).

The substantial presence of Korean conglomerate groups as significant shareholders of Korean NRAs is testified by the distribution of these institutions' shares reported in Table 6.

(2) Industry Structure and Practices

According to some observers, in the United States, in spite of the NRSRO certification introduced in 1975 – which reportedly favors collusion among GRAs (White, 2001) – the rating industry has experienced some form of competition. This may have led the GRAs to seek out quality, and thus enhance the credibility of their credit ratings. In contrast, the competition in the industry is quite limited in Korea. The industry is dominated by only three firms, and these firms have a steady stream of business due to the regulation that requires newly issued corporate bonds to be rated by more than two RAs. This lack of competition strongly indicates that NRAs in Korea face little market-based discipline to improve their rating quality. Furthermore, they appear to “ride the herd” in rating the same company – possibly by sharing information. Therefore, the current industry structure and practices in Korea may undermine the objectivity of the credit ratings assigned by local NRAs.

(3) Conflicts of Interest

While the rating fees collected from customers account for a small portion of incomes of GRAs, the income of Korean NRAs depends heavily on the rating fees.

Table 6**Ownership Structure of Korea RAs**

	As of December 2005	As of March 2006 ¹⁾
	Share(Stockholders holding more than 5%)	Share(Stockholders holding more than 5%)
National Information & Credit Evaluation	Kwang-Soo Kim and affiliates (36.05%) VANDA PTE LTD(14.93%) TOKYO SHOKO RESERCH (6.88%) Employee Stock Ownership Association (5.93%) Initech (5.07%)	Kwang-Soo Kim and affiliates (48.74%) Korea Lottery Service and affiliates (7.23%) TOKYO SHOKO RESERCH (6.88%) Initech (5.07%)
Korea Ratings	Hanil Cement and affiliates (38.92%) KDB(9.66%) JF ASSET MANAGEMENT (8.49%) Fitch-Ratings (7.88%)	Hanil Cement and affiliates (38.92%) KDB (9.66%) JF ASSET MANAGEMENT (8.49%) Fitch-Ratings (7.88%)
Korea Investors Service	Moody's Investors service (50%+1stock) KIS Information service(50%-1stock)	—

1) National Information & Credit Evaluation (as of March 16), Korea Ratings (as of March 31)

The heavy dependence on rating fees is likely to create a serious conflict of interest. The limited customer base in Korea may intensify such a conflict of interest even further. As pointed out above, fewer than one-third of listed firms at KOSPI hold a credit ratings from NRAs, and many of them are subsidiaries of a limited number of large business groups. Given their income structure, RAs may not be entirely free from the influence of their large business group customers. Furthermore, NRAs also provide other services (or incidental services) such as sales of firm's credit information, collection services, consulting services, which may themselves create a conflict of interest as well and lead to less objective ratings.

For those two RAs (RA 1 and RA 1 in Table 7) simultaneously conducting credit rating services as well as incidental services for 68 firms during 2000~04, a total of 8 cases are reported as being "differently-rated" compared to ratings by other RAs only doing credit rating business. These cases clearly show the behavior of favorable treatment by RAs engaging in incidental services.

Table 7**Incidental Services and Credit Rating Gap of Corporate Bonds among RAs**

	<i>RA 1</i>			<i>RA 2</i>		
	Number of Firms when RAs are doing Incidental + Credit Rating services simultaneously	when credit ratings of <i>RA 1</i> are higher than that of credit rating-only RAs	when credit ratings of <i>RA 1</i> are lower than that of credit rating-only RAs	Number of Firms when RAs are doing Incidental + Credit Rating services simultaneously	when credit ratings of <i>RA 2</i> are higher than that of credit rating-only RAs	when credit ratings of <i>RA 2</i> are lower than that of credit rating-only RAs
2000	11	1		1		
2001	7	2				
2002	11	2		1		
2003	12	1	1	3		
2004	19		1	3		
Total	60	6	2	8	0	0

source: Lee & Park (2005)

(4) Other Issues

Although Korean NRAs provide information on individual ratings, methodology and default study on their webpages or through e-mails, more information need be made available in public especially in English. In addition, Basel II requires a 10 year average of three-year CDR for the mapping of credit ratings and risk weights. However, Korean NRAs have difficulty in calculating the relevant CDR due to their short history and credit rating assigned during the financial crisis in 1997-98.

4.3. ECAI Recognition

The FSS aims to designate ECAIs in preparation for Basel II scheduled to be introduced at the end of 2007. ECAIs will assign credit ratings to loans held by financial institutions and their borrowers, securities and their issuers, and asset-backed securities. These ratings by ECAIs will be used mostly by banks adopting the standard approach to determine risk weights for calculation of risk-weighted assets. The ratings by ECAIs may also be used by banks adopting IRB (Internal ratings-based) approach as a benchmark for the ratings of their internal risk management models. According to the Core Proposal for ECAI Recognition prepared by the FSS, the designation will be based on the 5 criteria: (i) objectivity; (ii) independence; (iii) consistency; (iv) transparency; and (v) credibility.

4.4. Some Preliminary Conclusions

Korean NRAs appear to give systematically higher ratings to local firms than GRAs. The introduction of ECAs may help somewhat mitigate this upward bias. The more active participation of GRAs also will help to a great degree. However, GRAs have currently very limited presence in Korea. The credit rating industry was in fact completely closed to GRAs until Moody's made a business alliance with National Information & Credit Evaluation Inc. on 18 August 1998 and currently holds a 50%+1 stock stake of the company. Fitch-IBCA also came to hold a 7.88% share of Korea Ratings Inc. following the business alliance on 20 January 1999.

The Korean government will completely phase out any remaining restrictions on the entry of GRAs in July 2006. This is definitely a policy move in the right direction, and will introduce competition in the industry, enhance the independence of credit ratings, and promote the import of sophisticated rating techniques. With more reliable credit ratings that might follow, foreign investors are expected to invest in the Korean corporate bond market more actively. The current share of foreign investors in the market is below 1%, whereas the foreign investor share in the Korean stock market exceeds 40%.

It should be also noted that a conflict of interest prevalent in the Korean NRAs can be greatly reduced via the introduction of a subscription-based fee system. According to BIS (2000), RAs are increasingly adopting the business model based on subscription-based fees rather than issue-based fees. It is widely believed that RAs with the former business model were quicker to downgrade the ratings of such companies as Enron and WorldCom than Moody's and others with issue-based fee system.

5. Conclusions and Policy Implications for Asia

To conclude, it appears that some emerging Asian countries already have a relatively thick network of national agencies and don't need to build a new one. In view of Basel II, however, there is a need to expand the clientele and to improve the rating quality. Bearing in mind the large economies of scale in the rating business and of the fact that supranational RAs may be better able to issue independent assessment, emerging Asia might benefit by fostering some consolidation at the regional level of its RAs. Such consolidation could give rise to a few more solid regional-level RAs. This would probably allow Asia to reap the advantage of better cost efficiency and rating reliability building on institutions which maintain a strong focus on understanding the local business practice and have an incentive to seek expanding the rating market toward smaller-sized companies. In this

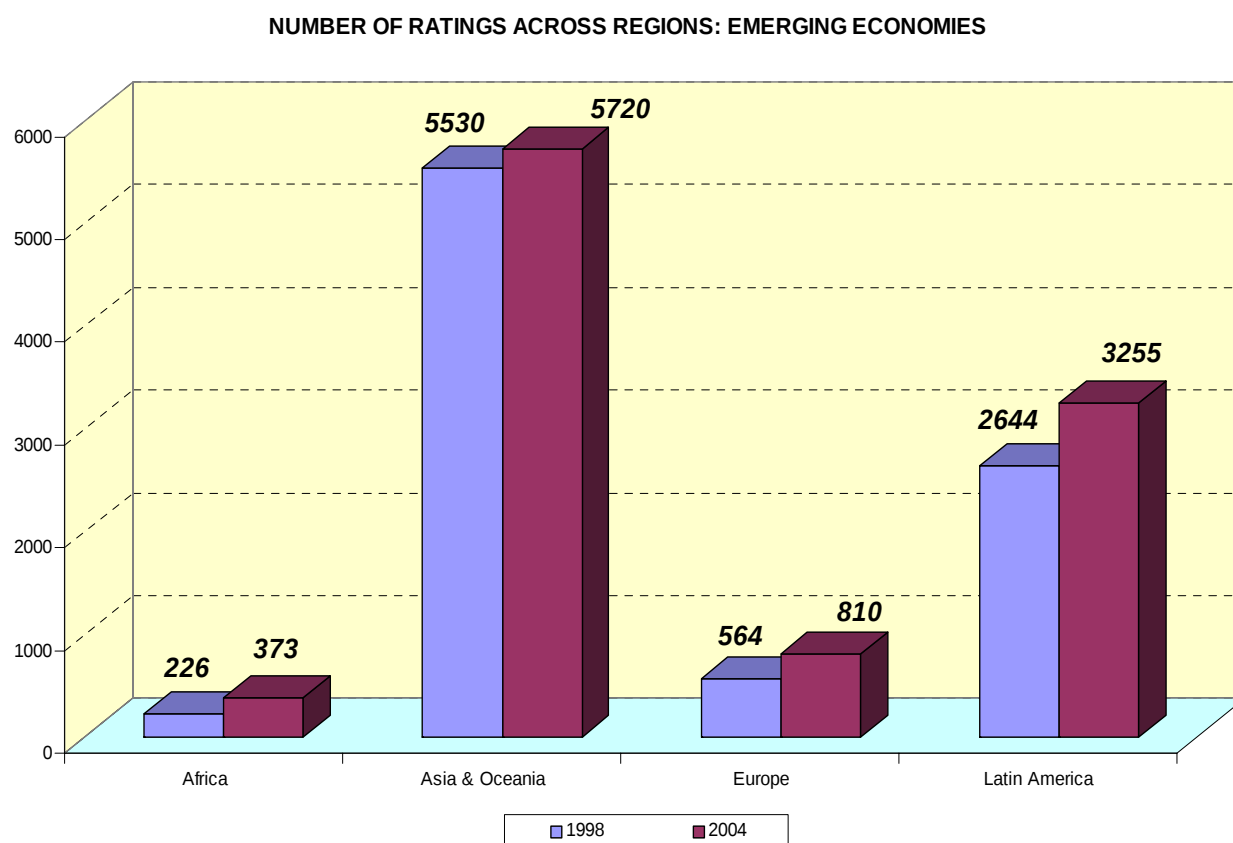
sense, the benefit would not be limited to a smoother working of Basel II but would extend to providing a potential boost to financial market development at large.

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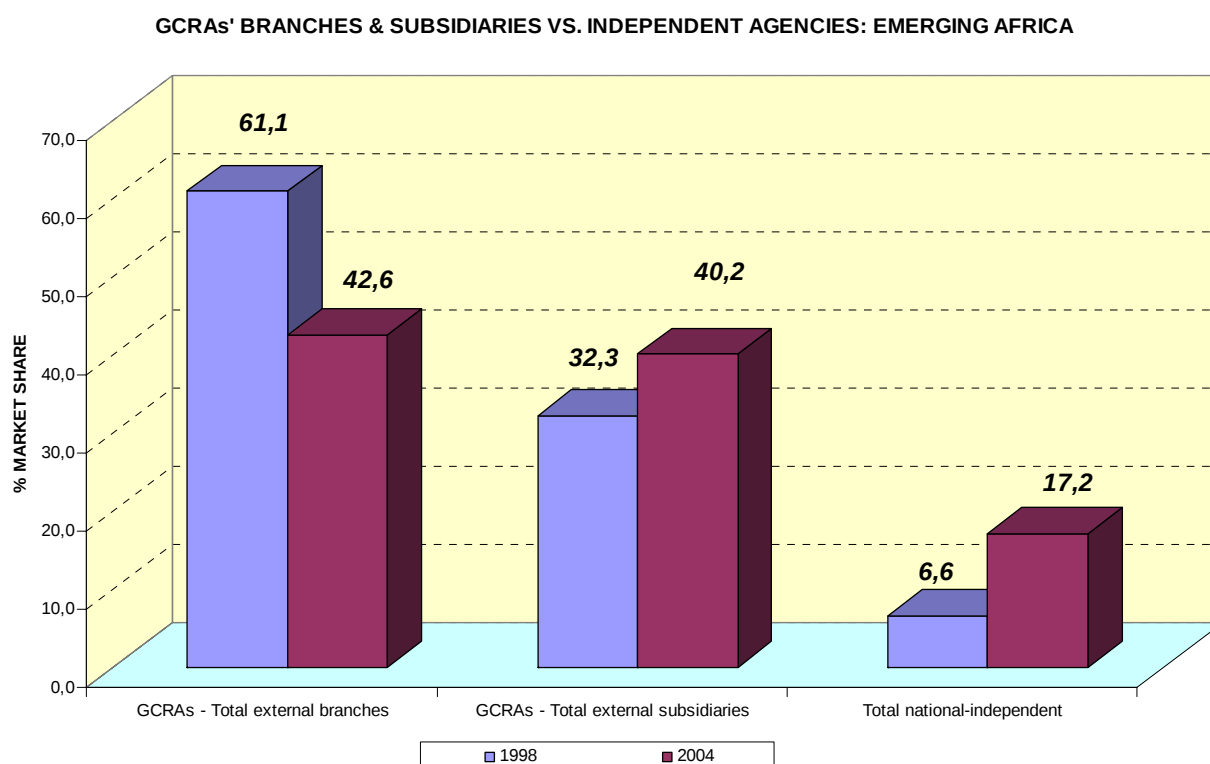
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Figure 1



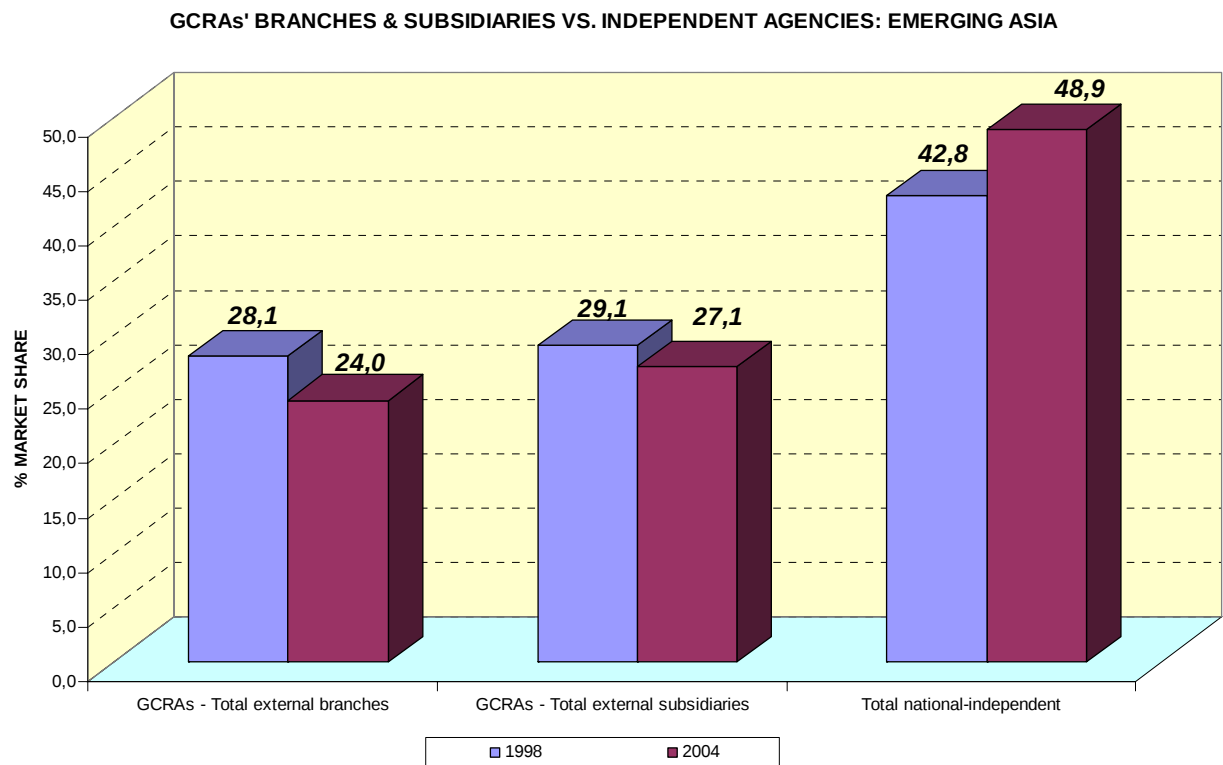
Source: Our calculations on Financial Times Interactive data for Winter 1998-99 and Winter 2004.

Figure 2a



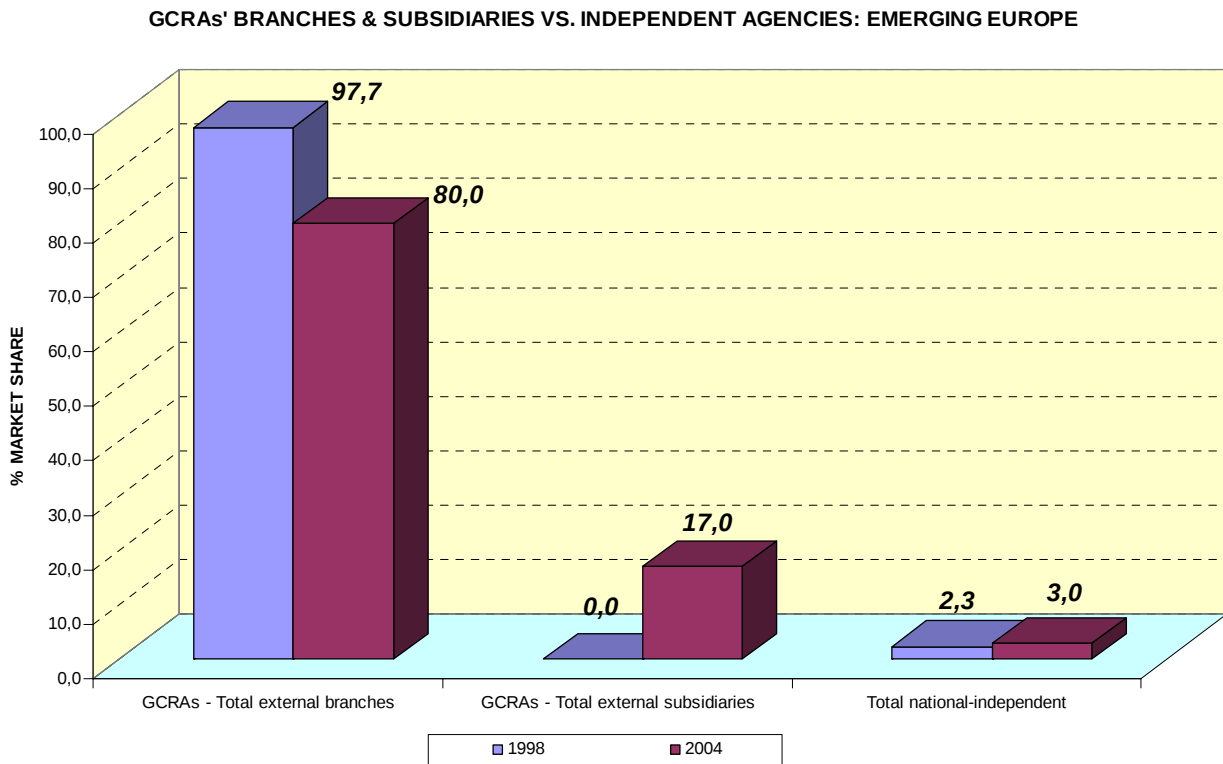
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Figure 2b



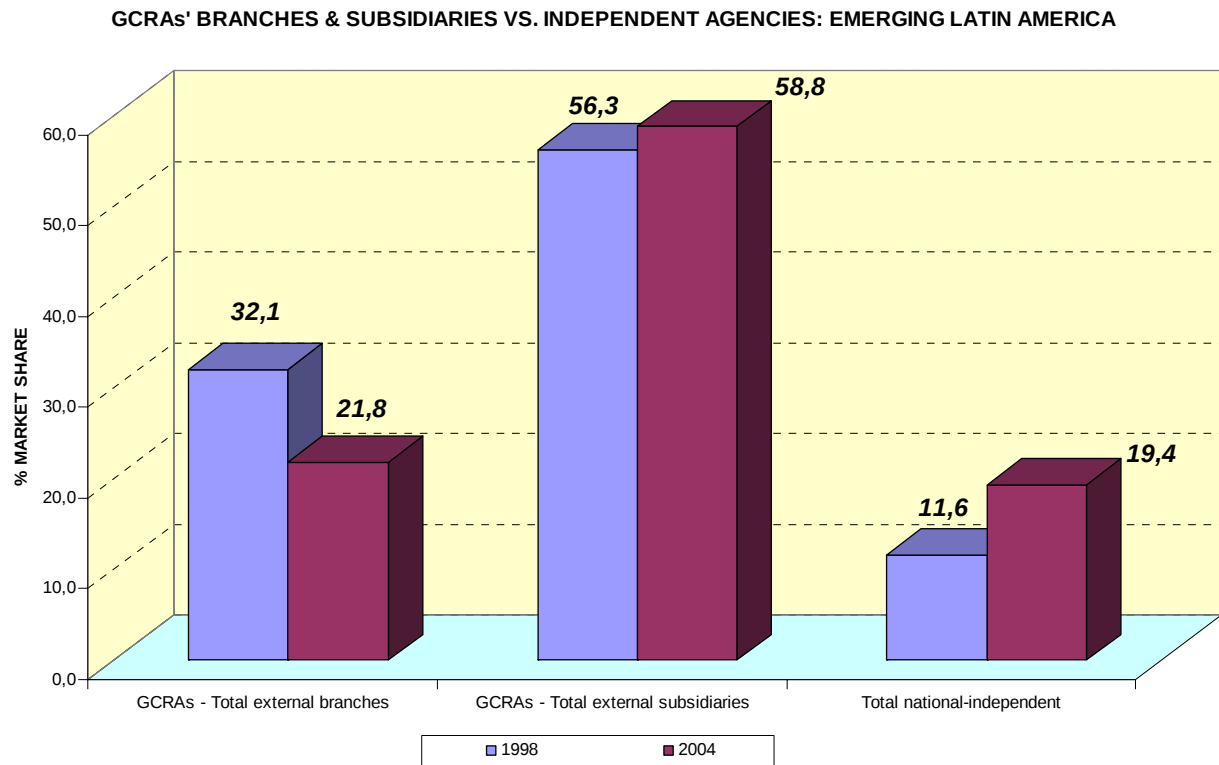
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Figure 2c



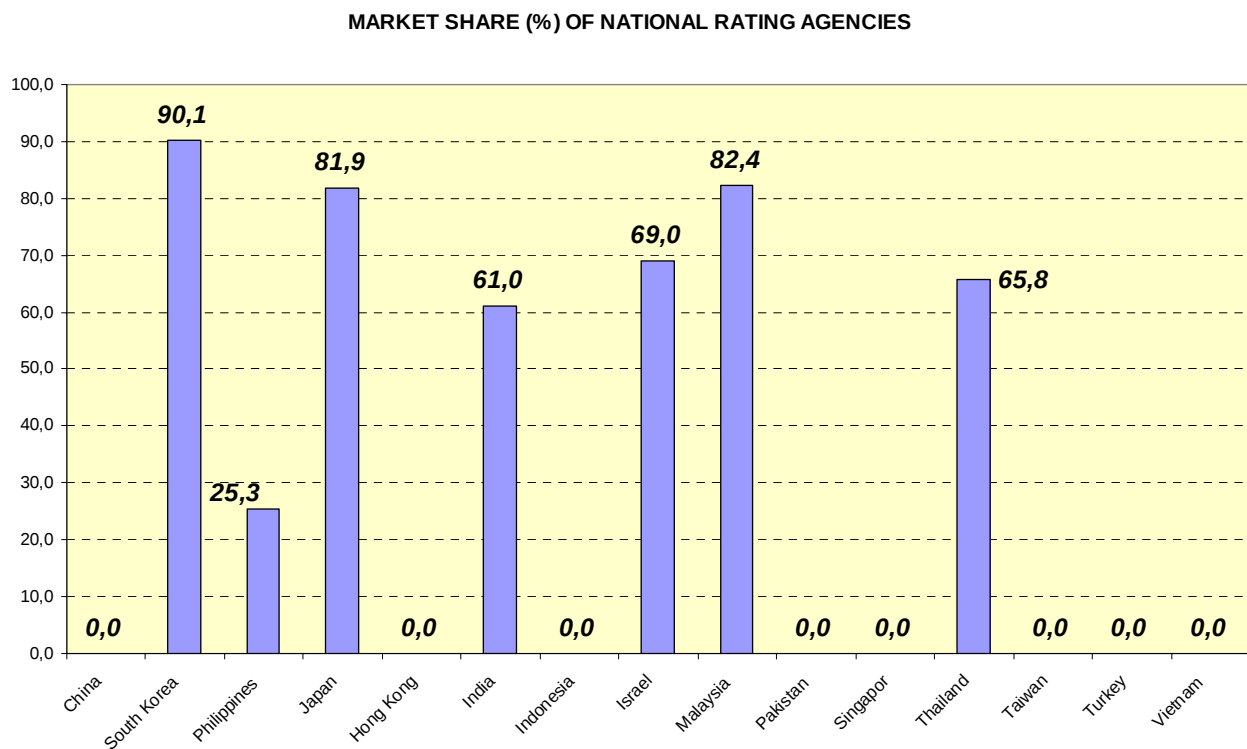
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Figure 2d



Source: Our calculations on Financial Times Interactive data for Winter 1998-99 and Winter 2004.

Figure 3



Source: Our calculations on Financial Times Interactive data for Winter 2004.

Figure 4

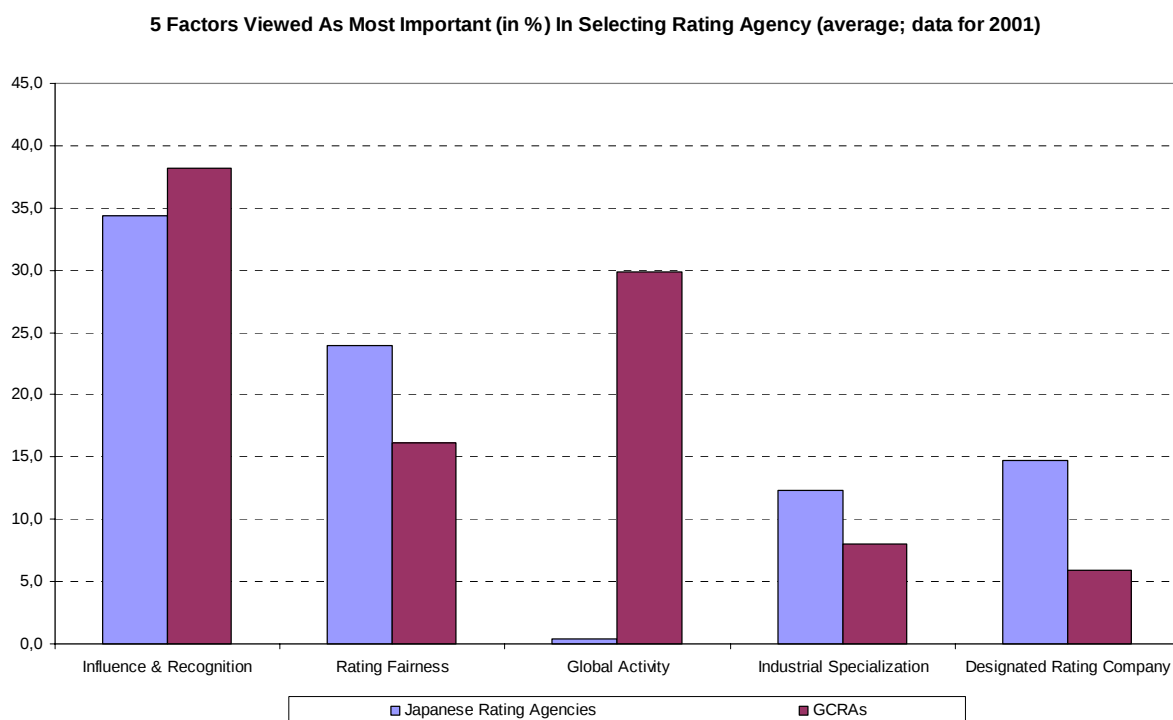
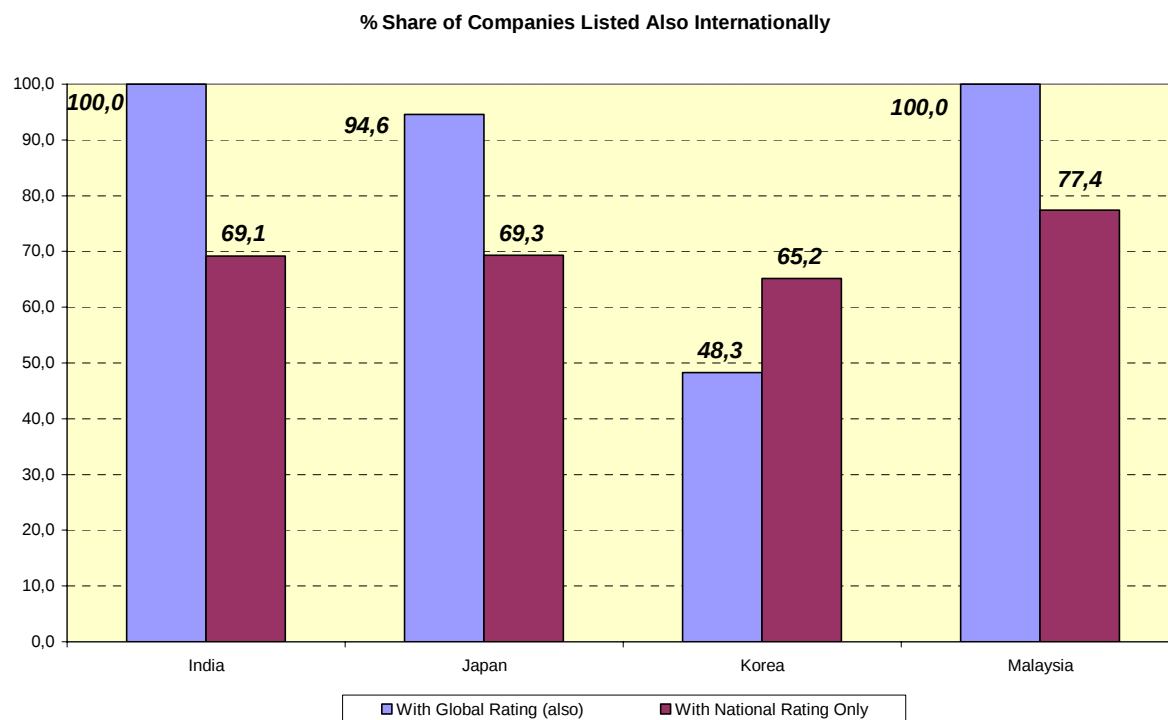
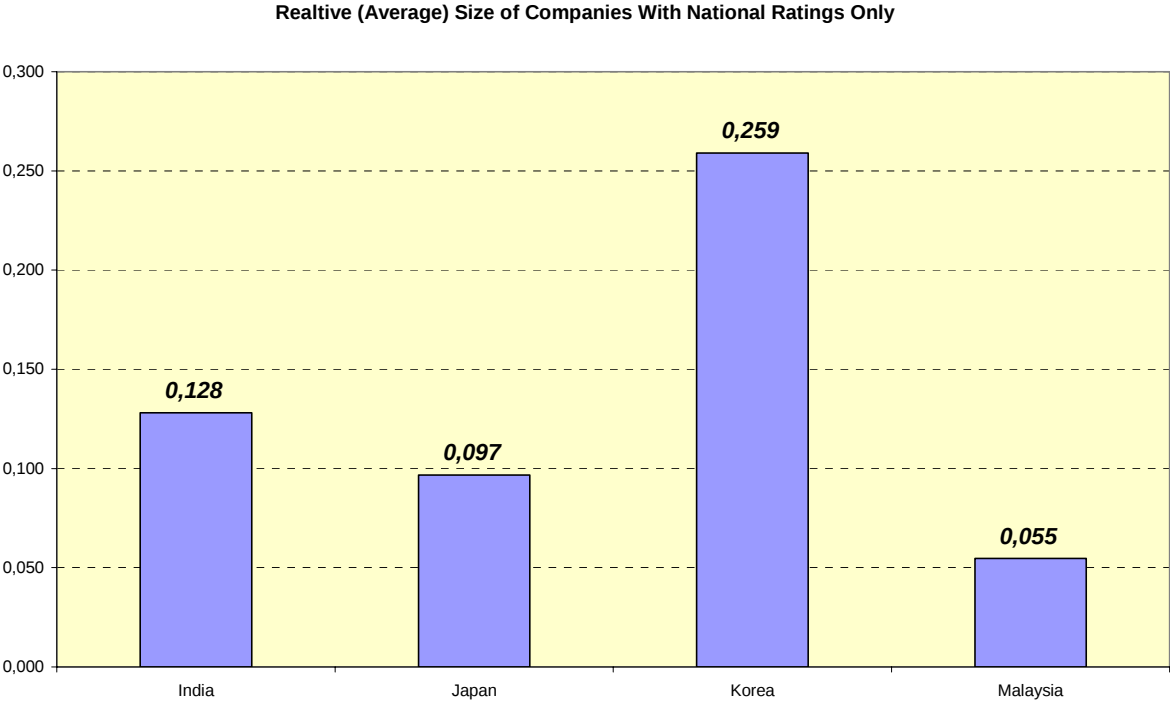


Figure 5



Source: Our calculations on Bloomberg data between 1990 and may 2005.

Figure 6



Source: Our calculations on Bloomberg data between 1990 and may 2005.