

ACRAA Working Paper on Harmonization
Presented by Mr. Faheem Ahmad
President & CEO, JCR-VIS Credit Rating Co. Ltd. (Pakistan)

I would like to begin this paper by recognizing the success of ACRAA in its objectives of training of analysts and providing the regional rating agencies a forum to discuss various issues of mutual interest. A special case in point was the June 2005 meeting in Manila to discuss the impact of the implementation of Basel-II on the member rating agencies. ACRAA provides unique opportunities for members with less developed capital markets and rating cultures to learn from those members who have more experience.

However, the topic of my current paper is harmonization, one of the key objectives set by ACRAA for itself at the time of its formation some five years ago. To date, the progress on this area has not been at the rate which we may have hoped. Although, we had a good interaction on this topic in November last year in Malaysia with Mr. Ravimohan of CRISIL presenting his views and myself being the reactor, we need to identify concrete steps in order to achieve our goals in this regard. In the time frame given today this paper is designed to give food for thought to the participants of this meeting and is by no means an end solution.

To put harmonization into context would also mean taking a look at what ACRAA perceives as its future. There has been some mention that ACRAA could grow from just being an association of rating agencies in the region to being an regional rating agency in its own right. However, such an ambition does not recognize the heterogeneous structure of the ACRAA membership. Not only do we have a large number of members who are each others competitors in their domestic markets, a large number of the members have some form or another of affiliation with major international rating agencies such as Moody's, S&P, Fitch and JCRA. It would be almost impossible to bring all the members to agree to such an objective which would not only entail commercial cooperation between competitors but also put some members in the unenviable situation of participating in the creation and running of a competitor for their principals. That concept would therefore probably remain an ideal rather than a practical approach.

This does not mean that ACRAA is a redundant body. Far from it. In fact by remaining a non-commercial organization dedicated to improving the

standards of rating agencies in the region ACRAA will only gain in credibility. The Code of Conduct for Rating Agencies promulgated by the Securities & Exchange Commission of Pakistan makes ACRAA membership mandatory for all licensed rating agencies. All ACRAA has to do is to define for itself a role that will enable it to continue making an effective contribution to the rating culture across the continent. Obviously, there will be some teething pains but that is natural since there is no model of such an association in the world that ACRAA can just copy.

Now where does this leave us with respect to harmonization? It all depends on how ACRAA eventually defines harmonization and how it then chooses to implement it. One of the first benefits of harmonization as envisaged at the time of the formation of ACRAA was the improvement in cross-border investment flows. However, keeping in view the very nascent stage the bond markets of most of the countries represented in this forum find themselves in, this would be akin to putting the cart before the horse. For cross border investment flows to be encouraged would first require depth in the individual debt markets of the member countries. Rating is only a secondary requirement in this case. Cross-border flows of investment are also subject to sovereign risks. Since the entire membership of ACRAA, with the exception of JCRA, consists of domestic credit rating agencies that assign rating on their respective national scales the rating assigned by one rating agency to a company inside its own country will have little meaning to a foreign investor. The efficacy for a foreign investor would be in the relative standings of the various companies within a country, assuming that he is aware of the sovereign risk and is willing to assume it. It is at this point that that he will need to be confident of the quality of the rating agency assigning the ratings. Now what assures quality ratings? Is an international affiliation from a major international rating agency enough to satisfy questions about the quality of a rating agency? How does an outside party determine the extent of involvement of the foreign principals in ensuring quality controls at the rating agency? What about those agencies that do not have international affiliations?

To answer the above questions we will have to determine what constitutes a quality rating agency. Some time back, just defining the parameters of rating agency quality would have been a separate exercise in itself. Luckily, today we have the guidelines of the Basel Committee on Capital Adequacy available, which have defined the major parameters for rating agency quality as far as they are concerned. I am sure that like my own company many of

the members here are either already in the process or shortly expect to begin the process of communicating with their banking supervisors with regard to the criteria for External Credit Assessment Institution as envisaged by the standardized approach to calculating capital adequacy under the new Basel-II Accord. Just for a quick recap the areas for assessment listed by the Basel-II Accord are:

- **Objectivity (methodologies/ continuous surveillance/ responsiveness to change in financial condition/rigorous back testing)**
- **Independence (potential conflicts arising due to economic/political pressure, shareholding structure or board composition)**
- **Disclosure (methodologies/ meanings/ time horizon/default studies/equal access)**
- **Resources (human resources, infrastructure, systems)**
- **Credibility (internal systems for misuse of confidential information, reliance by third parties)**

Using the above criteria, banking supervisor's the world over are expected to carry out mapping of the rating agencies i.e. to assign specific risk-weights to the ratings assigned by each rating agency in their jurisdiction that applies for ECAI status. The option of not applying for this status does not really exist due to the significant business ramifications, particularly in countries where the voluntary rating culture is not very strong. There may be a possibility that the risk-weights assigned by the respective supervisor's may be used as a basis of relative quality of ratings but this will be more applicable within the supervisor's jurisdiction rather than on a cross-border basis. This is because each supervisor may have a different perspective on quality of rating agencies and also the fact that they will again be assigning the risk weights keeping in view their respective economic condition. Also, the controversy will remain regarding the fact that even if the same considerations are taken into account by different supervisor's the mapping will eventually be a subjective exercise and therefore there could be controversy about the judgment of different supervisors. There will also remain the issue of timing differences in the implementation of Basel-II in various jurisdictions. Lastly, using the Basel-II mapping as a benchmark for harmonization will not work in the case of rating agencies not granted ECAI status.

Keeping in view the above discussion, I believe that ACRAA can play an effective role in harmonizing the best practices of rating agencies in line with the Basel-II criteria rather than areas such as content of methodologies etc. This will allow ACRAA to play an important role in improving the rating culture across Asia and provide benchmarks for newly forming rating agencies to aspire to, without encroaching on the actual proprietary areas of the rating business. It must be remembered that difference of opinion is a must in a research oriented business like ratings and in fact acts as a spur for competing rating agencies to excel further and any attempt to standardize methodologies, apart from creating the inevitable conflicts with principals for foreign affiliated rating agencies and issues of collaborating with competitors, would actually act as a dampener to innovation in the industry. However, there can be no denying that a single standard of ethics and best practices can be created (allowing room for alternative approaches where necessary). ACRAA can create its own code of conduct for rating agencies and going forward, even provide some kind of certification function regarding compliance with the code. This would significantly help in improving the image of the rating business. In the end I would like to propose that we form a working committee with a specific deadline (say one year) to finalize ACRAA's approach to harmonization and then, once they have received approval for the same from the ACRAA members, to devise suggestions for practical implementation of that approach.