The Regional Credit Guarantee and Credit Rating System

Workshop on Developing Asian Bond Market in Financial Crisis:
New Roadmap and Regional Financial Cooperation

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Outline

- Credit Guarantee & Investment Mechanism (CGIM) and Credit Rating Agency (CRA) are important components in developing bond markets in Asia
- Asian Bond Markets: Review issues and Asian Bond Market Initiative (ABMI) milestones
- Analysis of the Financial Crisis and implications to bond markets development in Asia

Why a credit guarantee and credit rating facilities needed?

Information asymmetries / lack of transparency prevent private corporations from issuing bonds

↓

Information gap between issuer's credit quality and investors' minimum credit requirement

↓

Significant impediments to the development of the efficient and liquid bond markets in the region

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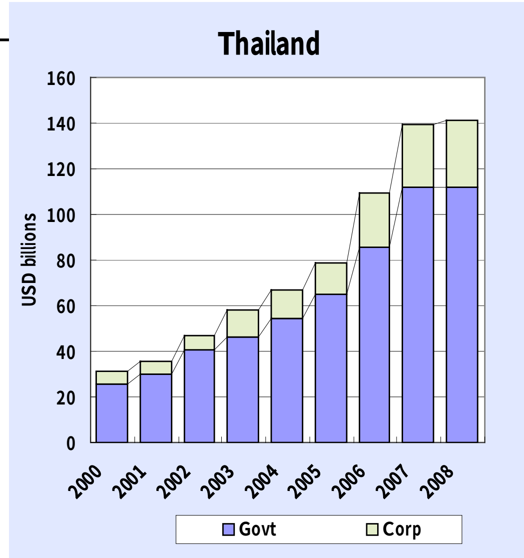
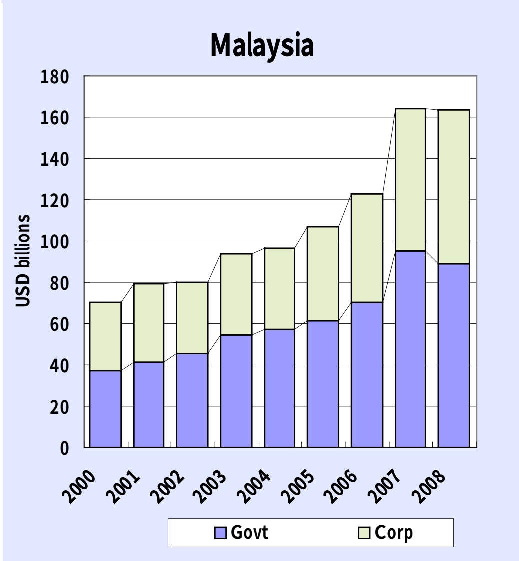
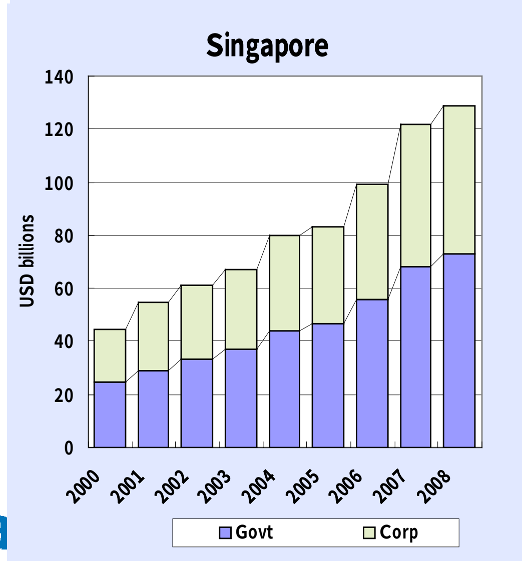
A regional credit guarantee facility and credit rating agency could help the bond market development by enhancing issuer credit quality and narrowing the information gap

Size and composition of Asian Bond Markets

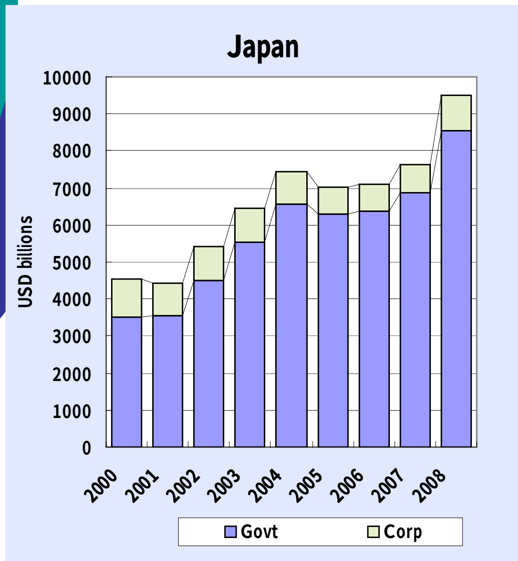


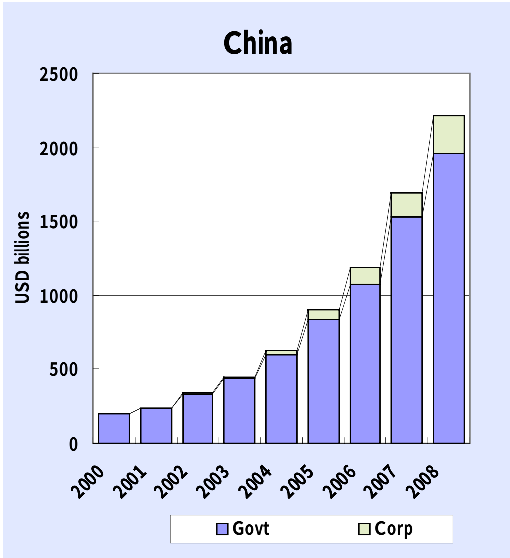


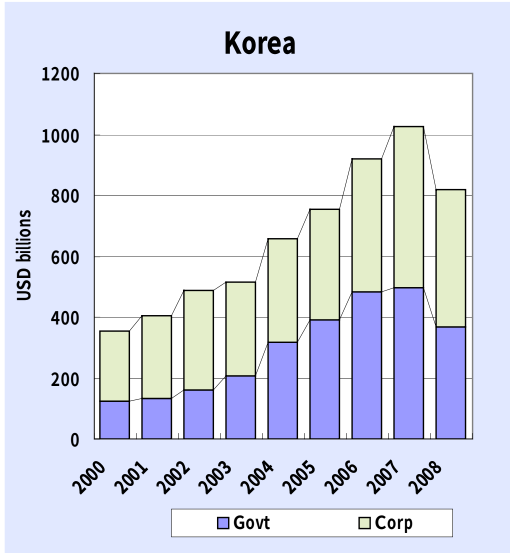


(Source ADB Asian Bonds Online)

Size and composition of Asian Bond Markets







(Source ADB Asian Bonds Online)

(Emerging East Asian bond markets: People’s Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Thailand; and Viet Nam)

- At the end of June, emerging East Asia had $3.94 trillion in local currency bonds outstanding
- 5.2% more in local currency terms than at the end of March
- 12.8% more than at the end of the first half of 2008
- Government issuance jumped 59.8% in the second quarter of the year from the first quarter, and was 38.0% higher than in the second quarter of 2008
- Corporate issuance rose 26.8% on quarter and leapt 90.6% on year

Issues in developing bond markets in Asia

- Information asymmetries prevent effective and efficient interaction among market participants, especially in matching bond issuers with investors.
- This informational gap between an issuer’s credit quality and the minimum credit requirements of investors is one of the most significant impediments to the development of liquid bond markets, both domestic and regional.

Information gap: asymmetric information in the capital market

Cost in the capital market might be higher than in the banking market.

symmetric		asymmetric	
borrower	lender	borrower	lender
	interest rate		interest rate
Borrower1	8%	Borrower1	15%
Borrower2	8%	Borrower2	15%
Borrower3	8%	Borrower3	15%
Borrower4	20%	Borrower4	15%
Borrower5	20%	Borrower5	15%
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Borrower99	8%	Borrower99	15%
Borrower100	8%	Borrower100	15%
Average	9%	Average	15%

15% - 9% = 6% (agency cost)

Rating agency and credit guarantee eliminates the asymmetric problem

Regulations on corporate bond issuance/ CRA

- The disclosure-based model
  - increasingly becoming the global standard
  - the issuer is required to disclose all relevant information, but investors have to decide themselves whether the bond is fairly valued.

- The merit-based model
  - A regulator decides whether an issuer is fit to launch a bond
  - The regulator's decision may be based on pure discretion, but more typically is based on a number of criteria, like the issuer's past financial performance, capitalization, size of the issue, rating and so on

	China	**Japan**	**Indonesia**	**Korea**
Issuance model	Merit	Disclosure	Merit	Merit
Mandatory rating	Yes	No	Yes	Yes
CRAs	6	5	2	4
	Malaysia	**Philippines**	**Singapore**	**Thailand**
Issuance model	Disclosure	Merit	Disclosure	Merit
Mandatory rating	Yes	Yes	No	Yes
CRAs	2	1	None	2

(Source BIS Papers No 30 DIR)

Asian Bond Markets Initiative

- Endorsed at the ASEAN+3 Finance Ministers Meeting in August 2003 to accelerate the development of efficient and liquid bond markets in the region
- Credit Guarantee Investment Mechanism (CGIM) and enhancing Domestic Credit Rating Agencies (DCRAs) are key issues
- Enhancing credibility and visibility of the local CRAs in the Region
  - Enhancing comparability and harmonization
  - Capacity building of local CRAs in Asia
- The primary role of the CGIM is to provide local currency bond guarantees, which should aid in removing credit quality information asymmetries and with DCRA help bridge the gap between issuers and investors.

ABMI milestones (CGIM/CRA)

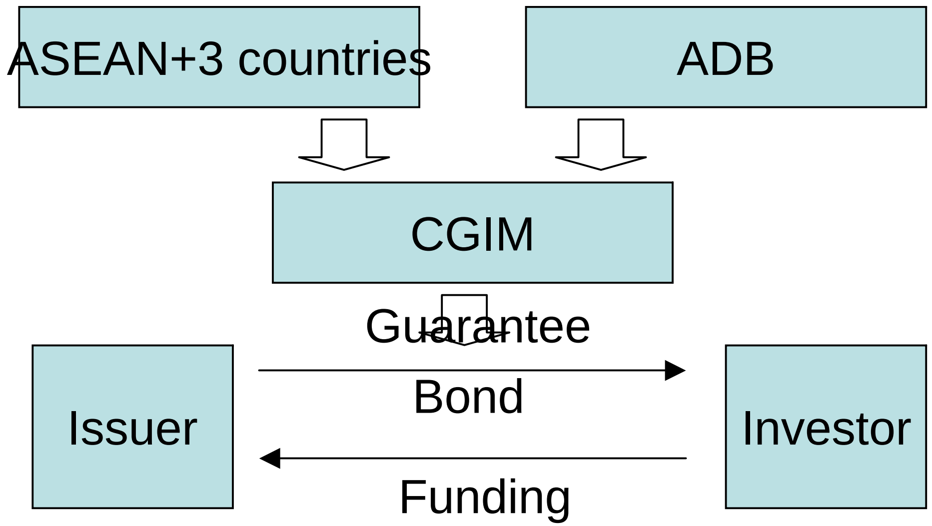
- CGIM
  - "We endorsed the establishment of the Credit Guarantee and Investment Mechanism (CGIM) as a trust fund of the ADB with an initial capital of US$500 million which could be increased once the demand is fully met. The objective of CGIM is to support the issuance of local currency-denominated corporate bond in our region. This initiative would contribute to developing regional bond markets. Issues regarding the establishment of CGIM such as business scope, leverage ratio and country limit are to be further discussed at the working level in order to make the mechanism to be effective by the 2010 AFMM+3.

    (The Joint Media Statement of The 12th ASEAN+3 Finance Ministers' Meeting 3 May 2009, Bali, Indonesia)"

- DCRA
  - Established on going collaboration in the region including capacity building
  - Established "Best practice" regarding common rating practice, methodologies, database etc in cooperation with the rating agencies in the region

Structure of CGIM

- A trust fund under ADB provide credit guarantee for the Asian corporations
- Focus on the long term finance, i.e plant investment infrastructure investment
- Contribution by ASEAN+3 countries plus ADB with $ 500 million on the launch



Best practice: Credit Rating by DCRAs

- Essential Best Practices
- Desirable Best practices
- Three-Phase Recommendation

The guide—based on extensive consultations with a wide spectrum of industry experts—will not only enhance rating practices but also pave the way toward regional harmonization of ratings. This will help investors (domestic and global) better understand credit ratings by DCRAs and enable them to compare the risks of different issuers. This will boost the credibility of DCRA ratings and help investors better participate in Asia's bond markets, a critical measure in building well-functioning bond markets. (ADB 2008)
(http://www.adb.org/Documents/Books/Handbook-Credit-Rating/default.asp)

Global Financial Crisis

- Origination to Distribution Model and Moral hazard
- Dependency on monolines
- Complementary and dependency on credit rating
- Mark-to-Market accounting and “pro-cyclicality”
- Weak risk management

Process of the collapse of the credit bubble

	1st Stage (07 fall ~ year end)	2nd Stage (08Jan~mid-Feb)	3rd Stage (late Feb ~ late July)	4th Stage (late Aug ~ present)	5th Stage
Stage of Financial Crisis	Subprime Crisis	**Mono-line Crisis**	Solvency Crisis	Chain reaction in financial institution failures	The worst-war financial recession
Credit Crisis	Huge subprime-related losses Plunge in securitized products prices SIV Issues (Liquidity risk) Drastic contraction of ABCP market	Downgrading of mono-line insurance companies Expansion of the credit crisis Functional breakdown of the securitization market CDS counterparty risk	Deepening of the mortgage crisis Tightening of financial institutions` credit lines Default of major hedge funds Management crisis of Bear Stearns Securities GSE Issue	Chain reaction of solvency failures Increased financial systemic risk Further plunge of global stock and the USD	First post-war case of a chain reaction of major banking failure Global spread of the financial crisis Global stock market crash, accelerated capital repatriation Dysfunction in the financial markets
Countermeasures (U.S)	Gradual rates cuts TAF (Emergency type of liquidity provision) Request for rate reductions/exemptions to subprime loan debtors	Emergency rates cut, Decision for a major tax cut ($168 bill.) Strengthening of equity capital (SWF)	Continued major rates cuts TSLF (U.S. term securities lending facility) Emergency lending to Bear Sterns PDCF (Fed`s primary dealers credit facility) Establishment of a bridge institution to administer bad debt disposal? Financial regulatory structure reform	Financial policies in response to the crisis (FF 1%, mortgage securities buying operation, etc) Expansion of housing loan rescue measures Injection of public funds (RFC, RTC) Expansion of rescue measures for housing loan borrowings	Declaration of a financial moratorium Legislation of bills to rescue financial institutions Modern version of "New deal Policies"
Countermeasures (Developed countries)	Joint participation on TAF (4 central banks: ECB, BOE, Canada, Switzerland)	G7 issued a statement for the "downward risk of the global financial institutions" (Feb) BOE implements rate cut	Joint participation in TSLF (4 central banks: ECB, BOE, Canada, Switzerland) Enhanced capital strengthening	Enhanced policy coordination (joint rate cut by the U.S. and Japan, joint market intervention in dollar buying, international assistance framework), Safety net for bad debt disposal (injection of public funds)	Global structure for a financial moratorium Substantial public expenditure Prolonging a negative real interest policy
U.S. Economy	Rapid deceleration after the Christmas sales season. Deterioration led by a lack of business confidence	Rapid slowdown in personal consumption and decline in employment increased recessionary concerns	Acceleration of employment adjustment, start of economic recession phase becomes realistic. Business confidence worsens from concern over prolonging the housing bubble.	Start of a serious recession due to accelerated credit tightening (Increased corporate/individual bankruptcies and unemployment)	Increased unemployment and asset deflation leads to surging outlook concerns. Major decline in consumption /investment, 3-4 years of serious recession.
Global Economy	Generally firm except for the U.S. In particular, strong concerns for economic overheating in emerging economies, stricter financial tightening in China and India	European economy shows signs of a slowdown. Emerging economies remain firm, particularly strong demand in resources producing countries. However, global stock declines stars raising concerns for future slowdown.	Major corrections in emerging country stock prices increase the risk for a global economic slow down. However, emerging countries` domestic demand-driven economies remain firm, and the risk for a global slowdown is low.	Increased cancellation of a new investment projects, repressed consumer demand, plunge in international commodity markets, rapid slowdown of emerging economies. Global economy falls into a simultaneous recession phase.	The global economy falls into a state of contraction, substantial decline in trade and production volume. Protectionist policies will be adopted by the governments (shift to block economies). Non-resources producing countries and exports dependent countries are seriously affected.

(Source: The Bank of Tokyo-Mitsubishi UFJ)

Financial Guarantor (Monolines)

- Industry established in 1971 to serve U.S. municipal bond sector; today serves both public infrastructure and asset-backed global markets
- Monolines are specialized insurance companies – participants must operate solely as a separately structured and capitalized entity, providing guarantees of financial obligations only. No other insurance can be written.
- Regulated by government agencies and rating agencies:
- Insurance company operating under Article 69 of the New York State Insurance law
- Three principal agencies: Moody's, Standard & Poor's and Fitch Ratings
- Investment-grade underwriting practice has resulted in low industry loss experience
  - Low probability/low severity/highly diverse credit portfolios
  - Withstand highly strenuous scenarios
- Since inception, industry has incurred only 3 bps in losses on net debt service. (Banks had weighted average annual charge-offs on principal of 60 bps from 1992 to 2006.)

- Total industry insured net par outstanding is approximately $2.3 trillion, and approximately 50% of all U.S. municipal bonds are insured. The largest primary providers: AMBAC, FGIC, FSA & MBIA have nearly $2.0 trillion in insured net par outstanding.
- From 2001-2006, monolines have insured:
- - More than $1 trillion of U.S. municipal bonds to fund schools, highways, airports, transit systems, hospitals, environmental systems and other projects.
- - Almost $82 billion of bonds to fund essential public projects outside of the U.S.
- - More than $1 trillion of asset-backed bonds to provide cost efficient funding to corporate and financial institutions throughout the world.

Monolines & Financial Crisis /Rating Downgrade

Mortgage deterioration was faster than projected.

High-grade and mezzanine CDOs of ABS ultimately contain a high percentage of subprime mortgage loans. Some observations about expected credit performance:

Potential for collateral losses are higher than the original assigned credit rating

Diversity and correlation assumptions may be low

Embedded leverage magnifies the effects of poor collateral performance.

Attachment at Triple-A or higher levels will be able to withstand greater collateral losses.

- ➢Bonds lose value, investor take market-value losses
- ➢Monoline less able to take new business
- ➢Municipal borrower face higher borrowing cost
- ➢Structured credit insured by monoline is no longer "risk-free" banks face writer-downs

$bn	Guaranteed Net Par Outstanding	Non-U.S. Municipal Net Par Outstanding	2008 Net Income	2008 Total Equity	Rating 2007/7		Rating 2008/12	
					S&P	Moody`s	S&P	Moody`s
MBIA	667.8	230.1	-2672.69	994.42	AAA	Aaa	AA	Baa1
Assured Guaranty	535.0	211.4	68.88	1926.22	AAA	Aaa	AAA	Aa2
AMBAC	511.1	234.0	-2609.25	-3782.31	AAA	Aaa	A	Baa1
Radian	116.8	50.9	-410.58	2030.71	AA	Aa3	BBB+	A3

(Source: DIR)

Advantages in Utilizing Credit Guarantees/ The factors for the Financial Crisis

From Issuers' Perspective

- Reduction of financing cost
- Longer term financing
- Wider investor base
- Reduction of uncertainty in interest cost

From Investors' Perspective

- Improved level of security in investment
- Enhanced liquidity and stabilized prices
- Outsourcing of assessment / monitoring to monoline insurance companies → sense of reassurance and easier internal decision of investment

From Investment Banks' Perspective

- Reduction of underwriting risks
- Transfer of risks of complex issuance to monoline insurance companies
- Acceleration of issuance process due to credit rating agency's recognition of monoline insurance companies

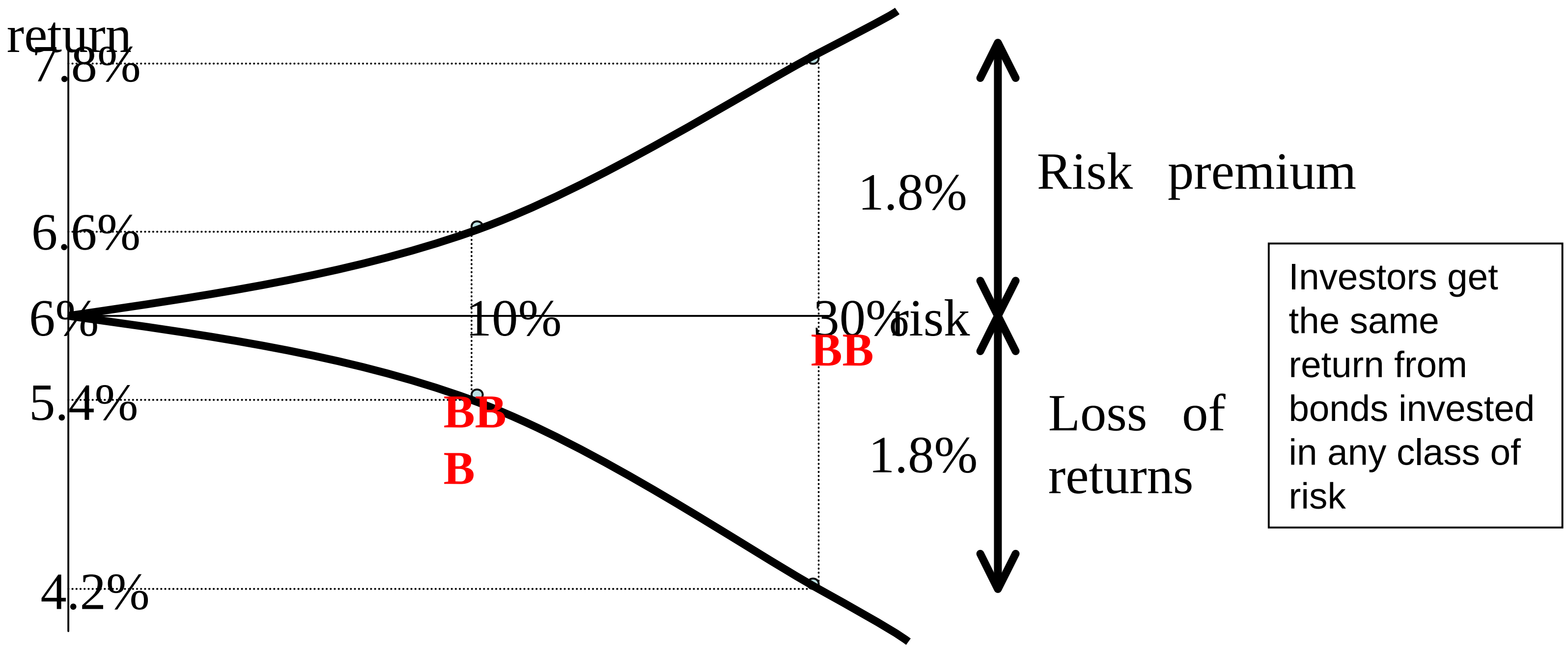
Now some of those constitute the factors of the financial crisis :

➢Issuer, Investor, Investment bankers are over-reliance on monolines

➢Monolines are dependant on CRAs

➢CRAs are complementary with issuers, investors and investment banks

CRA and Efficient Capital Market Hypothesis



- ✓Credit rating system is to provide “expected loss” information (Rating) and to monitor “expectation” (Default study).
- ✓In order to evaluate the required premium, investors should know how much risk is associated.
- ✓With “default study” including accumulated default rates (rating transition matrix), investors can see the expected loss level behind each rating.

CRA and Financial Crisis

➢With mortgage defaults in the subprime market soaring and mortgage-backed securities along with them, credit rating agencies have come under increased scrutiny by regulators and lawmakers over how they rate complex structured-finance products in general, and residential mortgage-backed securities (MBS) in particular.

➢Critics argue that rating agencies are too optimistic initially when rating these securities, and slow to adjust them downward as defaults rise.

➢They also suggest a potential conflict of interest given the credit rating agencies' "issuer-pays" model. Their advisory services to investment banks issuing and underwriting mortgage-backed securities on how to package the securities to achieve a targeted rating pose another potential conflict of interest.

Structured Finance Products Rating downgrade

(12 months Moody`s)

	2008	**2007**	**1999-2008**
Global Structured Finance (SF)	35.5%	7.4%	7.4%
US SF	38.0%	8.1%	7.8%
EuropeMiddle EastAfrica SF	19.1%	2.7%	4.5%
Asia Pacific SF	7.7%	0.9%	1.3%
Lain America SF	17.8%	1.0%	7.8%
Global Corp Bond	18.2%	8.8%	13.2%
US SF CDO	90.8%	20.0%	32.0%
Japan (R&I) SF	6.1%	0.4%	2.0%
Japan ABS	0.6%	0.0%	0.2%
Japan Corp Bond	5.9%	1.6%	7.2%

(Source Moody`s R&I)

The regulatory framework of CRA in US. EU and Japan

	US (Rating Agency Act, Exchange Act, Rules)	EU (Commission rules)	Japan (The Cabinet Ordinance Concerning the Disclosure of Corporate Affairs under the Securities and Exchange Law)
Registration	Business performance as CRA at least for 3 years Admitted by qualified service subscriber	Credit Rating Agency Company filed in EU	The Commissioner of the FSA designates certain CRAs as Designated Rating Agencies ("DRAs")
Effectiveness	For determination for rating-dependent regulation For designation for ECAI	For determination for rating dependent regulation For establishing minimum quality investment standards for Financial intermediaries For designation for ECAI	For determination for regulatory capital requirements For establishing minimum quality investment standards for Financial intermediaries For determining the form and/or content of issuer disclosures For designation for ECAI *Registration system in 2010

"Equivalency" assessment over CRA regulation in third countries (US Japan Canada) now being studied by CESR.

(Source DIR)

Examples of Ratings Dependent Regulations in the US

Year adopted	Rating-dependent regulation	Min. rating	Regulator/Regulation
1931	Required banks to mark-to-market lower rated bonds	BBB	OCC and Federal Reserve examination rules
1936	Prohibited banks from purchasing “speculative securities”	BBB	OCC, FDIC, and Federal Reserve joint statement
1951	Imposed higher capital requirements in insurers’ lower rated bonds	Various	NAIC mandatory reserve requirements
1975	Imposed higher capital haircuts on broker/dealers below-investment-grade bonds	BBB	SEC amendment to Rule 15c3-1: the uniform net capital rule
1982	Eased disclosure requirements for investment-grade bonds	BBB	SEC adoption of Integrated Disclosure System (Release #6383)
1984	Eased issuance of non-agency mortgage-backed securities (MBSs)	AA	Congressional promulgation of the Secondary Mortgage Market Enhancement Act of 1984
1987	Permitted margin lending against MBSs and (later) foreign bonds	AA	Federal Reserve Regulation T
1989	Allowed pension funds to invest in high-rated asset-backed securities	A	Dept of Labor relaxation of ERISA Restriction (PTE 89-88)
1989	Prohibited Savings & Loans from investing in below-investment-grade bonds	BBB	Congressional promulgation of the Financial Institutions Recovery and Reform Act of 1940
1991	Required money market mutual funds to limit holdings of low-rated paper	A1	SEC amendment to Rule 2a-7 under the Investment Company Act of 1940
1992	Exempted issuers of certain asset-backed securities from registration as a mutual fund	BBB	SEC adoption of Rule 3a-7 under the Investment Company Act of 1940
1994	Imposes varying capital charges on banks’ and S&Ls’ holdings of different tranches of asset-backed securities	AAA & BBB	Federal Reserve, OCC, FDIC, OTS Proposed Rule on Recourse and Direct Credit Substitutes
1998	Dept of Transportation can only extend credit assistance to projects with an investment grade rating	BBB	Transport infrastructure Finance and Innovation Act 1998
1999	Restricts the ability of national banks to establish financial subsidiaries	A	Gramm-Leach-Biley Act of 1999

(Source DIR)

➢Currently 44 SEC rules stipulates a reference to Ratings and 38 of them are under review.

Implications to developing bond markets in Asia

- CGIM and CRA are the most important component in developing bond markets.
- The motive should be to meet funding or investment needs in the real economy rather than balance sheet arbitrage of the kind that experienced in the financial crisis.
- In CRA , its reliability and comparability of DCRAs are important.
  - Reliability should be achieved by improved capability, enhance disclosure, improve accountability
  - Regulators in the region and DCRA management need to be convinced of the benefits of adoption of the recommendations in the Best Practice and IOSCO Code of Conducts, and thereafter obtain buy-in from the hierarchies of their respective organizations.
- Need to enhance Credit Risk Management

CGIM Business Model

<u>Assistance to local economic development</u>

- to micro-enterprises, small and medium-scale businesses, farmers, mortgage markets and certain infrastructure sectors

<u>Potential Products to be Guaranteed</u>

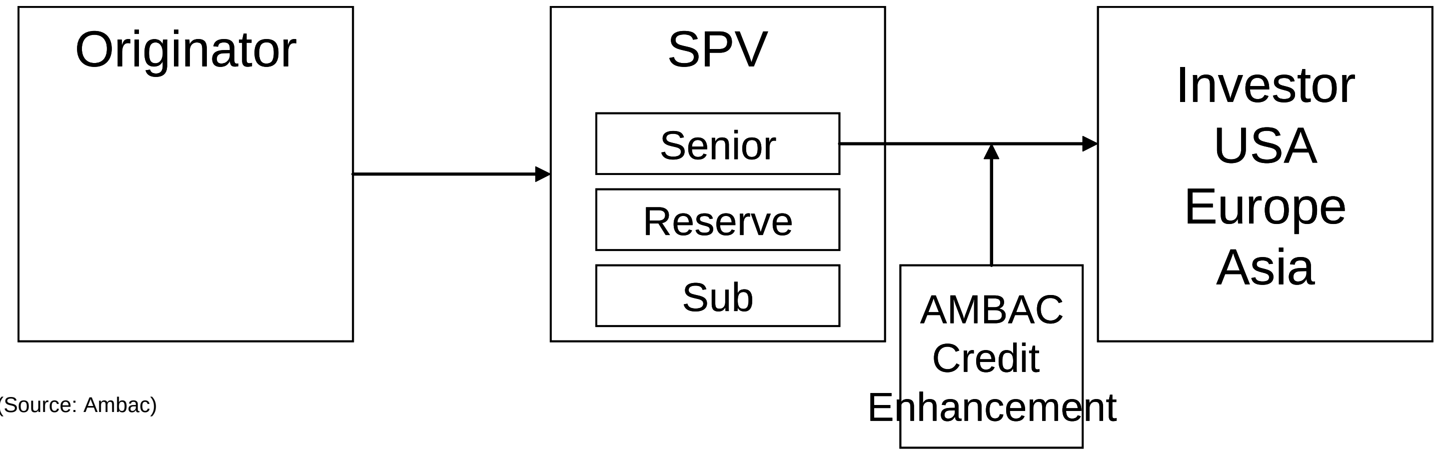
- Public Sector Bonds
- Asset-backed Securities
- Mortgage-backed Securities
- Collateralized Loan or Debt Obligations
- Bonds backed by publicly or privately funded public-purpose projects
- Sovereign and sub-sovereign bonds
- Future cash flow securitization products e.g. overseas remittance

	Demand Estimate $Bn
1 Equity Investments in Financial Sector Infrastructure	75
2 Bond Guarantees	9,169
3 Governance Equity Investments	150
4 SME Warehouse Loans	1,885
5 SME Securitization Guarantees	1,377
6 RMBS Securitization Guarantees and Other ABS Guarantees	5,189
7 Infrastructure Bond Guarantees	1,409
8 Infrastructure Loans	1,623
9 Infrastructure Equity Investments	80
TOTAL	18,171

(Source DIR 2008)

Ambac: Bichumi Global 1 Limited

- Samsung Life issued the first cross-border Securitization of Residential Mortgage
- $299.6 million US denominated note, the 144A private placement market
- The transaction carries a AAA-rated surety policy from, AMBAC, a specialty bond insurance company
- Part of strategy to raise the company's profile internationally

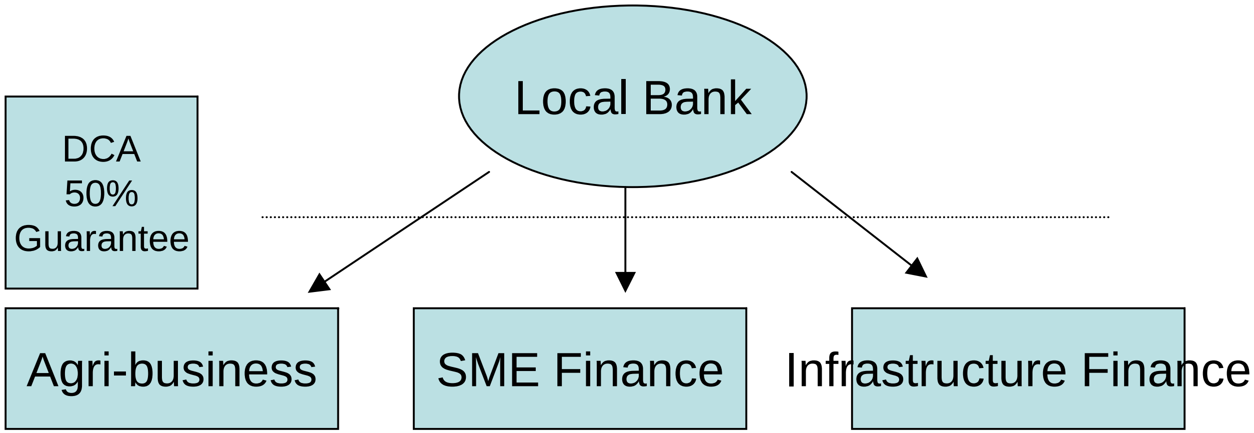


(Source: Ambac)

USAID/The Development Credit Authority Program

In April of 1999, USAID implemented a new credit-financing mechanism to address the need for financial resources to rural sectors.

- Target to micro-enterprises, small and medium-scale businesses, farmers, mortgage markets and certain infrastructure sectors such as water and energy.
- It covers up to 50 percent of private sector loans, providing a true risk-sharing element that encourages local institutions to take an active role in funding projects in new or underdeveloped areas.
- It is provided to secure debt denominated in local currency.
- It is generally complemented by technical assistance to both lenders and borrowers.



(Source “Guarantees for Rural Financing” USAID)

ADB`s “Best practice/DCRA”

1, Essential Best Practices

Pre-rating requirements	A DCRA and the entity it proposes to rate should sign a written contract requisitioning the DCRA’s credit rating services.
Rating definitions and recognition of default	A missed payment on a debt obligation on the due date or after a pre-specified grace period should constitute default
Policies and processes for ratings	A DCRA should have well-defined and updated credit rating criteria, which are publicly available and consistently applied
Confidentiality requirements	All information submitted by a rated entity or an issuer in connection with a credit rating assignment is presumed confidential and should be kept so at all times
Independence and avoidance of conflicts of interest	A DCRA should not refrain from taking a rating action because of the potential effect of the action on the DCRA, issuer, investor, or other market participant
Private ratings	Issuers may seek private credit assessments of their businesses, and a DCRA should, in such cases, maintain complete confidentiality of its ratings
Unsolicited ratings	A DCRA should publicly state its stance on assigning unsolicited ratings
Unaccepted ratings	A DCRA should have a published policy regarding disclosures on unaccepted ratings, where the rated entity has not accepted the initial rating assigned to its debt issuance
Process audit	A DCRA should set up audit checkpoints to ensure that the adopted best practices, policies, and procedures in acquiring, executing, communicating, and surveillance of ratings are implemented

(Source ADB)

ADB`s “Best practice/DCRA”

2, Desirable Best Practices

Computation of default statistics	Every rating agency should publish, at least annually, a default and transition study, along with the methodology used for calculating default rates
Dedicated advanced functional groups	It is recommended that a DCRA have dedicated functional groups for industry focus, quality assurance, and library and data management
Use of rating enhancers and early warning indicators	It is recommended that a DCRA provide some indication, such as a rating outlook, of the possible movement of the assigned rating
Market feedback before major changes	A DCRA should seek feedback from market participants whenever it contemplates major changes in its rating criteria or key rating policies, and apprise market participants of these changes

3, Three Phase Implementation

➢Phase 1 includes recommendations that do not require significant policy changes and focuses mostly on increasing awareness among stakeholders. The recommendations can be implemented within 3 months.

➢Phase 2 is to be implemented within 6 months. It includes policy-level and organizational changes and compliance with general codes of conduct.

➢Phase 3 includes key policy and process changes, such as modification of the appeal and surveillance process for private, unsolicited, and unaccepted ratings. These can be implemented within 1 year.

(Source ADB)

Thank you very much

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