Regulatory Perspective on DCRA's Best Practices

Speech by Thirachai Phuvanatnaranubala
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Ladies and gentlemen,

Here in Thailand, the existence and the role of rating agencies was not widely known to our general population, until ten years ago.

Ten years ago, Thailand of course suffered a temporary imbalance in our macro economy, which led to the Asian Crisis. We were at that time repeatedly downgraded by the major international rating agencies. We made several protests against the downgrades. Later there was even a proposal for a regional credit rating agency to be set up, one that would understand Asian situations better.

No such regional agency has yet been set up. And subsequent events did prove that the credit rating agencies were right to downgrade Thailand. The global rating agencies did their job well, at that time.

This year, however, rating agencies again came under the spotlight. Because of the collapse of subprime Collateralized Debt Obligations. This time, instead, the rating agencies were widely accused of not doing their job well.

The debate becomes much more heated because the financial losses that were incurred across the globe kept climbing day by day, to the tune of hundreds of billion US dollars.

Are we right to blame the global rating agencies?

The answer lies in the fact that capital markets rest on the four pillars of trust and confidence. Without trust and confidence, investors will not part with their money.

Trust and confidence can be built only by transparency. To satisfy transparency, issuers of securities are required to furnish volume of information on a regular basis to the public.

It is designed to enable the investors to monitor financial health of the issuers of securities, and to be able to detect any impending change. The information must cover all aspects of the issuers' operations and enable analysts to identify all major risks - both today and tomorrow.

Without proper information, debt issues cannot be sold in the primary market. Without proper information, debt issues cannot be accurately priced in the secondary market.

But information analysis can be costly. Investors' need for information can easily become overly burdened by its sheer quantity. Thus comes the service of rating agencies.

Rating agencies assume the task of analyzing, reviewing and monitoring of complex and voluminous information and present it in a simple and easily understandable form, the ratings.

Investors, accountants and regulators have been led to rely on credit ratings for so long. And the ratings, up to now, have been so efficient that both markets and fund trustees all over the world took them for granted, without going into too much detail as to the rationale behind.

This is why they were all shocked by the subprime CDO's problem. So what is to be done to rectify the situation?

Recent debates have suggested many things for improvement. The most important one is the consultation paper issued by the International Organization of Securities Commission. Many of the suggestions are useful, but some I think are not enough.

One recommendation is for rating agencies to disclose more of their work processes. But I am not sure that the users will really benefit from this.

If users have the capacity to analyze the sometimes highly complicated work process as used by rating agencies, they can probably look through the ratings and assess the risk of securities by themselves.

There is also a suggestion for the rating agencies to explain more clearly that ratings are just for credit risk, not liquidity or price risk. Ratings should not be used as a gauge for estimating potential price movement.

Again this is easier said than done. In the case of subprime CDOs, even the tranches with AAA rating, those that were below super senior, were found to deteriorate so quickly that when their market prices went down it was as if there was no bottom.

Under normal circumstances, a country with a AAA rating may, of course, deteriorate down to AA and A respectively, step by step. But there will be enough warning signals. The GDP growth would have slowed. Current account deficits would have ballooned. Non performing loans would have climbed.

For straight bonds with AAA rating to go down, therefore, one will have seen many tell-tale signs unless it is a case of fraud well hidden. But this is not so for structured products.

I therefore advocate for a different set of grades and ratings to be used for structured products. Investors will therefore have room to realize that deterioration and decay of credit in structured products may occur at a much faster pace than in straight bonds.

Another point for improvement is that I think that rating agencies have the responsibility to review the due process of loan origination as well.

In the case of US subprime CDOs, there were too many mortgages originated that were for speculative home, perhaps the third, or fourth, or fifth homes. And there were too many mortgages that borrowers simply declared their income without any proper verification.

Global CRAs have no choice but to look into these recommendations and improve the way they work.

What about the domestic CRAs? Do they need to take all this into account?

Domestic CRAs in this region have been spared the tsunami of subprime CDOs, simply because most regional countries are not yet sophisticated enough to generate these type of complicated structured products. But they must learn from their global counterparts for three reasons.

First, capital markets in the region will become more and more sophisticated. Many countries are setting up futures exchanges and the use of derivatives will multiply.

Over time this will lead to more and more complicated structured products being accepted by the general investors. The complexity that in the past were confined only to developed markets will be faced by the region in the not too distant future.

Second, capital movement across borders within the region will also grow. Many countries have accumulated very high international reserves. Domestic investment growth in many regional countries has also been slowed by global competition.

Therefore, more and more countries will have no choice but to relax exchange control to allow outbound portfolio investments.

Investors that place their savings in debt securities across borders will seek to rely on domestic credit rating in the host country to function properly. Domestic CRAs will have to realize that their future responsibility will not be confined only to domestic investors, but also to their neighbors.

The final reason is that many regional countries are rushing to speed up development of their local currency bond markets. All international financial institutions have turned to giving assistance towards local currency bond market development.

The IMF will enquire after this progress every time they make yearly Article IV visit to regional countries. The World Bank is launching an index of local currency emerging market bonds to help make it an asset class worthy of attention of the global investors.

The Asian Development Bank, not to be outdone, is also giving assistance to various regional countries on this issue. The reason all international financial institutions are giving high priority to this is because local currency bond market can strengthen a country's financial system a great deal. It serves as the "spare tire." Whenever there is a systemic failure in the banking system, at least the very large firms can still turn to the bond markets to continue to finance their operations.

The local currency bond market can also serve another important function in controlling capital inflow. Whenever an emerging market country is faced with a sudden flood of capital inflow, the bond market can ensure that the imported funds can be better allocated to firms with worthy projects.

The reason is because the bond markets demand more transparency. The bond markets are subject to more scrutiny by analysts and rating agencies. Commercial banks, on the other hand, deal in secrecy.

Capital inflows intermediated through the bond market channel therefore incurs far less risk than through the bank channel in causing over investment, over capacity and over diversification as we faced before the Asian Crisis.

In developing local currency bond markets, the role of domestic CRAs is absolutely vital. For local currency bond markets in this region to succeed, this is the role that all of you here must play well.

I therefore very much welcome the initiative of Handbook of Best Practices. It can serve as a strong back bone to the work process of all domestic CRAs. Not only in this region, but its application can and should be extended worldwide.

Thank you.