

# Special Report

## Asia Credit Rating Seminar

- Jointly held with ACRAA and the ADBI -

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Japan Credit Rating Agency, Ltd. (JCR), together with the Association of Credit Rating Agencies in Asia (ACRAA) and the Asian Development Bank Institute (ADBI), held the “Asia Credit Rating Seminar” in Tokyo in July 2015. This seminar was intended to share an overview of Asia’s credit rating industry with the Japanese business and financial community by taking the opportunity when the fourteen credit rating agencies (CRAs) from eleven jurisdictions in Asia gathered in Tokyo. It particularly focused on: (a) mandatory credit rating requirements and domestic CRAs in Asia, (b) Islamic finance and ratings, and (c) ratings for small medium enterprises (SMEs).

### 1 Overview

JCR, together with ACRAA<sup>\*1</sup> and the ADBI, held the “Asia Credit Rating Seminar” on 10 July 2015. It was organized on the afternoon of the same day when the “ACRAA-ADBI Credit Rating Forum: Dialogue on Sovereign Credit Ratings” took place in which the representatives of 14 CRAs from 11 jurisdictions in Asia participated. In the seminar, mandatory rating

requirements and the profile of domestic CRAs in fast-growing Asian financial markets were explained to the audience from the Japanese business and financial community. It also discussed the evolution of ratings in Asia particularly on Islamic finance and SMEs.<sup>\*2</sup>

### 2 Dialogue on Sovereign Credit Ratings

Prior to the “Asia Credit Rating Seminar”, the “ACRAA-ADBI Credit Rating Forum: Dialogue on Sovereign Credit Rating” was convened. The forum began with opening remarks by Mr Shokichi Takagi, JCR’s President and CEO, and Prof Naoyuki Yoshino,

Chart & Graph 1 List of participated ACRAA member CRAs

	Jurisdiction	Credit Rating Agency
1	Bahrain	Islamic International Rating Agency (IIRA)
2	Bangladesh	National Credit Ratings Ltd.
3		Brickwork Ratings India Pvt. Ltd.
4	India	Credit Analysis and Research Limited (CARE)
5		SMERA Ratings Limited
6	Indonesia	PEFINDO Credit Rating Indonesia
7	Japan	Japan Credit Rating Agency, Ltd. (JCR)
8		Korea Ratings Corporation (KR)
9	Korea	NICE Investors Service Co., Ltd.
10	Pakistan	JCR-VIS Credit Rating Co., Ltd.
11	Philippines	Philippine Rating Services Corporation (PhilRating)
12	Taiwan	Taiwan Ratings Corp (TRC)
13	Thailand	TRIS Rating Co., Ltd.
14	Turkey	JCR Eurasia Rating

Chart & Graph 2 Shokichi Takagi, JCR's President and CEO



<sup>\*1</sup> ACRAA, the Association of Credit Rating Agencies in Asia, was founded in September 2001 at the initiative of JCR. As of September 2015, it has 33 members from 15 jurisdictions. Details of ACRAA’s history, activities and future prospects are compiled in “Special Report: Association of Credit Rating Agencies in Asia (ACRAA) - History and Future Prospects of ACRAA (Feb 2015), available at JCR’s website.

<sup>\*2</sup> A joint press release was issued by ACRAA, ADBI and JCR on 10 July 2015  
<http://www.jcr.co.jp/reportqa/pdfen/2015071010e.pdf>

Chart &amp; Graph 3 Participants in Sovereign Rating Dialogue



Dean of the ADBI. There were then two keynote presentations on (i) “Sovereign Rating Methodology” by Mr Atsushi Masuda, JCR’s Chief Analyst, and (ii) “Sovereign Default: Lessons from History and Future Implications” by Prof Toshiro Nizhizawa, Graduate School of Public Policy, The University of Tokyo. Subsequently, participants in the forum, varying from ACRAA member CRAs, the Asian Development Bank (ADB), the ADBI to financial regulators in Asia, had active discussions about methodologies, limitations, and analytical tools for sovereign ratings. The moderator concluded by summarizing the discussions as follows:

(1) Both sovereign ratings and corporate ratings share that they both look at “past” developments and also analyze “future” certainty to honor debt obligations by taking into account policies and strategies. Nevertheless, sovereign ratings are distinctive, vis-a-vis corporate ratings, in the following aspects:

- (a) There exists no legally-backed bankruptcy framework for sovereignties;
- (b) Given the nature of cross-border transactions, it is necessary to take into account foreign exchange transfer and convertibility risks;
- (c) Sovereignties are equipped with the power to impose tax and to issue currency; and
- (d) Cross-sovereignty comparisons may not be so simple given that the criteria and methodologies to compile statistics, such as for public finances, are not necessarily internationally standardized.

(2) In recent years, it has become increasingly important to assess the impact of fluctuations in foreign exchange rates, interest rates, and asset prices on the balance sheets of households, corporates, banks and the government given:

- (a) The amplified scale of private capital inflows and outflows;
- (b) The prolonged period of an ultra-low interest rate environment and non-conventional monetary policy, such as quantitative easing; and
- (c) The magnified range of foreign exchange rate fluctuations under the floating foreign exchange system.

(3) Sovereign ratings constantly meet stern criticisms in the market such as: (a) rating actions tend to be too slow, (b) negative rating actions may act as a spur to deteriorate conditions, (c) cases of rating failures have been observed in the past in that ratings were downgraded by more than 10 notches at a time of crisis.

(4) The Greek issue has highlighted the importance to consider: (a) the difference between liquidity and solvency, (b) the distinction between the will to pay and the capacity to pay, (c) political and social aspects, (d) geopolitical factors, and (e) implications of adopting a single currency, the euro, and having a supranational safety net mechanism across the euro-zone.

(5) Domestic CRAs, savvy to micro-level information such as domestic corporates and banks, may potentially have a comparative advantage vis-a-vis international organizations and global CRAs.

### 3 Local Currency Bond Markets and Domestic CRAs in Asia

In the afternoon, the “Asia Credit Rating Seminar” was organized where participants from the Japanese business and financial community joined. In the first session, a series of introductory presentations were delivered on: the local currency bond markets in Asia; mandatory rating requirements in Asia; domestic CRAs in Asia; and ACRAA’s activities.

First, Mr Noritaka Akamatsu, Senior Advisor of the ADB, explained an overview of the local currency bond

markets in Asia. He said:

(1) The outstanding balance of local currency bond markets in ASEAN+3 countries, excluding Japan, grew steadily. Between the end of 2004 and the end of 2014, increases were 4.2 times for the government bonds and 6.3 times for the corporate bonds;

(2) The size of local currency bonds in terms of GDP is particularly large in Korea and Malaysia;

(3) In recent years, the share of foreigners in government bonds investors soared and exceeded 30% in Indonesia and Malaysia; and

(4) The authorities and market players started to collaborate with each other to promote standardization and the integration of local currency bond markets in the ASEAN+3 countries. The efforts include: for example: (a) Compilation and publication of “ASEAN+3 Bond Market Guide”, (b) Undertaking on “ASEAN+3 Multi-Currency Bond Issuance Framework (AMBIF)” that aims to adopt a uniform information disclosure requirement among the ASEAN+3 countries for the segment of professional bond markets; and (c) A study to establish a Regional Settlement Intermediary (RSI).

Secondly, regulatory-based rating requirements in each jurisdiction in Asia were explained by the representatives of domestic CRAs in Asia; they could be categorized as follows:

(1) Jurisdictions with mandatory rating requirements in issuing bonds: Indonesia, Korea (two ratings), Pakistan, the Philippines, Taiwan (issuer ratings are accepted in lieu of issue ratings) and Thailand;

(2) Jurisdictions with mandatory rating requirements for the cause of financial stability: Islamic banks in Bahrain (encouragement); listed companies in Bangladesh; private companies that make external borrowings in Indonesia; deposit taking financial institutions in Pakistan; and banks that issue unsecured

subordinated debt instruments in the Philippines;

(3) Jurisdictions where ratings are required by banks for bank borrowings in order to minimize a risk weight under the BIS regulations: Bangladesh, India and Pakistan.

Thirdly, the 14 CRAs from 11 jurisdictions introduced their rating agencies including their presence in each market (i.e., rating coverage and market share). It was explained that NICE from Korea has 71%<sup>\*3</sup> coverage, JCR from Japan 62%, PhilRatings from the Philippines 95%, TRC from Taiwan 67%, and JCR-ER from Turkey 85%. Domestic CRAs in Asia, therefore, have a strong presence in each market; this is quite a contrast to the situations in the US and Europe where the US rating agencies hold more than 90% of market share. The session was concluded after Mr Faheem Ahmad, Chairman of ACRAA, made an introductory presentation about ACRAA’s history, membership and activities.<sup>\*4</sup>

#### 4 Islamic Finance and Sharia Quality Rating

The second session dealt with “Islamic Finance and Sharia Quality Rating”. It started with an introductory presentation by Mr Ghulam Ahmed Mahatarem, Senior Advisor at Islamic International Rating Agency (IIRA) from Bahrain.

Mr Mahatarem began by defining Islamic finance as “a faith-based finance whose principles derive from Islamic Sharia laws”. Sharia laws were then explained as “a system of several laws, based on the Qur'an, Hadith and Sunnah, plus interpretation, precedent and consensus on issues between religious scholars”. He then raised some salient features of Islamic finance including “prohibition on giving and taking of interest, risk and profit sharing, and prohibition on dealing in transactions involving certain items like alcohol, gambling, pork etc.”

<sup>\*3</sup> The figures are those explained by each of CRAs in the seminar, consisting of a mixture of bond-based rating coverage, issuer-based rating coverage, and market share. Also, criteria and methods of calculations may differ from one another. In the case of rating coverage, aggregated percentage may exceed 100% as substantial portion of companies or bonds are rated by more than one rating agency.

<sup>\*4</sup> More detailed information is available in the Special Report “ACRAA - History and Future Prospects” at JCR’s website.

Chart &amp; Graph 4 Asia Credit Rating Seminar



Afterward, typical Islamic finance products were introduced as follows:

- (a) Mudaraba: Deposits without principal guarantee. Deposits are invested in projects whose profits are returned to depositors. The rate of return may, therefore, vary.
- (b) Musharaka: Partnership finance or project finance.
- (c) Murabaha: Mark-up sale of tangible assets with deferred payments.
- (d) Ijara: Leasing of tangible assets.
- (e) Istisna: Pre-financing for production.
- (f) Slama: Pre-financing for agricultural produces.

Mr Mahatarem pointed out the “lack of globally accepted regulations and uniform accounting and auditing standard” as the major challenge faced by the Islamic financial services industry. This is because the “interpretations of Sharia may differ from country to country and even, at times, from organization to organization”. But, he added that efforts are being made to tackle such challenge by setting up the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

In the latter half of the second session, IIRA’s “Sharia

Quality Rating” was explained. The Sharia Quality Rating is a fiduciary rating that evaluates the degree of adherence to Sharia laws through scoring. For example, a score of “71-75” is given based on the degree of compliance with Sharia laws (e.g., “not taking interest”, “risks are not solely borne by a borrower”). In considering “sharing profit and loss”, the assessment even includes “the transparency of the process” and “the managers’ awareness of the responsibility to act in a prudent way”.

## 5 Ratings for Small and Medium Enterprises

The last session discussed the methodologies for SMEs ratings. It began with a presentation by Prof Naoyuki Yoshino, ADBI’s Dean, and Dr Farhad Taghizadeh-Hesary, Assistant Professor of Economics at Keio University, on an analytical framework of SMEs’ credit risks that used banks’ lending data in Thailand and Iran. It was followed by a presentation by Mr Satoshi Kuwahara from CRD Association in Japan. He explained that the CRD Association has built a credit scoring model for SMEs that uses a credit information database it has developed by collecting financial, non-financial and default data from its member SMEs on an anonymous basis.

In general, credit risk assessment of SMEs, especially in developing countries, encounters serious bottlenecks such as the shortage of a default database and the insufficient quality of financial statements. Therefore, discussions at the seminar concentrated on how such bottlenecks could be rectified. A number of CRAs from India with significant experiences in SMEs ratings pointed out the need to adjust dubious financial statements and to conduct a trend analysis. They also stressed the importance of supplementing the quantitative analysis with qualitative factors such as the management’s profile and the owner’s personal asset.

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