

**ASIAN DEVELOPMENT BANK**

**TAR: TRA 38483**

**TECHNICAL ASSISTANCE**  
(Financed by the Japan Special Fund)

**FOR**

**CAPACITY BUILDING OF SELECTED CREDIT RATING AGENCIES IN ASIA**

**PHASE III**

**October 2004**

### **ABBREVIATIONS**

ABMI	–	Asian Bond Market Initiative
ACRAA	–	Association of Credit Rating Agencies in Asia
ADB	–	Asian Development Bank
ASEAN	–	Association of Southeast Asian Nations
CRA	–	credit rating agency
REMU	–	regional economic monitoring unit
TA	–	technical assistance

### **TA CLASSIFICATION**

<b>Poverty Classification</b>	–	Other
<b>Sector</b>	–	Finance
<b>Subsector</b>	–	Capital markets and funds
<b>Themes</b>	–	Regional cooperation, sustainable economic growth, private sector development
<b>Subthemes</b>	–	Promoting macroeconomic stability, private sector investment

### **NOTE**

In this report, "\$" refers to US dollars.

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## I. INTRODUCTION

1. A key lesson from the 1997 Asian financial crisis is that bond market development is crucial to maintain financial stability in the region. Maturity mismatches that resulted from overreliance on short-term bank financing for long-term investment, as well as currency mismatches, could have been reduced if the region had well-developed bond markets capable of channeling the huge savings of Asian countries into long-term investment. This realization led many countries in Asia to place more attention on developing bond markets after the crisis to better balance the financial sectors. Regional and national initiatives have focused on removing obstacles to bond market development, including inadequate or weak credit rating systems.

2. In March 2001, recognizing the role that credit rating systems play in developing bond markets in the region, 15 credit rating agencies (CRAs) in Asia reached a consensus to form an association that will promote the development of bond markets and cross-border investment. In September 2001, the Association of Credit Rating Agencies in Asia (ACRAA) was established at a meeting convened at the Asian Development Bank (ADB) headquarters. ACRAA aims to promote exchange of ideas, experiences, information, and skills among CRAs in Asia. This will enhance their ability to provide reliable market information, as well as promote the adoption of best practices and common standards to ensure high quality and comparability of ratings throughout the region.

3. In response to ACRAA's request for assistance in financing and organizing training workshops and a conference, which were to be the association's initial activities, ADB approved a small-scale regional technical assistance (TA) in April 2002.<sup>1</sup> Under this TA, ADB provided financial and organizational support for a conference, three training workshops, and a best-practices dialogue. Through the partnership of ADB and ACRAA under the TA, a network of domestic CRAs in the region was established, allowing them to share their experiences, discuss common as well as unique issues, and work to attain comparability of rating standards and adopt best practices. ACRAA requested additional support to strengthen the capacity of domestic CRAs and, in August 2003, ADB approved a second-phase small-scale regional TA.<sup>2</sup> Under this phase, the network of domestic CRAs was strengthened through training workshops and a best-practices dialogue.

4. This TA is proposed in response to ACRAA's request for additional support to strengthen the institutional and technical capacities of Asian domestic CRAs through training workshops and best-practices dialogues. This TA will be part of ADB's continued support for the Association of Southeast Asian Nations (ASEAN)+3 (People's Republic of China, Japan, and Republic of Korea) Asian Bond Markets Initiative (ABMI), and will complement other regional efforts to promote bond markets. The TA's purpose and output, methodology and key activities, cost estimates and financing plan, and implementation arrangements are reflected in this paper.<sup>3</sup> The TA framework is in Appendix 1.

## II. ISSUES

5. In the aftermath of the Asian crisis, considerable importance has been attached to developing Asian bond markets to reduce overreliance on bank-based financial systems. The

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<sup>1</sup> ADB. 2002. *Technical Assistance for Capacity Building of Selected Credit Rating Agencies in Asia*. Manila.

<sup>2</sup> ADB. 2003. *Technical Assistance for Capacity Building of Selected Credit Rating Agencies in Asia, Phase II*. Manila.

<sup>3</sup> The TA first appeared in *ADB Business Opportunities* (Internet edition) on 9 July 2004.

growing consensus is that the currency and maturity mismatches that contributed to the Asian financial crisis could have been reduced if bond markets had been well developed. Efficient and liquid bond markets could have been an attractive option for investing the large amount of Asian savings and foreign reserves accumulated over the years, which were largely intermediated through banks or invested outside the region, particularly in the United States and other developed countries. A portion was reinvested in Asia in the form of short-term portfolio investments that were sometimes used for speculation and led to sharp liquidity problems.

6. Asian bond markets, however, will attract more issuers and investors only if (i) the financial sector's legal, accounting, and regulatory framework is improved; (ii) settlement and clearing systems for cross-border transactions are harmonized; (iii) comprehensive guarantees and credit enhancements are provided; (iv) bond market information is disseminated; and (v) mechanisms of financial risk mitigation are improved. CRAs are critical in shaping this environment because credit ratings support investment decisions, enable investors to optimize risk-return profile, help investors monitor portfolio through regular surveillance, and provide timely information and thus facilitate decisions on trading and sectoral exposures. A 2004 study by the National Information & Credit Evaluation, Inc. of the Republic of Korea reveals that the bond market reacts to the ratings assigned by domestic CRAs. In the Republic of Korea bond market, credit rating changes accounted for 76% of the fluctuation in bond yield to maturity.

7. CRAs also serve a prudential purpose by assessing loan risks, which are a major factor in business entities' ability to raise funds, and, therefore, encourage local businesses to conform to prudent corporate practices. This could promote sound and efficient financial markets. Credible CRAs, complementing other mechanisms of financial risk mitigation, such as credit information bureaus, can influence Asian businesses to adopt high standards of good corporate governance.

8. In Asia, where risk perception remains a major factor in investment decision making, domestic CRAs (some affiliated with global CRAs) provide an alternative source of risk-return assessments. Global CRAs' services are usually too expensive for average-sized local companies. Domestic CRAs, therefore, have a niche in serving smaller issuers. Domestic CRAs have a deeper understanding than global CRAs of local companies and, therefore, a better sense of their creditworthiness; have greater access to local information; and are more acquainted with domestic business practices as well as the corporate governance, legal, and regulatory framework. Domestic CRAs can help investors, and even global CRAs, understand the local markets. As many Asian bond markets are at a nascent stage, domestic CRAs are critical since global CRAs generally do not enter local markets so early.

9. Domestic CRAs' credibility, especially vis-à-vis global CRAs, must be firmly established among investors. Without regional and international benchmarks and credibility with regional investors, domestic CRAs, especially the new and small ones, will find it difficult to undertake regional or foreign currency ratings. Domestic CRAs must, therefore, improve their rating practices and standards to conform to international best practices. The capacity of domestic CRAs is uneven due to differences in their stages of development, which is a by-product of uneven development of their capital markets. Investors in an Asian country may have difficulty accepting information published by a CRA in another country and determining if that CRA's rating reflects the risk level they consider appropriate for that rating. Lack of access to credible and reliable but affordable rating services limits cross-border capital flows and leads to lackluster performance of bond markets.

10. Domestic CRAs should build their capacity by training their analysts in various technical aspects of rating as well as harmonizing rating processes across Asian domestic CRAs. The Rating Agency Malaysia found widespread agreement among domestic CRAs that harmonization would enhance their credibility and improve rating quality. A certain degree of comparability (perfect convergence is impossible given constraints such as different national legal frameworks and requirements) across CRAs has to be achieved in terms of rating methodology, criteria, definitions, benchmarks, and overall rating processes. Harmonization should result in greater acceptability, understanding, and use of ratings by issuers, investors, and regulators. Harmonization can lead to the preferred situation where a rating of a bond in one country can be taken to mean the same thing (reflecting the same risks) in another country. Harmonization should improve activity in capital markets as players become more confident and familiar with the credit rating processes and what credit ratings mean.

11. It may be too costly for individual rating agencies to work toward harmonization as well as independently undertake regional ratings without regional or international benchmarks. Regional cooperation is, therefore, required. Recent regional efforts made by Asian domestic CRAs, mainly through ACRAA, are steps in the right direction, and ADB has supported them. Under the first two phases of this TA, ADB provided financial and organization support for a conference on strengthening the credit rating discipline in Asia, and for five training workshops on practical securitization, infrastructure project finance rating, financial analysis of banks, advanced securitization, and credit rating for general insurance companies. Feedback received from ACRAA and workshop trainers and participants indicated that the topics were relevant and useful, and drew on rating agencies' diverse experiences in a range of market, economic, and legal environments, especially in examining specific rating issues in guided case studies or group discussions. The training activities are paying dividends in building the capacity of domestic CRAs.

12. The earlier best-practices dialogues covered a wide variety of issues, including codes of ethics and conduct for rating agencies, communication of ratings, parent-subsidiary relationships, rating well-secured debt, meaning of default for debt securities, and factoring governance practices into credit ratings. Rating agencies' practices that enabled the laying out of a road map to improve practices were compiled, as was a glossary of rating-related terms for rating agencies and market participants. ACRAA has adopted a code of institutional and individual ethics, and a checklist of best-practice parameters.

13. Improving the capacity of domestic CRAs in the region is an important component of the ASEAN+3 ABMI, which ADB supports. ADB proactively supports this effort and has provided TA to study the possibility of establishing a regional credit guarantee mechanism<sup>4</sup> and improve settlement and clearing systems,<sup>5</sup> co-organized a symposium to promote issuance of local currency bonds,<sup>6</sup> and disseminates information on bond markets through the AsianBondsOnline Web site ([www.asianbondsonline.adb.org](http://www.asianbondsonline.adb.org)) maintained by the regional economic monitoring unit (REMU).<sup>7</sup> This TA will form part of ADB's continued support for the ABMI, which complements other regional efforts, including the Asian Bond Market Development Initiative of the Asia Cooperation Dialogue, Regional Bond Market Initiative of the Asia-Pacific Economic Cooperation, and Asian Bond Fund of the Executives' Meeting of East Asia and Pacific Central Banks.

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<sup>4</sup> ADB. 2003. *ASEAN+3 Regional Guarantee Mechanism*. Manila.

<sup>5</sup> ADB. 2003. *ASEAN+3 Regional Settlement Linkage*. Manila.

<sup>6</sup> ASEAN+3 Finance Ministers Symposium on Issuance of Bonds Denominated in Local Currencies. Beijing, 14 November 2003.

<sup>7</sup> ADB. 2004. *The Asian Bonds Online Web Site*. Manila.

### III. THE TECHNICAL ASSISTANCE

#### A. Purpose and Output

14. The TA objective is to continue ADB's support for strengthening the institutional and technical capacities of Asian domestic CRAs to develop the region's capital markets (particularly bond markets). More broadly, the TA aims to facilitate regional financial cooperation, and improve corporate governance and financial market supervision, which are key to financial market stability.

15. The TA will finance and organize several training workshops and best-practices dialogues for staff and officials of domestic CRAs. Through these activities the CRAs will gain important technical know-how and adopt high standards of performance to increase credibility, usefulness, and comparability of ratings; transparency; and accountability, which will benefit investors, financial intermediaries, and regulatory authorities.

#### B. Methodology and Key Activities

16. The TA will finance training workshops and best-practices dialogues for staff and officials of domestic CRAs (ACRAA members) from 10 developing member countries: Bangladesh; People's Republic of China; India; Indonesia; Republic of Korea; Malaysia; Pakistan; Philippines; Taipei,China; and Thailand. Letters of no objection from the countries where the activities will be held will be obtained before holding the activities.

17. Following a review of previous training activities, the training workshops under this TA will be conducted at two levels—basic and advanced—to make the courses suitable to participants' level of knowledge, skills, and experience. The basic training will target analysts who are likely to have less than 2 years' rating experience, come from CRAs in operation for less than 5 years, or come from countries with developing capital markets. The training will feature case studies drawn from experiences of other CRAs. Resource persons could be sourced from more experienced or developed members of ACRAA. The advanced training will meet requirements of analysts who come from more developed markets and have at least 2 years' rating experience. Each workshop will have about 40 participants from CRAs (about 2 from each). The training workshops will focus on topics and sectors that have not been covered under the previous workshops. Possible topics for the training workshops are corporate credit rating; advanced securitization (rating of collateralized loan, bond, and debt obligations, and rating of credit card companies); and project finance rating with a focus on selected infrastructure projects.

18. The best-practices dialogues will discuss special issues and current business and rating practices that need to be revised, reinforced, or improved. Thereafter, the CRAs will adopt the recommendations and suggestions arising from the consensus of peers from other CRAs in the region. The long-term agenda for these dialogues is to develop tools for cross-agency and cross-border comparison of ratings, and compile rating methodologies and databases of all ratings issued by agencies and of regulatory support measures across the regulatory environments of the CRAs. Heads and other senior officials of CRAs, with the assistance of outside resource persons, will be tapped as facilitators. About 40 senior officials of CRAs (about 2 from each) will attend the dialogues. Selected written papers or proceedings, compiled rating methodologies, and ratings issued by CRAs will be posted on the AsianBondsOnline Web site.

**C. Cost and Financing**

19. The total estimated TA cost is \$300,000. It will be financed on a grant basis by the Japan Special Fund, funded by the Government of Japan. Details of the cost estimates and financing plan are in Appendix 2.

**D. Implementation Arrangements**

20. The TA will be implemented over 2 years, from October 2004 to September 2006. ADB will be the Executing Agency for the TA. REMU, jointly with ACRAA, will conceptualize and organize the training workshops and best-practices dialogues and monitor and review the activities' impact.

21. The TA will require at least five resource persons for a total of about 1 person-month to conduct the training workshops. The resource persons, who are experts in credit rating services, securitization, corporate finance, and financial (particularly bond) market development, will prepare detailed outlines of the workshops, conduct them, and propose follow-up activities. An outline of the terms of reference is in Appendix 3.

**IV. THE PRESIDENT'S DECISION**

22. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$300,000 on a grant basis for the Capacity Building of Selected Credit Rating Agencies in Asia Phase III, and hereby reports this action to the Board.

### TECHNICAL ASSISTANCE FRAMEWORK

<b>Design Summary</b>	<b>Performance Indicators/Targets</b>	<b>Monitoring Mechanisms</b>	<b>Assumptions and Risks</b>
<p><b>Goal</b> Promote the development of capital markets, particularly bond markets; bring about balance within financial sectors; stabilize financial markets; and sustain economic growth in Asia.</p>	<ul style="list-style-type: none"> <li>• Economic and financial stability.</li> <li>• Greater activity in capital markets.</li> </ul>	<ul style="list-style-type: none"> <li>• Regular monitoring of capital market developments by the Asian Development Bank (ADB).</li> </ul>	
<p><b>Purpose</b> Strengthen the institutional and technical capacities of Asian domestic credit rating agencies (CRAs) in fostering the development of capital markets.</p>	<ul style="list-style-type: none"> <li>• Development of the regional credit rating industry.</li> <li>• Improved corporate governance.</li> <li>• Improved knowledge and expertise of staff of CRAs in various technical aspects of credit rating and in international best practices. Improved skills in applying these practices to Asia.</li> </ul>	<ul style="list-style-type: none"> <li>• Review of the growth and development of the regional credit rating industry.</li> <li>• Monitoring of corporate soundness indicators.</li> <li>• Perception of capital market participants about CRAs' professional and technical standards.</li> <li>• Review of rating agencies' market assessments.</li> <li>• Periodic feedback from CRAs on the impact of the training workshops and best-practices dialogues in improving CRAs' professional and technical capabilities.</li> </ul>	<p><b>Assumptions</b></p> <ul style="list-style-type: none"> <li>• CRAs continue to be committed to cooperate with one another to improve rating standards across Asia.</li> <li>• Participating CRAs will nominate the relevant staff.</li> <li>• CRAs will provide sufficient and honest feedback to assess the impact of the workshops and dialogues.</li> </ul>
<p><b>Outputs</b> Staff and officials of domestic CRAs in Asia trained in technical areas and international best practices.</p>	<ul style="list-style-type: none"> <li>• Completed on-site training of at least 120 staff members of domestic CRAs.</li> </ul>	<ul style="list-style-type: none"> <li>• Feedback from trainees and the Association of Credit Rating Agencies in Asia (ACRAA) after completion of the workshops and dialogues.</li> </ul>	<p><b>Assumptions</b></p> <ul style="list-style-type: none"> <li>• CRA officials and staff continue to improve professional and technical standards in the industry.</li> </ul>

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<b>Design Summary</b>	<b>Performance Indicators/Targets</b>	<b>Monitoring Mechanisms</b>	<b>Assumptions and Risks</b>
<p>Papers on selected topics prepared for the best-practices dialogues.</p> <p>Rating methodologies used by CRAs compiled.</p> <p>Databases of ratings and regulatory support measures prepared.</p>	<ul style="list-style-type: none"> <li>• Completed papers and initial compilation of rating methodologies and databases of ratings and regulatory support measures.</li> </ul>	<ul style="list-style-type: none"> <li>• Progress reports from resource persons.</li> <li>• ADB staff presence and participation in the workshops and dialogues.</li> </ul>	<ul style="list-style-type: none"> <li>• Relevant staff are sent for training and have sufficient knowledge to absorb the technical information.</li> <li>• Resource persons with the required expertise are available.</li> <li>• Resource persons provide satisfactory training and submit useful activity reports.</li> </ul>
<p><b>Activities</b></p> <p>Short training workshops.</p> <p>Dialogues on best practices.</p>	<ul style="list-style-type: none"> <li>• Two basic training workshops.</li> <li>• One advanced training workshop.</li> <li>• Two best-practices dialogues.</li> </ul>	<ul style="list-style-type: none"> <li>• Supervision from ADB, ACRAA, and CRA officials.</li> </ul>	<p><b>Assumptions</b></p> <ul style="list-style-type: none"> <li>• Relevant staff and officials from CRAs will participate.</li> <li>• Resource persons with the required expertise are recruited on time.</li> </ul>
<p><b>Inputs</b></p> <p>Resource persons.</p> <p>ADB staff inputs.</p> <p>Inputs from officers and staff of ACRAA.</p>	<ul style="list-style-type: none"> <li>• At least five resource persons for a total of about 1 person-month.</li> <li>• Supervision from ADB staff.</li> </ul>	<ul style="list-style-type: none"> <li>• Progress reports by resource persons and ACRAA.</li> <li>• Progress monitoring and review by ADB staff.</li> </ul>	<p><b>Assumptions</b></p> <ul style="list-style-type: none"> <li>• Resource persons with the required expertise are recruited on time.</li> <li>• Resource persons provide satisfactory training and submit useful activity reports.</li> <li>• ACRAA provides useful feedback and sufficient assistance.</li> </ul>

**COST ESTIMATES AND FINANCING PLAN**  
(\$'000)

<b>Item</b>	<b>Total Cost</b>
<b>Japan Special Fund Financing<sup>a</sup></b>	
1. Resource Persons	
a. Honorarium and Per Diem	35.0
b. International Travel	30.0
2. Training Workshops and Meetings	185.0
3. Miscellaneous Administration and Support Costs	5.0
4. Contingencies	45.0
<b>Total<sup>a</sup></b>	<b>300.0</b>

<sup>a</sup> Funded by the Government of Japan.  
Source: Asian Development Bank estimates.

### **OUTLINE TERMS OF REFERENCE FOR RESOURCE PERSONS**

The technical assistance (TA) will require the services of at least five resource persons (for a total of about 1 person-month) who are experts in credit rating services, securitization, corporate finance, and financial/bond market development. They will have the following responsibilities:

- (i) Design and develop training workshops, and prepare detailed outlines for them.
- (ii) Collate and prepare materials for participants.
- (iii) Conduct the training workshops.
- (iv) Prepare training workshop activity reports that include activity outlines, participant profiles, responses and outcomes, lessons learned, overall impressions, evaluations of the workshops in relation to the TA objective, and remaining issues and suggestions for possible follow-up activities.