Rating Agencies and Securities Market Development

By Leo O'Neill
President and Chief Rating Officer
Standard & Poor's Ratings Group

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I. Introduction

The 1980s saw major structural changes in the world's debt securities markets. The growth of major cross-border markets for both long and short-term debt instruments in Europe and the U.S. as well as the emergence of domestic corporate debt markets in Japan and industrialized European countries. The most notable development, however, has been the burst of economic and political reform that brought about the establishment of active capital markets in the newly industrialized countries known as "Emerging Markets." There isn't a major international investment bank or fund manager that has not already set up an emerging markets unit to analyze and participate in these new markets. This decade will determine how these markets interact with each other.

It is worth looking at some of the key policies and events which have led to the dramatic dramatic developments in the emerging capital markets.

The rescheduling of the sovereign debt, particularly in Latin America, was an essential first step in re-establishing foreign and domestic investor confidence.

Privatization of state-owned enterprises was another important breakthrough for many of these countries. The sale of these companies had both a revenue and expense saving effect that brought dramatic improvements in the public finances which in turn reduced the public sector's crowding effect on the capital markets. The substantial deficit reductions also helped significantly inflation bringing inflation under control. This made the development of a medium and long-term debt market possible.

The development of an institutional investor base has also been critical to the evolution of capital markets. In most emerging markets, insurance company reserves have not reached levels where they represent a significant factor in domestic savings. Mutual funds have had varying levels of success and in many cases have been the single largest pool of institutional investor funds. But the biggest push in the long term will come from pension funds. Driven by the need to build up the volume of the domestic savings and by the failure of government retirement programs, several countries have already embarked on pension reform programs. The newly launched individual pension program in Mexico is expected to supply about $1 billion per year to the capital markets by 1994.

But one of the most important success factors has been the commitment by many countries to establish and enforce international standards of accounting and disclosure. What distinguishes a modern, professional capital market from a traditional debt market is the reliance on high quality and readily available market and issuer information. I would venture to say that progress in the area of financial reporting and disclosure can

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have a more direct and lasting effect on investor confidence than the existence of rating agencies absent reliable information.

Accompanying these developments has been an explosion in the visibility, importance, and number of rating agencies. At the beginning of the 1980s, there were seven rating organizations, five located in the United States and two in Canada. Today, in the emerging markets alone there are at least 28 domestic rating agencies operating in 9 countries. Based upon inquiries into our own organization, the number is sure to grow substantially. There is a strong linkage between rating agencies and the growth of the capital market system and, for good reason. As markets grow in size and complexity in an environment of privatization, reduced government involvement and liberal capital exchange regimes, investors look for objective, third party opinions as to the quality of the securities they are asked to buy. But how this occurs and the value that rating agencies add will differ markedly depending on the stage of market development.

In my presentation I will discuss the role and development of rating agencies. I will then outline the most important qualities of a credible rating agency with particular emphasis on their relationship with regulators, a topic that I expect is of particular interest to an audience such as this.

II. Role of Rating Agencies

Ratings have proven their worth in the capital markets in ways that can be best described by looking at the specific benefits to the investor and issuer.

Rating agencies provide a consistent and widely recognized nomenclature of credit quality that permits a fund manager in the US to meaningfully compare the relative risks of debt instruments issued by a Korean corporation against a Turkish municipal bond. Of key importance is that since the agency is not a party to the transaction, its opinion is impartial.

The ratings provided by a credible rating agency also help the efficiency of primary markets by speeding the process of distribution. Investment bankers very often target investors on the basis of their risk preference. The rating quickly identifies the risk profile of the transaction making it easier for the banker to position the security against the right group of potential investors.

Ratings also enhance the liquidity in the secondary markets by allowing traders and investors to transact blocks of similarly rated securities on the basis of their risk profile, even though the individual securities may be from very different companies and countries.

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What then, are the benefits to an emerging market issuer? In international markets, investors may not recognize the company, but they would be prepared to consider the company's debt instrument if it were rated. The rating also provides access to key institutional investor markets, such as the pension funds in the United States, that will usually not consider unrated debt securities. What is interesting is that his investor preference of rated over non-rated debt issues is already being manifested in emerging capital markets.

Perhaps the most important consideration is that over time, investors will begin to adjust their return expectations according to the risk of the issue. In the near term one can expect that rated issues will simply be easier to sell in the market, but that eventually higher rated paper will pay a lower rate of interest. Name recognition alone will no longer be sufficient to assure quick placement and the best pricing of a debt issue.

Even though most Latin American regulators currently require ratings for domestic debt issues, as investors begin to risk adjust their return expectations, ratings will no longer have to be required, the market will demand them. Let me illustrate with some basic data from the U.S. experience.

This first slide demonstrates the correlation between ratings and their respective default rates over a 10-year period. You could look at this as a tribute to the accuracy of the ratings. But I'd rather focus on the default expectation which ratings represent for the investor. The result is the following:

You can clearly see the price premium which the market demands from higher risk paper. It is understandable why issuers are also attentive to ratings.

III. Development of Rating Agencies

In order to better understand the issues facing the ratings business in emerging markets, it would be useful to compare and contrast the development process of ratings in the United States with the process that is now going on in emerging markets in Latin America.

The development of rating agencies in the United States evolved over a period of almost 30 years. In the early years, the agencies derived market recognition through the development of highly credible financial and performance information on corporations and institutions operating in the capital markets. The agencies' earnings were derived from subscriptions to the publications containing this information. The ratings were an analytical component of the overall performance information provided in those publications. The real value of these independent risk rankings of institutions had not yet been recognized by the markets. A series of shocks including the Penn Central default drew the market's attention to potential use of these ratings in managing and monitoring

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the quality of large, complex portfolios, particularly those of institutional investors such as pension funds and insurance companies.

From the early 70's onward, rating nomenclature, particularly distinctions between investment and non-investment grade, began to be written into portfolio guidelines. It happened that the only widely recognized and objective rankings of risk were being provided by 2 agencies, Standard & Poor's and Moody's. These agencies became the de facto "Nationally Recognized Statistical Rating Organizations" described by the SEC. As the debt markets grew in size and complexity, the ratings of debt securities became an essential part of any public debt issuance. But it is noteworthy that, despite their importance in the capital markets, there are no specific regulations governing the creation, operation, or methodology of rating agencies in the United States.

This pattern of development has occurred in a few other markets such as Australia, but the experience thus far in the emerging markets and in Latin America in particular, the development of rating agencies are being driven by forces that cannot wait for a leisurely evolution of this activity.

In Latin America, the development of capital markets is being driven by central governments as a way to stimulate domestic savings. Very often these development programs are tied to pension fund reform programs and other related macro-economic programs. This activist role of government extends to the development of rating agencies as well. The regulatory authorities expect the rating agencies to play a key role in enhancing the credibility of public markets by providing domestic and international investors high quality risk information in markets where full disclosure and consistent performance data are relatively new phenomena.

Another factor is that governments wish to take themselves out of the business of approving or disapproving securities for issuance particularly when this activity creates an implied liability for the government as to the reliability of the issuer. They prefer to have the market determine the eligibility of the security through the rating process. Given the issuers long-standing resistance to detailed scrutiny of their condition and performance, regulators have felt compelled to force the discipline of the rating process by making ratings a pre-condition for issuance or eligibility for specific securities programs. In Mexico, all securities must be rated prior to issuance, in Chile, securities must be rated in order to be eligible for acceptance in pension fund portfolios, and in Argentina, the ratings are required in order for the security to qualify for the tax benefits of designation as a "negotiable obligation".

In an environment of a "managed development" of capital markets, the requirement that publicly traded debt securities be rated may be necessary, but this could present problems in establishing market credibility for the rating agencies. I will address these problems in the context of the critical success factors of a rating agency.

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IV. Rating Agency Success Factors

Although independence is the most important factor, let me leave it for last since so I can discuss it more fully.

One of the first concerns of issuers and investors is the quality of the agency's analytical and management staff. There should be a balance of high quality academic preparation and relevant business experience. The financial strength of the agency is also a consideration in that ability to attract and retain that caliber of staff.

For an agency's findings to be credible, the investor and the issuers must clearly understand the methodology used to arrive at those findings and also the rationale behind specific ratings. Publication of methodologies and rationale should be encouraged.

Lastly, there should be consistency in the agency's application of its criteria so that ratings are comparable across industry types and location.

Now let us consider the matter of independence.

The opinions and conclusions of a rating agency must be considered by the investing public to be independent and unbiased. The ownership structure, scope of activity, and rating committee proceedings should be free from outside influence and conflicts of interest.

While a rating agency should have the support of the regulatory authorities, it should not be seen as an instrument of the regulatory body. Here we get into some of the key problems facing the relationship of rating agencies and regulators in the Latin American markets. How can rating agencies develop and maintain their credibility if they are the creature of a regulatory mandate?

Let me pose a series of questions relating to this issue and talk through their implications with you:

1. Should regulators determine the criteria which agencies use to determine the ratings on securities?

The argument in favor is that since the market has no background or experience with ratings, the imposed methodology assures some minimum standard of analytical quality.

A codified methodology cannot anticipate the many market and company-specific considerations required for a rigorous evaluation of financial and performance risk. Modern, professional risk analysis relies heavily on high quality judgmental assessments of qualitative factors such as management quality, product competitiveness, and

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international market conditions. It is unlikely that a pre-determined methodology will encourage the development of more sophisticated and higher cost analytical methods.

Any process that is the product of a highly structured or mechanical process will not be highly valued in the market. Ratings will be perceived as low value added exercises that are an extension of the bureaucratic red-tape associated with the issuance of a security. Little will be done to enhance investor confidence in the public markets. If the product is perceived as low value, the market will price it accordingly. The basis for competition will, in fact, become price. In a low margin environment, it then becomes economically unfeasible for an agency to upgrade its methods and personnel.

2. Should there be more than one rating agency?

There is no easy answer to this question. In the spirit of promoting open competition, most regulators have been silent on this issue. While it is true that competition is healthy, there is a risk that an excessive number of agencies will lead to price-based competition with the risk of declining analytical quality.

Restraints on competition are ultimately counterproductive. Perhaps the best approach is to set guidelines relating to transparency and independence. By requiring that agency methodologies and rating rationale be made public, the market is allowed an opportunity to judge the quality of the analytical quality. This is the proper basis for competition and discourages casual participants that are unwilling or unable to dedicate the time and resources to producing the highest quality product. Strict rules governing conflicts of interest will also help reduce the number of participants that engage in ratings as a side activity to their main line of business particularly when these activities could compromise the independence of the rating process.

3. How actively should regulators involve themselves in the day-to-day monitoring of the rating agencies?

Regulators are concerned that the agencies adhere to their stated methods and standards. There is a concern that the rating activity will be less than rigorous or compromised. These are genuine concerns. But the question is: what is potentially more damaging: that a particular rating agency fails to perform in the public interest or that the entire rating activity becomes discredited by excessive regulatory intervention? Let me a address two main concerns.

To the extent that the confidentiality of the analytical process is breached, regulator's participation can only undermine the credibility of the process and lead to a breakdown in the issuer's comfort level with full disclosure of its market assessments and strategic plans. An extremely valuable component of the analysis will be lost.

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If regulators are seen to have any influence whatsoever in the rating committee proceedings or conclusions, the ratings will be hopelessly tainted as politically-induced.

For these reasons, S&P's position in this regard is that it is opposed to government regulation of the rating process but is fully committed to working with the regulatory organizations so that they understand our standards and methodology.

Before closing, let me switch over to the role that international rating agencies might play in this development process.

V. Role of International Agencies

Major international agencies bring with them proven analytical methodologies, globally recognized nomenclatures and long standing reputations for integrity and discipline. All of these qualities could benefit the rating activity in an emerging market.

Whether a local agency decides to seek an alignment with a major international rating agency depends largely on the stage of development in which it finds itself and its experience thus far in the activity. Some agencies started by creative entrepreneurs have grown and flourished without assistance from a major agency. Others have sought affiliation at different times. Standard & Poor's has been involved in several different approaches including start-ups, joint ventures, acquisitions, and technical assistance agreements.

For example, in partnership with the Stockholm School of Economics, S&P established Nordisk Ratings, AB in Stockholm. In 1990, S&P acquired 50% of Agence d'Evaluation Financiere (ADEF) in France which now operates as a joint venture. That same year S&P acquired 100% of Australian ratings. More recently, S&P entered into a technical assistance agreement with the Thai Ratings and Information Services of Bangkok.

S&P is actively reviewing the emerging markets for opportunities where the regulatory environment and market conditions would support S&P's participation. In some cases, S&P has been approached by regulators or large institutional sponsors to conduct feasibility studies or provide consultation on the setting up of rating activities in those countries.

There is another role for international agencies to play in the emerging markets. With the increased local rating activities and growing globalization of capital markets, a key task will be to encourage convergence in the methodology and nomenclature between the domestic rating agencies and their international counterparts. Confusion and inconsistency in these areas does not serve the investor public nor the rating industry. At S&P we are doing everything possible to extend our professional relations with rating agencies throughout the emerging markets.

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VI. Conclusion

Let me conclude by saying that tremendous strides in the development of domestic capital markets have been made by countries that have undertaken the difficult task of substantive reform of macro-economic policies and supportive market regulation. Rating agencies can play a critical role in providing high quality, readily accessible performance and risk information to the investor public. If it is done right, it can contribute significantly to market confidence by both domestic and international investors.

I must admit that the underlying regulatory concerns were easier to deal with in the United States. You will recall that by the time ratings became important in the capital markets, the agencies had already established nationwide credibility as providers of high quality information and analytics. This background was also a natural barrier to entry that kept the number of rating agencies low. The market had already imposed its own discipline.

Your task is much more difficult, you are not only trying to set up modern capital markets but also attempting to build in factors to assure their credibility. This is not an easy task for which there are no simple solutions. The temptation to over-regulate will be very strong.

I'm sure there are many more issues I could address, but I would rather let you raise them during the question and answer period. I trust I've been sufficiently provocative to stir up many questions from the floor.

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