CREDIT RATING AGENCY: INTERNATIONAL EXPERIENCES AND SUGGESTIONS TO DEVELOP IN VIETNAM

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Abstract

The activities of Credit rating agency (CRA) were created since 1909 by John Moody. After hundred years, CRAs gradually showing their special role in capital market of many countries. During the past decade, CRAs also draw a lot of attention from investors, policy makers, especially during the financial crisis in 2008. This report will illustrate some specific issue around these agencies, include: the overview of CRAs, the role of CRAs on financial crisis, positive and negative effect of "Credit Ratings Mistrust" during crisis, and the chance to run a CRA in Vietnam, as well as some suggestion to improve their performance in risk assessments.

Keywords: *Credit rating agency, Financial crisis, credit ratings mistrust, financial market, bond market*

1. Introduction

Although Credit Rating Agency is a specific type of companies who does not directly invest in financial market, their role to the financial system is undeniable. CRAs not only reduce the asymmetric information but also take part in risk management of investors. Theoretically view, CRAs also helps to predict the financial crisis. However, CRAs have potential problem in their business model. Global Financial Crisis 2007-8 exposed these shortcomings. Despite the misleading credit rating of CRAs during the Global Financial Crisis, the role of CRAs in enhance the efficient of financial market is worth to considered. A Vietnamese credit rating agency is an interesting business for financial market and policy makers to setup.

2. Overview of credit rating agencies

2.1. Who are Credit Rating Agencies?

There are 2 main problems in the capital market, which make this market less attractive: transaction cost and asymmetric information. When a lender gives money to a borrower, the first and most important matter they care about is whether they can get their money back. In order to solve this problem, the lender require more and more information about their counter parties. However, it is not easy to collect all information about partners, especially when they have too many borrowers. In this case, the existence of a third party who can record and analyze companies' information became necessary.

CRAs aim to provide their opinions about the securities' debt risk, including private corporations and all levels of government. On the other words, based on the information about firms' framework, sovereign, capital… and specific instruments of CRAs, such as: financial analysis, statistical modelling, risk volatility assumptions… CRAs give their subjective judgments about the firms' securities, whether the issuers can keep their promises of interest and principal payment on due date (Bilson & Delacour, 2011)

It is clear that the operation of CRAs reduce the asymmetric information in the capital market. By dint of these analyses, the investors can nurture their knowledge about the firms and their securities, hence, they can make the right decisions in relationship with their risk taste. (Elkhoury, 2007)

2.2. How to run Credit Rating Agencies?

All of the very first and biggest CRAs in the world are U.S companies. The first CRA is Moody, which was found by John Moody in 1909, followed by the Poor's Publishing Company in 1916, Standard Statistics in 1922 and the Fitch Publishing Company in 1924 (White, 2010). Although they have the same objective, CRAs is different in several sectors, the important are: Business model and methodology.

- *Business model*

- "Investor-pays" model

From the beginning, 4 major CRAs worked as the model "investor-pays". To specific, these CRAs released their judgment about several securities of a company or portfolios, and then sold their assessments of credit worthiness to investors.

This model was used in half of the century until the early 1970s, when several issues occurred, which made the model of these CRAs changed. (White, 2010)

- First, free-riding or information leak problem, which reduce the revenue of CRAs.
- Second, regulation changes which made the issuers had to pay for CRAs to rate their securities in order to put their securities in portfolios.
- Third, as CRAs working in the information market, they could be paid by both issuers and investors.

Consequently, the new model for CRAs business was held, called "issuer-pays".

- "Issuer-pays" model

In the "issuer-pays" model the bond issuers had to pay for the rating while these grade was public to the investors with no charge. "Issuer-pays" model is the most common model to be used in CRAs.

Despite its popularity, the "issuer-pays" model raises the conflict of interest, this lies on the potential relation between CRAs and their clients. Theoretically speaking, CRAs should rate the issuers' securities based on its risk, or more particular, the abilities of paying back their loan. However, although there are only few rating agencies which are recognised in the world, the competition is still exist. Consequently, to keep their market-share and revenue, CRAs may distort ratings or provide ancillary services to enhance the relation with their customers. Moreover, they may gain some further business from clients. For example, CRAs can give their clients pre-rating assessments, so that the issuers can modified to obtain the rating they want, this is called "ratting-shopping". (Pagano & Volpin, 2010)

- *Methodology*

Each CRA has their own methodology to rate securities. In forming their opinions of credit risk, rating agencies typically use analysts or mathematical models, or a combination of the two. (S&P Global Ratings, 2019)

- <u>Model driven ratings.</u>

A small number of credit rating agencies focus almost exclusively on quantitative data, which they incorporate into a mathematical model. For example, an agency using this approach to assess the creditworthiness of a bank or other financial institution might evaluate that entity's asset quality, funding, and profitability based primarily on data from the institution's public financial statements and regulatory filings.

- <u>Analyst driven ratings.</u>

In rating a corporation or municipality, agencies using the analyst driven approach generally assign an analyst, often in conjunction with a team of specialists, to take the lead in evaluating the entity's creditworthiness. Typically, analysts obtain information from published reports, as well as from interviews and discussions with the issuer's management. They use that information and apply their analytical judgment to assess the entity's financial condition, operating performance, policies, and risk management strategies.

2.3. The roles of Credit Rating Agencies

- *Role of Credit Rating Agencies in financial system*

- <u>Reduce asymmetric information</u>

Providing risk rating scales of securities is the main target of CRAs. In order to fulfill their goal, CRAs need to collect not only public but also nonpublic information from the clients, such as industry report, price trends, acquisition agreements, business forecasts, firm's future project,…With high experience employees and professional methods, the rating of CRAs contain superior information. The investors can base on CRAs opinions to evaluate their own investment's value and risks. Hence, CRAs is useful to minimize information asymmetries. (Mullard, 2012)

- <u>Tool to maintain regulation</u>

In the early 1930s, when the regulation of investment became more tighten, the role of CRAs became more important. For example, in order to issue a new security to the market, the rating of CRAs become a regulatory license and requirement. Hence, issuers need to pay for CRAs to rate their new securities. Moreover, the law restrictions also require some types of investors, such as commercial bank, pension fund…to follow the minimum credit rating policies, which make the role of CRAs become higher. In a sense, CRAs became a tool of regulation, used for regulatory purpose in the world to reduce risk in the market.

- <u>Source for risk management</u>

The higher risk, the higher return the investors require. CRAs provide an indication about clients' risk, therefore, became a source on risk management of investors. The assessments of CRAs can affect the interest rate of payment in a contract, or even can break a deal of clients. In addition, for some buy-side companies (for instance: insurance companies, pension funds…) or sell-side companies (such as broker dealers), the result of credit rating process is an important input to their investment analyses

- *Credit Rating Agencies in anticipating future financial turmoil*

Theoretically, CRAs could satisfy their role, even in anticipating future crisis. With independent working and high reputation, the result of credit rating process will be the main source for investors to make decision. CRAs will reduce the asymmetric of information by provide the issuers risk level. In addition, with the reliable report, investors can evaluate their risk and have suitable reserve for their investment. The result of credit rating should remain valuable in a long period of time. Therefore, the downgrade of many issuers also indicate that the crisis may happened.

However, in CRAs' business model, their work is not independent. It is clearly that "issuers pay" model exist the conflict of interest. This conflict raises the question of the credit rating accuracy. In this case, instead of disclosing information, CRAs make the market less transparent. Moreover, overrating securities leads to the mistake in risk management, and become worthless in regulation. The incorrect risk appreciation cannot be the source to predict financial crisis. Hence, the business model of CRAs make them fail their roles.

3. Credit rating agencies and financial crisis

3.1. Financial crisis in 2007 - 2008

The recent financial crisis in 2007-8 can be recorded as the biggest global crisis after World War II, which led to bankrupt of large financial institutions. Down Jones Industrial Average was stood at more than 14.000 in September 2007, however, 1 year later, this figure was only 8.000, 40% was lost in 1 year (Reavis, 2012). Not only was stock market suffer from the crisis but credit market also were nearly paralysis. Unemployment rate in U.S raise dramatically, loans could not be made, and other countries beside U.S also suffer with the crisis.

The very first source of the crisis was US housing market. It was blamed that the significant rising in the house price from 1990s in relation with several contributing factors, such as low interest rate, was key points to let the market down.

In 2006, the houses' price in U.S was about 4 times of average family income, which illustrated the high demand of this asset. In spite of flat incomes, household was able to buy their own house by the easy access to capital of bank, which created the subprime loan in the market.

The securitization process transformed these subprime loans into subprime Mortgage Backed Securities (MBSs) and Collateralized Debt Obligations (CDOs) and was held by many investors in the market.

The crisis occurred when the balloon of houses blew up. Housing price dropped dramatically. Households could not pay back their loans to their lender. The subprime loans became bad debt. The securities based on these type of loans became worthless. And the revenue of investors became negative.

The explosion of the house' balloon also pull down the stock index. Hence, the crisis happened and many firms, especially financial institutions was involved.

3.2. Role of Credit Rating Agencies in Global Financial Crisis

In order to have clear evaluation of CRAs' role in the financial crisis, the report will discuss the securitization process, therefore, summary the huge effect of their misleading credit ratings.

- *Securitization process and affections of misleading credit rating*

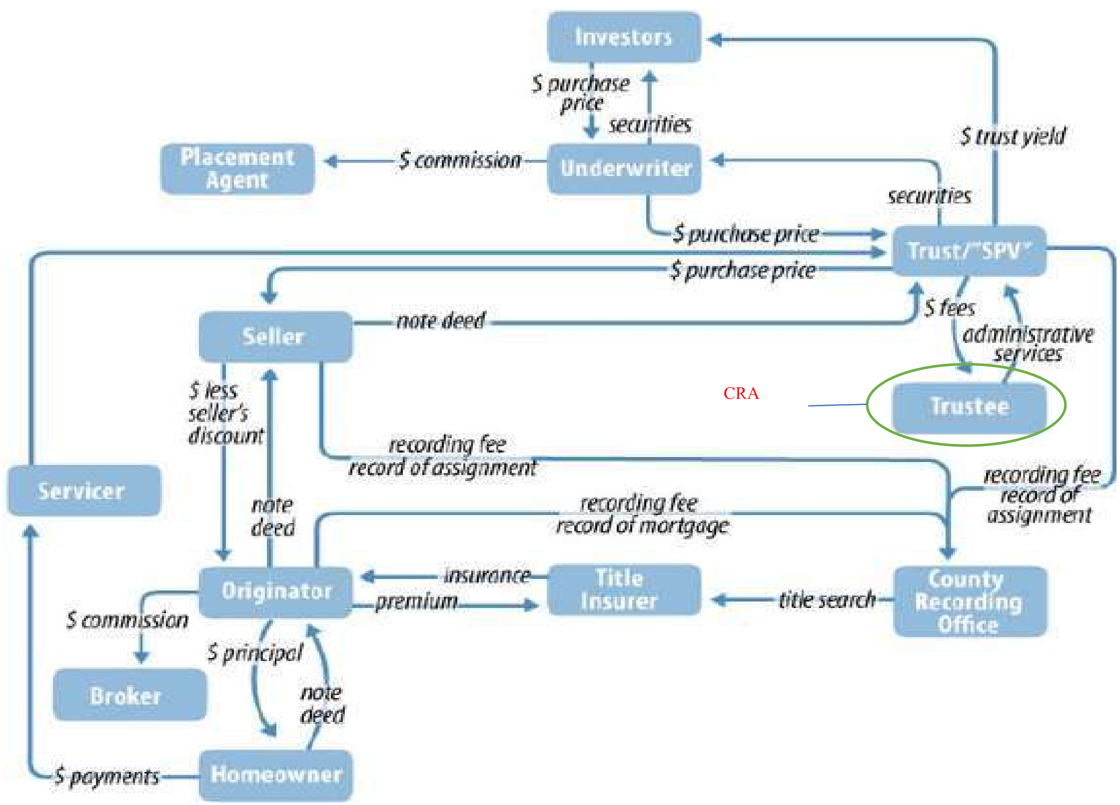

Diagram 1: Securitization process (Peterson, 2009)

It can be said that the misleading credit rating of CRAs exacerbate the Global Financial Crisis. (Mullard, 2012)

First, the misleading of CRAs provided favourable condition for SPV to sell the subprime MBSs and CDOs in the market. The mix and match of the securities in the portfolios made it complicated and then the information became coarse. CRAs, in that case, became more important on deducting information asymmetry. However, their misleading only raise the gap between the subprime securities and its source, subprime loans.

Consequently, when the housing price dropped, its negative effect not only affected the originators, but also put the investors in the secondary mortgage market in danger. The domino effect made many big financial institution suffer, and with the limit power, FED could not rescue them all.

Second, the high rate of securities increased the liquidity in the market. The originator, instead of waiting for their borrowers pay back their debt, could sell the loans to other institutions, and continued lending money for the subprime homeowners. This situation, in some case, made the originator suffer more from the broken of housing balloon. The same problem also was recorded in other investors in the market. Moreover, the securitization process also reduced the responsibility of the lender in the loan contract.

Third, the misleading credit rating also meant that the risk of the portfolios was low. In this situation, the holder of the portfolios did not require large provision for the investment. Therefore, they became passive when crisis happened.

- *Causes of the misleading credit rating*

From the beginning, secondary mortgage market working normally for decade. But after the Dot com crisis, U.S government decided to reduce the interest rate, which given favourable condition for homeowner to make a loan. However, these loans did not conform the standard, so that it was called subprime loan. After securitization process, these loans became subprime MBSs and CDOs. From 2001, subprime MBSs increased significantly as shown in table 3. The misleading in credit rating of CRAs played the main role on this trend. (Pagano & Volpin, 2010)

Firstly, the conflict in the business model of CRAs made them give the portfolios which included subprime MBSs highest rating. In addition, the untighten regulation in CRAs' operation made their conflict of interest became more serious. There were no regulation restrict CRAs provide their rating requirement to the clients. Hence, the issuers can modified their financial situation to meet the certain rating, or on other words, shopping the rating. Furthermore, CRAs was concerned as "journalists", so they did not have responsibility for their rating result. The only thing that made them giving the right rating was reputation and tradition. Hence, when they wanted to keep the market-share and revenue, they may misleading their rating result. The relation between their rating and revenue was significant. From 2001 to 2006, three biggest rating agencies recorded dramatically rise in revenue, from $3 billion to $6 billion. They also charged for the triple-A rating securities, as Moody's received 4.75% for triple-A rated and 3.5% for AA rate.

Secondly, it is undeniable that the securities in the secondary mortgage market were very complex. Hence, it was not easy to evaluate the creditworthiness of these instruments. However, CRAs, instead of warning investors about the different between bonds and asset-backed securities, was very confident to assert that the risk level between triple-A bonds and triple-A securities was similar. This reassurance encouraged investors to purchase riskier AAA securities, and expand the market. "The FCIC estimated that Moody's and S&P rated some 10,000 securities as triple-A between 2005 and 2007 and that Moody's had rated US$4.7 trillion in RMBS and over US$400 billion in CDOs".

Table 1: Issuance of mortgage backed securities and CDOs over time

	Total mortgage origination ($bn)	Subprime origination		Subprime MBS		CDO issuance ($bn)
		($bn)	(% of total mortgages)	($bn)	(% of subprime mortgages)	
2001	2,215	190	8.6	95	50.0	6
2002	2,885	231	8.0	121	52.4	36
2003	3,945	335	8.5	202	60.3	30
2004	2,920	540	18.5	401	74.3	157
2005	3,120	625	20.0	507	81.1	272
2006	2,980	600	20.1	483	80.5	552
2007Q1	680	93	13.7	52	55.9	186
2007Q2	730	56	7.7	30	53.6	176
2007Q3	570	28	4.9	16	57.1	93

Source: Gorton (2008)

Thirdly, CRAs also had problem with their methodologies and experience employers. It seems that they were lack of historical data of subprime market, as well as the correlation in the default that may affect the securities. The demand for CRAs rating also increased, which could be describe by $4 trillion mortgage-back securities during 6 years from 2000 to 2006 that needed ratings. The rating process, which should be run in 1 months, reduced to 2 weeks. Therefore, the employers in CRAs always had to handle the stress time. These are some reasons which made the rating result become mistrust.

4. Suggestions for credit rating agencies

Theoretically speaking, CRAs should reduce the asymmetric information and provide sufficient reports for investors. However, in the past decade, especially during crisis time, CRAs did not satisfy their role in risk assessments.

Some suggestion in term of regulation, which should be bring forward to improve CRAs' performance will be discuss below:

First, the potential problem of CRAs is the business model. In long-term, CRA should change the "issuer-pays" model into "subscriber-pays" model to solve the conflict of interest. The new model should have the participation of a third party to fund the CRA on behalf of investors.

Second, in short-term, while changing the model is difficult to implement, a regulation restrains the relation between issuers and CRAs in the old model must be released. For example, prohibit issuers from shopping rating, restrict CRAs sell ancillary services, which has strong relation with the result of rating.

Third, the penalty of giving mistrust rating should be considered. Although CRAs are working as a "journal", the impact of their credit rating is enormous. Raising their responsible in credit rating is necessary, and also improve their trust.

Fourth, in order to enhance transparency, the issuers should public the portfolios data. Furthermore, CRAs also should be asked to disclose more complete and detailed data about the credit rating process.

5. Vietnamese credit rating agency

Although CRAs has some potential problem in the business model and methodology, which exacerbates the Global Financial Crisis, CRA is developed in many countries. Credit rating can be applied in the following areas/instruments:

- ✓ Equity shares
- ✓ Rating for banking sector
- ✓ Individual credit rating
- ✓ Rating for insurance sector
- ✓ New instruments, floating rate notes, index based bonds, long-term deep discount bonds, etc.
- ✓ Rating of intermediaries in financial services
- ✓ Securitization
- ✓ Rating of companies raising funds overseas.

However, in Vietnam, CRAs normally do their rating on bonds and show important role to boost bond market.

5.1. Vietnamese financial market

The role of CRAs is significant with the development of bond market. The Vietnam corporate bond market has grown rapidly since 2017 and issuances of $12.8 billion in 2019 were larger than those for Indonesia and the Philippines. Private placements accounted for 94% of corporate bond issuances in 2018 and 2019 following easing of disclosure requirements and issuance conditions. However, the lack of a credit culture poses significant risks to the bond market and the financial sector, particularly as individual investors currently own almost a fourth of all bond issues. (Kathpalia, et al., September 2020)

Table 2: Vietnam Bonds issuance

Year	Government	Guaranteed	Municipal	Corporate	Total
2012	141.3	52.6	4.8	28.7	227.5
2013	181.1	47.4	8.5	34.4	271.3
2014	248.0	27.7	7.1	48.0	330.9
2015	256.2	47.9	7.5	42.8	354.4
2016	312.2	34.5	3.5	97.4	447.6
2017	244.2	34.4	2.2	115.4	396.2
2018	221.0	26.2	0.8	238.4	486.3
2019	229.8	17.5	1.0	296.7	544.9

Source: Techcombank securities and Vietnam Bond market association

There are 4 types of bonds in Vietnamese bond market:

Government bond, which normally issued by the Ministry of Finance, accounted for the largest amount of bond in the market from 2012-2017.

Government guaranteed bonds is issued by state-own policy banks or state-own firms.

Municipal bonds issued by provinces to fund their own budget.

Corporate bonds saw a dramatic increase from 2012 to 2019, with the issued amount excess the government bonds in 2018 and 2019, accounted for the biggest type of bond that is established in the market.

5.2. Domestic credit rating agencies in Vietnam

The potential of bond market and financial market in Vietnam is huge. With the successful in controlling COVID-19, financial market in Vietnam grows stronger than ever. The urgent need for a domestic rating agency in Viet Nam is clear based on feedback from investors, intermediaries, issuers, and government officials. A credible domestic rating agency is a critical missing jigsaw piece in the orderly development of a healthy sustainable bond market in Viet Nam. (Kathpalia, et al., September 2020)

The first CRA in Vietnam is VietnamNet Credit ratings central, which is launched in 2005 but the demand for rating is poor, which led to it closed in a year. It is clear that in 2005, the financial market in Vietnam was run for 5 years, litter instruments was traded, therefore, the need for CRA was not existed.

In 2017, Phattinh Rating was the fist Vietnamese credit rating agency to be licensed under regulations. It has rated 30 enterprises, financial institutions and debt instruments. Later, in 2020, FiinGroup (formerly known as StoxPlus) became the second credit rating agency to be licensed by the Ministry of Finance. In 2019, it provide over 7000 reports on SMEs in Vietnam and created a scoring model to rate this type of firm. Fiin Rating is worked under an "investor pay" model.

5.3. Develop credit rating agencies in Vietnam

In Vietnam, The Ministry of Finance can grant up to 5 CRAs, therefore, the chances for this business is exist. Running a CRA in Vietnam bring both positive and negative effect on solving the mistrust of credit rating.

- *Positive effect*

First of all, setting up Vietnamese CRA is a good idea. To begin with, Vietnamese CRA works in Vietnam, therefore, they acquainted with the regional economic fundamental, hence, they may create better model to evaluate the risky of sovereign debt of their members, in case of FiinGroup.

Secondly, the asymmetric information in Vietnam financial market is high. Investors hardly access the real financial situation of the firms in the market, especially with the bond market, this makes it become inefficient. CRAs will provide more information for investors, therefore, bring the Vietnamese financial market into higher level and attract more local and foreign investors.

Last but not least, the more CRA, the higher information is provided. Each CRA has their own business model, so there will be the conflict between interest of the owners. This lead to the mistrust of CRA. FiinGroup is an "investor-pay" company, so they may face the problem of this model and may change into an "issuer-pay" firm. But "issuer-pay" model gave some wrong rating during the financial crisis, which exacerbated the recession. There is one more type of CRA that can be considered, which is "state-own" company. So different types of CRA will decrease the mistrust of the rating, and make the information more transparent.

- *Negative effect*

However, contrary policymakers claimed that this agency will put the reputation of credit rating in danger. Vietnamese CRA is a new agent, therefore, it is convincing that investors may consider about their rating scale and standard. The different of the standard on credit rating may help the bonds or stocks gain high level. More or less, Vietnamese CRA works under the funding of someone, and they have their own interest, so the risk of the wrong rating is existed. The mistrust on the result of credit rating result also raises the adverse effect on the growth of Vietnamese financial market.

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