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Optimistic ratings can help Asia ride out turmoil

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EARLY this year, an unprecedented admission came from a large Europe-based credit rating agency. Fitch IBCA - Europe's largest - buckling under international criticism, bowed its head and said it, and its bigger rivals had indeed failed.

They had failed to flash early warning signals on what was to become the biggest and most threatening crisis to grip Asia and the rest of the world. (This is not the first time they failed to put the saddle on the right horse. Their short sightedness also showed when they didn't predict the Mexican crisis.)

The reason for the oversight was simple enough. Fitch was reported to have said in the Financial Times: "We over-estimated the sophistication of Asian policymakers, who have proved good fair weather navigators but very poor sailors in a storm."

Since then, the like-never-before deluge of downgrades by these international agencies have been pouring into Asian debt, adding panic to the existing frenzy, further accentuating the bust.

For instance, Moody's and S&P's continued to rank Thai Government bonds as grade A until last October, three months after the baht collapsed. They downgraded ratings for Yamaichi Securities, which earlier boasted investment grade, merely days before the investment house went bust last November.

Hong Kong was not spared either when Moody's altered its rating on major banks to negative only after the stock market gave in to the sliding currency. The impeccable timing of Moody's and S&P's slashing of Malaysia's sovereign rating to near junk bond status hours before policymakers were expected to leave for a roadshow to raise funds overseas several months ago, have further cast a dark shadow of uncertainty over their credibility in the country.

And in what is deemed as the "most dramatic instances of sovereign rating downgrades in the history of sovereign ratings", South Korea which was rated at the same level as Italy and Sweden as early as last October, was slashed to junk bond status shortly after.

Could it now be possible that the economic meteorologists have failed (again), only this time by underestimating the resilience and fundamentals of these economies, most of which have never defaulted in their payments.

Having failed to perceive much earlier the extent of the problems still plaguing much of Asia for over a year now, could they be overreacting by throwing most of these countries to or almost to non-investment grade?

Back in April, a major Japanese financial house probably frustrated by the damage inflicted on its business by the ratings, suggested that these agencies be rated.

The people sitting at their desks in New York and London must have dismissed these calls with a chuckle, just like hedge fund managers and currency speculators who think of themselves as the untouchable marauders in a free-market capitalist system.

But rating agencies should watch over their shoulders. Once ridiculed for his call for transparency and regulations on hedge funds and currency trading - a call increasingly being echoed by other nations - Prime Minister Datuk Seri Dr Mahathir Mohamad has set his sights on the international rating agencies.

As the pattern goes, his thoughts over these agencies are increasingly

being expressed by other frustrated economies still stinging from the cuts in their sovereign ratings.

International rating agencies generally do not possess superior information on emerging market economies. In fact, they have very little scope to acquire advance knowledge on matters affecting sovereign risk.

Sovereign risk ratings are based on publicly-available information, such as the country's foreign debt, gross domestic product, reserves and political scenario.

This sets them apart from local rating agencies which judge the credit worthiness of companies based on information directly provided by the company which may not be of public knowledge.

For example, in Malaysia, there are two rating agencies - Rating Agency Malaysia Bhd and Malaysia Rating Corp Bhd. These agencies have access to inside information which includes details of a company's debt levels, financial and cash flow position.

The local rating agency is also in a position to directly assess the management competency of the company which plays an important role in determining the health of the company. With these data, it can then accord the company more accurate ratings after also taking into consideration the overall ambience of the particular industry and the economy in general.

As such, as opposed to sovereign borrowers, this advance knowledge obtained by local agencies can be conveyed to market participants through ratings on private borrowers.

Given that these factors tend to make investors have more faith and base their investment decisions more accurately on local ratings, it is important that RAM and MARC continue to remain independent.

They need not feel the heat being directed at international credit agencies as they are in a better position to come up with accurate judgements.

"What is important is they (local agencies) should not be pressured to give companies positive ratings for the sake of making things look better than they are. This will seriously jeopardise their credibility, hence ruining the country's private debt securities in the longer run," said a market observer.

We then return to sovereign ratings and the weight they carry in the market front. Evidence suggest that sovereign credit ratings are reactive rather than preventive, in that they tend to amplify boom-bust cycles in emerging-market lending.

If sovereign ratings have no additional knowledge of a country's standing, one wonders why sovereign yields still tend to rise when ratings deteriorate.

According to a technical paper by OECD Development, ratings are influential because of the prevalence of herd instincts in the market.

"Herd instinct, often reinforced by poor prudential regulation, give sovereign ratings the power to influence sovereign bond yields even though they add little to the market's information," it said.

In addition, the study concludes that sovereign ratings absolve money managers from making independent judgements about sovereign risk.

True, international credit rating agencies do not have a crystal ball to gaze into. But professionalism dictates that instead of merely playing "catch up" with the market, it's time for them to don a more responsible role in stemming further exodus of funds from these economies.

To achieve that, in a sentiment-driven market, it would help if they threw in a dash of hope and optimism. Then, instead of merely being judges of "navigators" and "sailors", they could well become captains helping to ride out the choppy weather in the region.

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