Executive Comment: Are Proxy Ratings Distorting Credit Risk For Taiwan's Investors?

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中華信用評等
Taiwan Ratings
An S&P Global Ratings Partner

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Are Proxy Ratings Distorting Credit Risk For Taiwan's Investors?

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Credit ratings have provided an important quantitative scale of relative creditworthiness for Taiwanese investors for almost two decades. But as the deregulation of Taiwan's corporate and financial sectors deepens, Taiwan Ratings Corp. wonders if there is now a growing misuse of the very tool that was meant to bring transparency and consistency to investment decision making.

To be clear, Taiwan Ratings stands fully behind the move to deregulate and reform local financial and bond markets. This would help to reduce risk and strengthen credit profiles in the nation's financial system, while at the same time encourage the development of more diverse reference tools for investor decision making. Indeed, we agree that giving investors a greater variety of decision-making tools could bring many benefits for the bond market as a whole. However, we believe the relaxation of regulations governing bond and debenture issuance should ensure that permitted decision-making tools appropriately measure real creditworthiness or potential credit risk.

Overview:

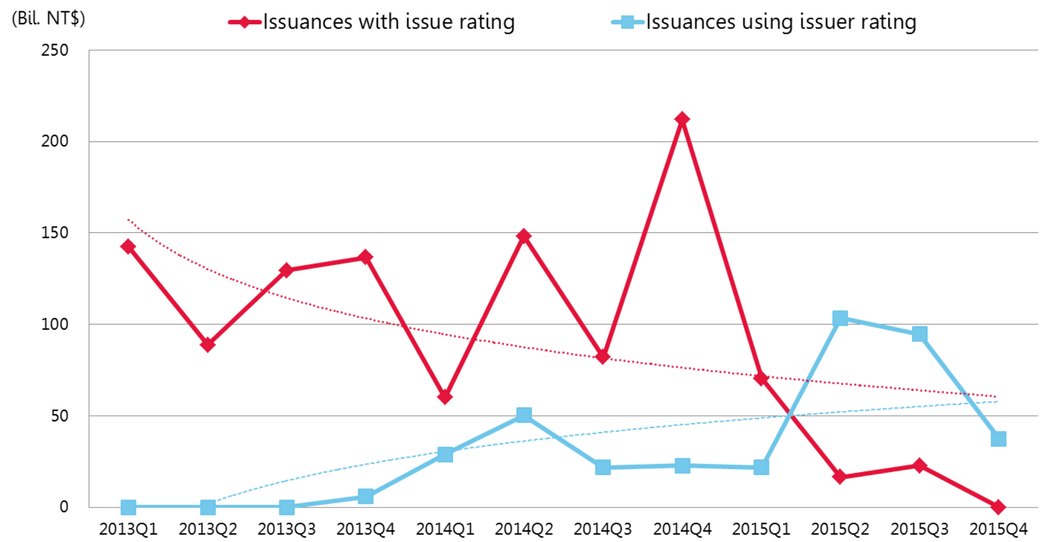
- Issuer credit ratings and issue credit ratings are entirely different measures of creditworthiness and risk.
- Bond and debenture ratings can be several notches below the related obligor issuer credit rating.
- The misuse of issuer credit ratings distorts real credit risk for unsecured bonds and debentures.
- The use of issuer credit ratings as a proxy for issue credit ratings runs contrary to international investment market practices.

Proxy Ratings Allow Issuers To Misrepresent Credit Risk And Investors To Underestimate It

Prior to deregulation, it was a mandatory requirement that rated entities seeking to issue non-guaranteed debt in Taiwan should obtain an issue credit rating for the specific debt, bond or obligation in question. However, on Aug. 27, 2013, the regulator removed this requirement for corporate bonds issued to professional institutional and professional individual investors (see footnote), leaving it up to the issuer and investor to decide whether an issue credit rating was necessary if other permitted measurements of credit risk were available--including the issuer credit rating on the issuing entity. Then on Feb. 13, 2015, the regulator relaxed the rules governing the issuance of bank debentures to professional institutional and individual investors while keeping in place the requirement for an issue credit rating on debentures issued by a bank to non-professional individual investors.

The relaxation of regulations governing bond and debenture issuance was intended to stimulate action by both investors and issuers. First, it would encourage investors to consider other assessments of credit risk in their decision making, and secondly, encourage more entities to issue debt by removing the need for an issue credit rating, thereby reducing the cost of raising funds. The result has been a dramatic fall in the number of Taiwanese corporates and financial institutions seeking issue credit ratings since late 2014, but the anticipated rise in new issuances of bonds and debentures has failed to materialize. In contrast, the volume of new issuances has declined significantly since deregulation began, slumping from NT$758 billion in 2014 to just NT$465 billion in 2015. More importantly in our view, the regulatory changes have created a worrying new trend for rated entities to issue debt using issuer credit ratings as proxies for issue credit ratings. The volume of such issuances has grown significantly since the start of 2015, with zero issuances of bonds or debentures carrying issue credit ratings in the second half of 2015 (see chart).

Issue Rating vs. Issuer Rating New Bond And Debenture Issuance In Taiwan 2013-2015



NT$--New Taiwan dollar. Source: Taiwan Ratings Corp., Taipei Exchange. ©Taiwan Ratings Corp. 2016

The numbers might appear to suggest that Taiwanese bond markets have readily accepted the use of issuer credit ratings as a proxy for issue credit ratings. However, Taiwan Ratings is deeply concerned that Taiwanese investors may be placing undue emphasis on a measure of creditworthiness that does not address the risks associated with the specific debt itself. This is because issuer credit ratings and issue credit ratings are two entirely different opinions of creditworthiness, and involve the assessment of different risks and other factors. Allowing investors to base their investment decision making partly or wholly on the wrong type of credit assessment sets a very dangerous precedent, in our opinion. To be clear, proxy ratings misrepresent a credit rating agency's assessment of credit risk and distort the market's perception of credit risk. This could have very serious financial consequences for investors and could potentially destabilize the bond market in the event of an issue default or defaults under even the most favorable of economic environments.

Distinguishing An Issuer Credit Rating From An Issue Credit Rating

So what sets an issuer credit rating apart from an issue credit rating? An issuer credit rating assigned by Taiwan Ratings is a forward-looking opinion about the overall capacity of a debt issuer, guarantor, insurer, or other provider of credit enhancement (an obligor) to meet its financial obligations relative to other obligors active in Taiwanese financial markets. Such obligors may include corporates, government enterprises, financial institutions, and insurance companies, among other types of entities.

By contrast, an issue credit rating is a forward-looking opinion about the capacity of an obligor to meet the financial commitments associated with a specific debt, bond, lease, commercial paper program, certificate of deposit, or other financial instrument (an obligation), relative to the debt servicing and repayment capacity of other obligors active in the Taiwanese domestic financial markets, with respect to their own financial obligations. Simply put, an issuer credit rating reflects our opinion of the likelihood that an entity might default with regard to all its financial obligations, whereas an issue credit rating reflects our assessment of a blend of default risk and the priority of a creditor's claim in bankruptcy associated with the specific debt being rated. It is an issue credit rating that investors need to evaluate in their investment decision making, because it interprets obligor risk toward a specific debt.

The nature of the obligation in question could affect our rating on it, and underlies our belief that issuer credit ratings are a wholly inadequate substitute for issue credit ratings in investment analysis. In general, we could assign a higher rating to secured debts than to unsecured debts, because secured debts have a higher recovery rate than that for unsecured debts in situations of issuer defaults. As default risk increases, the concern over what can be recovered takes on greater relevance and, therefore, greater rating significance. Accordingly, we give more weight to the loss-given-default aspect of ratings further down the rating spectrum.

Corporate issue credit ratings

So what does this mean for bond issuances in the corporate sector? In the case of corporate issue ratings, we may "notch down" the issue credit rating on unsecured corporate debts from the issuer credit rating (also known as a corporate credit rating) by one or two notches, depending on the recovery prospects. We can rate subordinated debt up to two notches below an issuer credit rating of 'twBB+' or lower, but one notch at most if the issuer credit rating is 'twBBB-' or above based on how much priority liabilities rank ahead of the rated debt issue. For example, let's say the issuer credit rating is 'twBBB-' and the issuer's priority liabilities account for more than 20% of its tangible assets then we generally rate its unsecured debt 'twBB+'.

This process of notching has important implications for investors' understanding of credit risk if they are mistakenly applying the issuer credit rating on an obligor as a proxy for an issue credit rating on the obligor's debt. To begin with, the investor would be applying the wrong rating methodology and resultant rating in the assessment of credit risk. More importantly, the credit rating the investor is using is unlikely to address the bond's secured or unsecured status for recovery prospects in the event of default and could be one or two notches higher than the true issue credit rating under the correct rating methodology (for more details see TRC Corporate Sector Issue Rating Criteria in Related Criteria).

Financial debenture issue ratings

When Taiwan Ratings evaluates the issue credit rating on a financial debenture, we mainly focus on the debenture's subordination, deferral clause, and nonviability contingency clause. For senior bank debentures, the issue credit rating is the same as the issuer credit rating on the respective obligor. The application of the Basel III framework has had an important impact on our assessment of subordinated debenture issue ratings. The Basel III framework is a set of international banking regulations developed by the Basel Committee on Banking Supervision in order to promote stability in the international financial system by strengthening bank capital requirements.

For subordinated bank debentures issued before the date targeted by the Basel Committee for implementation of the general Basel III framework (essentially, instruments issued before 2013), the issue credit rating is one notch down from the issuer credit rating on the respective obligor if the obligor is rated 'twBBB-' or above, and at least two notches down from the respective obligor issuer credit rating if the obligor is rated 'twBB+' or below. We generally rate subordinated bank debentures issued after the Basel III framework (issued from 2013 onwards) two notches below the bank's stand-alone credit profile (SACP) if the SACP is 'twbbb-' or above. One notch reflects the debenture's subordinated status and the other notch reflects the nonviability contingent clause. The assessment is again slightly different for perpetual hybrids under Tier II capital that banks issued after the Basel III framework as well as for perpetual hybrids issued under Tier I capital that banks issued after the Basel III framework (for more details see TRC Financial Services Sector Issue Credit Rating Criteria in Related Criteria).

We believe the implementation of the risk-based capital (RBC) framework also has a significant impact on the credit risk assumed by Taiwanese insurers, due to a change in the nature of capital charge assessment. Yet under Taiwan's “Regulations Governing Capital Adequacy of Insurance Companies” and “Regulations Governing Foreign Investments by Insurance Companies,” insurers can utilize an obligor issuer credit rating when choosing to invest in unsecured bonds that have not been assigned an issue credit rating. We believe the misuse of issuer credit ratings as a proxy for issue credit ratings results in a distortion in calculating an insurer's minimal capital requirement because the true issue credit rating on the proposed bond for investment could in some cases be a few notches below the obligor issuer credit rating depending on the terms and conditions of the bond.

Removing All Compulsory And Proxy Ratings Would Benefit Investment Analysis

Taiwan Ratings believes the behavior of issuers and investors since the removal of mandatory issue credit ratings in Taiwan highlights the risks to local financial markets and investors from the misuse of credit ratings. In fact, the use of issuer credit ratings as a proxy for issue credit ratings runs contrary to global market practice. We acknowledge the need for reform in the local bond market to stimulate new issuance volume and broaden the assessments of credit risk. However, we equally believe it would be beneficial for all market participants to first prevent this misuse from continuing. We also support the removal of all mandatory requirements for ratings including issuer credit ratings. This would allow credit rating agencies, obligors and investors to build a stronger and truly investor-oriented bond market supported by transparent assessments of credit risk without the perception of conflict of interest or the misuse of credit ratings.

*Footnote: Professional institutional investors and professional individual investors are defined according to Article 3 of the "**Regulations Governing Offshore Structured Products**" under Taiwan law*

Related Criteria And Research

Related Criteria

- **Taiwan Ratings' Ratings Definitions,** www.taiwanratings.com, Jan. 6, 2015
- **TRC Corporate Sector Issue Rating Criteria,** www.taiwanratings.com, Nov. 25, 2014
- **Understanding Taiwan Ratings' Rating Definitions,** www.taiwanratings.com, Nov. 18, 2014
- **TRC Financial Services Sector Issue Rating Criteria,** www.taiwanratings.com, Sept. 23, 2014

Related Research

- **Taiwan's Bond Market Could See Issuance Volume Decline And Credit Spreads Widen In 2016,** www.taiwanratings.com, April. 27, 2016
- **Credit FAQ: How A Debt Issue Rating Differs From An Issuer Credit Rating,** www.taiwanratings.com, July 27, 2013

Only a rating committee may determine a rating action. This report was not reviewed by a rating committee and does not constitute a rating action.