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Executive Comment

Taiwan's Regulatory Requirements Run Contrary To Global Practice And Conceal Investment Risk

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Key Takeaways

- Issuer credit ratings and issue credit ratings are different assessments of credit risk and are not interchangeable.
- Current regulations are likely to create confusion and underestimate and distort credit risk.
- Taiwan is the only jurisdiction allowing issuer credit ratings to be used as proxies for issue credit ratings.
- Some jurisdictions, including Hong Kong, explicitly state that issue credit ratings and issuer credit ratings are not interchangeable for investment purposes.
- An unrated debt should be listed as such, reflecting its true status and risk.

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Prior to deregulation, it was mandatory for rated entities seeking to issue non-guaranteed debt in Taiwan to obtain an issue credit rating for the specific debt, bond or obligation in question. Then on August 27, 2013, the regulator removed this requirement for corporate bonds issued to professional institutional and professional individual investors. Issuers and investors were left to decide whether an issue credit rating was necessary if other permitted measurements of credit risk were available--including, remarkably, the issuer credit rating on the issuing entity. On February 13, 2015, the regulator widened this exemption to 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.

Distinguishing An Issuer Credit Rating From An Issue Credit Rating

We view this change as debatable. The problem lies in the fact that issuer credit ratings and issue credit ratings measure different aspects of credit risk and are not interchangeable. An issuer credit rating reflects a rating agency's 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 therefore an issue credit rating that investors need to evaluate in their investment decision making. That is because the issue credit rating informs an investor of where that specific debt stands relative to the entity's other debts in the case of a default, which is particularly important in the case of non-guaranteed or subordinated debts.

Proxy Ratings Distort Risk And The Applicable Capital Charge On Subordinated Debt

In our view, proxy ratings not only lead investors to underestimate the embedded risk of their investments but they also create a loophole allowing investors to assign a lower capital charge on their subordinated debt than what should be applied if the debt was rated. That is because in our experience, issue credit ratings on subordinated debt are usually at least two notches below the long-term issuer credit rating on the obligor.

For example, we generally rate subordinated bank debentures issued after the general Basel III framework (essentially, instruments issued from 2013 onwards) two notches below the issuing 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. However, under certain circumstances we could rate subordinated debt as much as five notches below the obligor issuer credit rating. An investor in subordinated bonds would therefore very likely underestimate the actual investment risk because of the distortion in the applied risk-based capital charge. This is a loophole that we believe needs to be closed. Market forces should be allowed to ensure that the applicable risk and risk weighting apply to all market participants' bond investment positions.

Life insurers are the biggest purchasers of these subordinated bank debentures in Taiwan. Under current regulations, the applicable risk weighting for an unrated subordinated financial debenture is 0.2411--equivalent to the risk weighting for an issue credit rating of 'twCCC'. However, the loophole created by the use of proxy ratings allows insurers to apply a much lower risk weighting--that which corresponds to the obligor issuer credit rating. For example, under the proxy rating scenario, if an obligor rated 'twA-' issues unrated subordinated financial debenture, an insurer buying such debt can apply a risk weighting of just 0.0098--the level applicable if the debt was rated 'twA-'. This is far lower than the risk weight for unrated financial debenture of 0.241 and also lower than the likely capital charge that should apply had the debt been rated. In this case, after notching for the debt's subordinated status and other likely qualities, the true issue credit rating on the subordinated debt could have been two to five notches lower (that is, with risk weight ranging from 0.0263 to 0.0615) based on our existing issue rating portfolio.

Proxy ratings therefore create a serious distortion of embedded risk that allows buyers to make unreasonably low capital charges. Put simply, the greater the notching difference between the proxy credit rating and what would be the actual issue credit rating on the subordinated debt (or between the proxy rating and the 'twCCC' related risk weight for unrated debt), the greater the amount of underestimated or unaccounted embedded risk.

Financial institutions, particularly banks, continue to issue large amounts of subordinated debentures using proxy ratings because they can count such hybrid instruments toward meeting their regulatory capital requirement. The volume of subordinated debt issued in this way continues to grow, as does the level of underestimated risk, in our view. For example, the table on the following page shows that 80.4% of NT$-denominated and over one third of USD-denominated subordinated bank debentures issued in 2016 involves potential underestimated credit risk and the application of unreasonably low capital charges, given that we assigned no issue credit ratings on subordinated debts that year. In the first 11 months of 2017 over 81% of such subordinated debt issued involved potential underestimated credit risk. We assigned issue credit ratings to just NT$3 billion of subordinated bank debentures out of the total NT$1,574 billion issued between January and November 2017. That's because this debt was issued to non-professional individual investors.

Bank Debenture Issuance Volume By Type

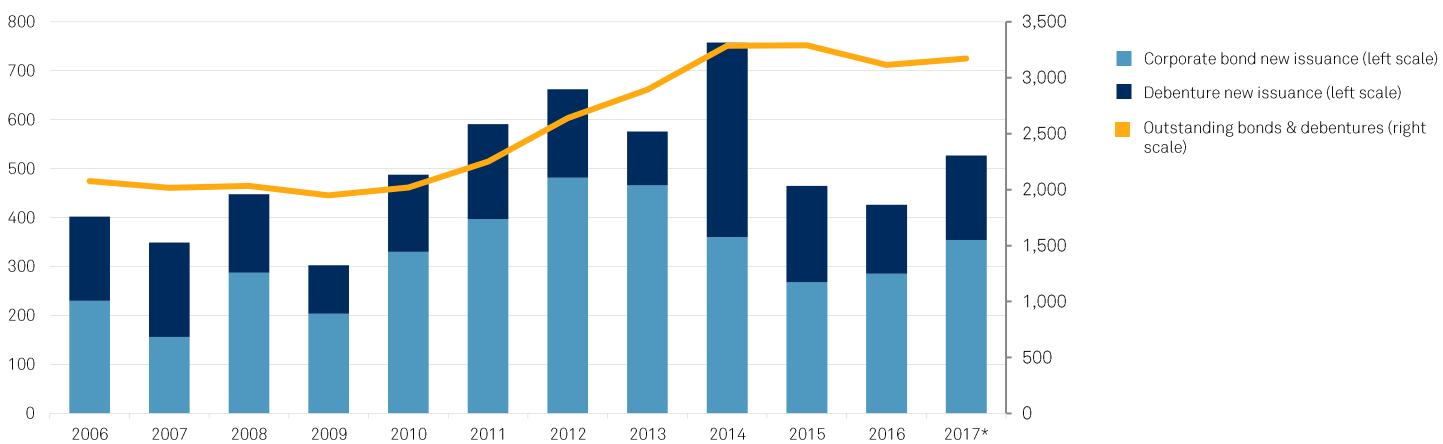
Debt type	2013	2014		2015		2016		2017*	
	NT$ bil.	NT$ bil.	USD bil.	NT$ bil.	USD bil.	NT$ bil.	USD bil.	NT$ bil.	USD bil.
Senior	15	3.3	3.653	62	1.733	31.77	1,280	31.85	3.115
Subordinated	85.5	192.28	1.190	113.16	0.276	130.591	760	157.355	-
Total	**100.5**	**195.58**	4.843	**175.16**	2.009	**162.361**	2,040	**189.205**	3.115
Subordinated debt as a proportion of total debenture issuance	85.1%	98.3%	24.6%	64.6%	13.7%	80.4%	37.3%	83.2%	0.0%

*Data are as of Nov. 30. NT$--New Taiwan dollar. Source: Taipei Exchange.

Deregulation Has Reduced Costs But Increased Confusion Due To The Misuse Of Supporting Measures

The gradual deregulation of Taiwan's financial markets has certainly reduced costs for issuers and altered market behavior because of the misuse of supporting measures. However, it has not led to the increase in issuance volume that the removal of compulsory ratings and subsequent lower issuance cost could have produced. There has been much slower growth in new issuance volume for bonds and debentures over the past few years of deregulation despite Taiwan's gradual economic recovery over the same period. In fact, according to data published by the Central Bank of The Republic of China (Taiwan), despite the increase in total new issuance volume in Taiwan (including corporate bonds and debentures) to NT$758 billion in 2014 from NT$576 billion in 2013, the volume nonetheless decreased in 2015 and further deteriorated in 2016 (see chart). This clearly runs contrary to the initial hope of the regulator of invigorating the domestic bond market by providing incentives for bond financing through lowering issuance cost.

Issuance Volume In Taiwan's Bond Market (Corporate Bonds & Debentures, Bil. NT$)



*Data are as of Nov. 30. NT$--New Taiwan dollar. Note: Excludes the NT$ and foreign-denominated bonds issued in Taiwan by foreign institutions but includes the NT$ and foreign currency-denominated bonds issued in Taiwan by domestic banks and local branches of foreign and mainland Chinese banks. Source: Taiwan's central bank.

Another distortion in the evolution of Taiwan's regulatory regime is the rise in confusion over the application and intent of current regulations. Take for example the rule governing Taiwan's insurance companies, specifically Paragraph 4 of Article 5 of the 'Regulations Governing Foreign Investments by Insurance Companies'. This rule states that when an insurer invests in the subordinated financial bonds issued or guaranteed by a foreign bank, the insurer shall obtain an issue rating on such bonds from a foreign credit rating agency. However, the insurer is not required to seek an issue credit rating in subordinated debts issued by a local bank. This inconsistency is illogical but is also contrary to reason. It also makes it hard for Taiwan's investment market to gain international credibility and investment attention which, in our view, would benefit the nation's long-term economic growth and investment stability.

Taiwan Stands Alone In Its Regulatory Requirements

Markets and investors operate more efficiently and effectively under a consistent regulatory framework; therefore the direction in which Taiwan's regulatory regime is developing, contrary to established and accepted global practices, could stifle the market's attractiveness to inward investment and distort risk. In response, we should remove unbalanced and confusing regulations for investing at home and overseas as well as ending the use of proxy ratings. This would swiftly restore the market's perception of real credit risk, build a mature and safe operating financial market, and create a healthier investment environment as seen in neighboring investment markets. For example, the requirements issued by Hong Kong's fund supervisory body (Mandatory Provident Fund Schemes Authority or "MPFA") explicitly refer to the correct use of credit ratings when funds invest in debt securities. The regulations state very clearly that issuer credit ratings cannot be used for the purposes of fund investments because it is inappropriate to equate the credit rating of the relevant issuer with the credit rating of the security. Fund investments may also only be made in debt securities that satisfy a minimum credit rating set by the MPFA, based on the credit rating of the securities as determined by an approved credit rating agency. For further details regarding the MPFA please **click here**.)

We believe that an unrated debt should be listed as such, reflecting its true status and risk. As things stand today, investors in unrated subordinated debentures are setting aside insufficient capital reserves due to, in many cases, the use of proxy ratings as well as their application of a lower capital charge. There will always be room for improvement, and learning from more advanced mature markets is a good place to start.

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.