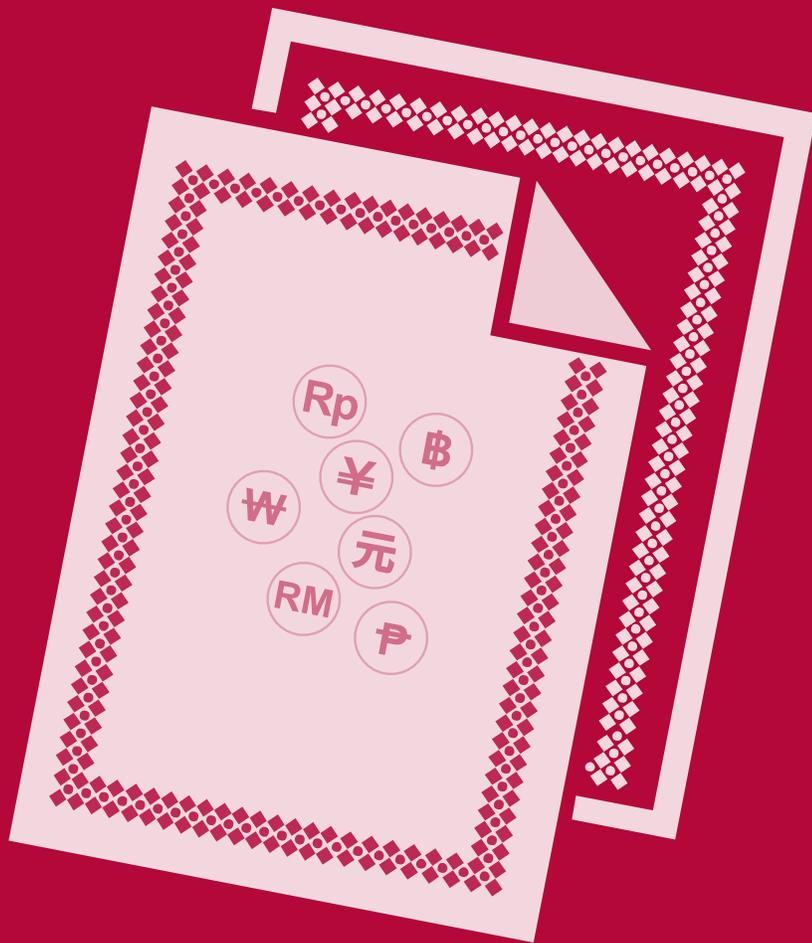


ADB



# Handbook on International Best Practices in Credit Rating

December 2008

Asian Development Bank

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Handbook on  
International  
Best Practices in  
Credit Rating

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# Foreword

The Asian Development Bank (ADB) and ASEAN+3 in recent years have been promoting the development of regional bond markets under the Asian Bond Markets Initiative. Among the measures, ADB has supported the capacity development of domestic credit rating agencies (DCRAs), helping them adopt international best practices and enhance the credibility of their ratings.

As part of this assistance, and with pleasure, the Office of Regional Economic Integration presents this *Handbook on International Best Practices in Credit Rating*.

The guide—based on extensive consultations with a wide spectrum of industry experts—will not only enhance rating practices but also pave the way toward regional harmonization of ratings. This will help investors (domestic and global) better understand credit ratings by DCRAs and enable them to compare the risks of different issuers. This will boost the credibility of DCRA ratings and help investors better participate in Asia’s bond markets, a critical measure in building well-functioning bond markets. We sincerely believe this guide will play a big role in this process.



Jong-Wha Lee  
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Officer-in-Charge, Economics and Research Department

ACRAA	–	Association of Credit Rating Agencies in Asia
ADB	–	Asian Development Bank
ASEAN+3	–	Association of Southeast Asian Nations and the People's Republic of China, Japan, and the Republic of Korea
CRA	–	credit rating agency
DCRA	–	domestic credit rating agency
GCRA	–	global credit rating agency
IOSCO	–	International Organization of Securities Commissions



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# 1. Introduction

The Asian Development Bank (ADB) has worked consistently for stability in Asian financial markets and believes bond market development will play a crucial role in achieving it.

To promote development of the regional bond market, the Association of Southeast Asian Nations and the People's Republic of China, Japan, and the Republic of Korea (ASEAN+3)—under the Asian Bond Market Initiative—and ADB have provided assistance to build capacity at domestic credit rating agencies (DCRAs) and to enhance the comparability of their ratings.

To that end, ADB has provided training to DCRAs on rating best practices and has prepared this *Handbook on International Best Practices in Credit Rating*.

As of now, global investors' participation in the Asian bond market may be limited by the fact that they do not understand DCRA ratings as well as they understand ratings assigned by global credit rating agencies (GCRAs). But GCRA penetration in many Asian financial markets is limited, while the penetration of DCRA ratings is significantly higher. Because these DCRAs operate in diverse geographical segments and are at different stages of evolution, the risk assessment frameworks, key rating policies, and rating processes vary widely. To lend credibility to their ratings, encourage global investors to use them more, and improve participation in Asian bond markets, it is important that they adhere to certain levels of international practice.

This handbook identifies international best practices and recommends measures for adopting them. Adherence to the recommendations will enhance the comparability of DCRA ratings and help global investors understand them as well as they understand ratings assigned by agencies such as Moody's Investors Service, Standard & Poor's, or Fitch Ratings.

Changing established practices may be difficult to implement, and DCRAs may not readily accept suggestions such as modifying existing rating scales or changing existing analytical frameworks and criteria.

Globally, too, regulators do not attempt to influence the credit rating assessment framework and nuances associated with it. Therefore, this handbook will focus largely on best practice guidelines at the macro rating policy level; recommendations on specific analytical best practices will be avoided, with a view to ensuring wider acceptance and providing rating agencies adequate latitude for innovation and the pursuit of analytical excellence.

This handbook recommends international best practices and divides them into two categories: (i) essential best practices, and (ii) desirable best practices. Essential best practices represent the minimum standards expected by global investors based on the practices of successful international and DCRAs. Desirable best practices would further

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enhance the credibility of DCRAAs that are willing to play a larger role in the financial market. Along with the guidelines, a step-by-step implementation strategy and time frame have also been provided.

Apart from their regular tasks, DCRAAs are expected to play larger roles in the financial market, and this expectation has been captured in desirable best practices. The desirable best practices for DCRAAs focus on more sophisticated issues such as undertaking default studies, using rating enhancers, and seeking market feedback before significant changes. DCRAAs striving to achieve the highest standards in credit rating are strongly urged to implement these recommendations.

For credit rating agencies, there are different codes of conduct prescribed by various regulators (for respective DCRAAs) and international agencies. However, this handbook is more comprehensive and covers topics beyond codes of conduct and focuses on various operational aspects of DCRAAs, including:

- the role of business development personnel;
- setting up an internal audit mechanism;
- the need for a rating enhancer; and
- the necessity of mapping rating scales of DCRAAs and GCRAAs.

The handbook is based on a study of 23 DCRAAs in 13 Asian countries. It recommends a comprehensive 1-year implementation plan for DCRAAs and a time frame to complete it. The guide is based on an extensive consultative process, reflecting views from a broad section of experts, and will be periodically updated.

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## 2. Summary of the Main Recommendations

### 2.1 Essential Best Practices

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**Pre-rating requirements.** A DCRA and the entity it proposes to rate should sign a written contract requisitioning the DCRA's credit rating services. The DCRA should not promise, assure, or guarantee—either implicitly or explicitly—a particular rating outcome. The DCRA's organizational structure and rating process should ensure that rating decisions are not influenced by the rating fees received by the DCRA.

**Rating definitions and recognition of default.** A missed payment on a debt obligation on the due date or after a pre-specified grace period should constitute default. Filing for bankruptcy and involuntary rescheduling of debt payments should also be construed as default.

**Policies and processes for ratings.** A DCRA should have well-defined and updated credit rating criteria, which are publicly available and consistently applied. Formal rating committees should have the sole authority to assign ratings. All rating actions should be announced promptly, and a list of all outstanding ratings should be freely available on the DCRA's Web site. Every rating should be kept under surveillance until it is withdrawn.

**Confidentiality requirements.** All information submitted by a rated entity or an issuer in connection with a credit rating assignment is presumed confidential and should be kept so at all times. Members of the Board of Directors should not have access to such confidential information submitted by the rated entity, unless as a part of the rating committee.

**Independence and avoidance of conflicts of interest.** A DCRA should not refrain from taking a rating action because of the potential effect of the action on the DCRA, issuer, investor, or other market participant. Rules regarding avoidance of conflicts of interest, maintaining neutrality of analysts, and preventing employees from making gains by misuse of confidential information are also included.

**Private ratings.** Issuers may seek private credit assessments of their businesses, and a DCRA should, in such cases, maintain complete confidentiality of its ratings.

**Unsolicited ratings.** A DCRA should publicly state its stance on assigning unsolicited ratings. Where it chooses to assign unsolicited ratings, a DCRA should distinguish unsolicited ratings from mandated ratings using a notation in the rating symbol.

**Unaccepted ratings.** A DCRA should have a published policy regarding disclosures on unaccepted ratings, where the rated entity has not accepted the initial rating assigned to its debt issuance.

**Process audit.** A DCRA should set up audit checkpoints to ensure that the adopted best practices, policies, and procedures in acquiring, executing, communicating, and surveillance of ratings are implemented.

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## 2.2 Desirable Best Practices

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**Computation of default statistics.** Every rating agency should publish, at least annually, a default and transition study, along with the methodology used for calculating default rates.

**Dedicated advanced functional groups.** It is recommended that a DCRA have dedicated functional groups for industry focus, quality assurance, and library and data management.

**Use of rating enhancers and early warning indicators.** It is recommended that a DCRA provide some indication, such as a rating outlook, of the possible movement of the assigned rating.

**Market feedback before major changes.** A DCRA should seek feedback from market participants whenever it contemplates major changes in its rating criteria or key rating policies, and apprise market participants of these changes.

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## 2.3 Three-Phase Implementation

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The following is a three-phase implementation schedule for these best practices.

- Phase 1 includes recommendations that do not require significant policy changes and focuses mostly on increasing awareness among stakeholders. The recommendations can be implemented within 3 months.
- Phase 2 is to be implemented within 6 months. It includes policy-level and organizational changes and compliance with general codes of conduct.
- Phase 3 includes key policy and process changes, such as modification of the appeal and surveillance process for private, unsolicited, and unaccepted ratings. These can be implemented within 1 year.

In all, essential best practices can be implemented within 1 year. It is recommended that the timeline for implementation of desirable best practices be decided by individual DCRA's based on the practicality of implementation, local market conditions, regulatory support for credit ratings, and each DCRA's desired role in the development of the financial markets.

Regulators in the region and DCRA management need to be convinced of the benefits of adoption of the recommendations, and thereafter obtain buy-in from the hierarchies of their respective organizations. Given that policy matters are sovereign to each DCRA and many may not accept intrusions on their autonomy, the adoption of the recommendations will probably be gradual, supported by appropriate training by ADB and the Association of Credit Rating Agencies in Asia (ACRAA) as well as incentives by regulators to encourage adoption.

## 3. Essential Best Practices

### 3.1 Pre-Rating Requirements

- 3.1.1 A DCRA and the entity it proposes to rate must sign a written contract,<sup>1</sup> covering the DCRA's obligation to render credit rating services.

This contract will list all DCRA obligations included in the provision of credit opinion, the main service. A written contract enables the rated entity to better understand a DCRA's deliverables, and is in line with high standards of ethical conduct. A well-drafted contract will avoid any disparity between a DCRA and the rated entity regarding the responsibilities and obligations of each party, and will forge a formal legal relationship between the two. In the contract, the obligations of the rated entity for cooperation and provision of updated information to conduct periodic surveillance should be clearly spelled out and the rights of the rated entity over the use of ratings clearly communicated. Conditions for contract termination, including withdrawal of assigned ratings, should also be clearly spelled out.

This contract is also the underlying legal document for arbitration between a DCRA and the entity, should the need arise. This helps foster a professional relationship between the DCRA and the rated entity. It is recommended that each DCRA have a standardized version of such a document for each type of rating, and use it consistently.

Box 1 presents a plan for implementing this practice.

#### Box 1

- **Steps for implementation.** *If a DCRA does not have its rating assignments covered by a legally enforceable agreement, then it has to seek legal counsel and frame a standardized agreement for all future rating assignments.*
- **Action plan.** *A DCRA should prepare a standardized agreement that will take into account the complete set of rights and obligations of both the DCRA and the rated entity. The DCRA should obtain the required approvals and clearance for adopting such an agreement from its decision-making authority (for example, the board of directors).*
- **Expected timeline for implementation.** *The preparation of a standard draft agreement along with an associated legal opinion should take 2 months; approving authorities may require another month to approve the draft. A time frame of 3 months is recommended for implementation of this best practice.*

<sup>1</sup> A written contract is recommended except when the DCRA assigns unsolicited ratings. Recommendations for unsolicited ratings are addressed elsewhere in the handbook.

### 3.1.2 A DCRA cannot promise, assure, or guarantee a particular rating outcome<sup>2</sup>—either implicitly or explicitly—while soliciting business.

Because a rating is based on an analytical decision by a rating committee and not the subjective view of an individual, no rating outcome should be promised or committed either implicitly or explicitly to the rated entity and/or the arranger while soliciting business. Promising a particular rating outcome falls outside the ethical standards expected from a DCRA; an assured rating outcome undermines the credibility of the entire credit rating process and erodes the authority of the rating committee. No employee with business development responsibility or any other representative of the DCRA should be allowed to promise, assure, or guarantee—either implicitly or explicitly—a particular rating outcome. Any employee who does should face disciplinary proceedings, including possible dismissal.

DCRAs are expected to provide objective and fair credit opinions for use by debt market investors. The assignment of a rating should therefore derive purely from independent and unbiased views based on the determinants of credit quality and not on any assurance or guarantee given beforehand.

Box 2 presents a plan for adopting this practice.

#### Box 2

- **Steps for implementation.** *If a DCRA has no formal policy of “non-assurance of rating outcome,” then necessary safeguards in the form of intensive briefings to personnel with business development responsibilities should be undertaken.*
- **Action plan.** *A DCRA should, in its orientation training to personnel with business development responsibility, make specific mention of this requirement and incorporate it in its operating manual.*
- **Expected timeline for implementation.** *3 months*

### 3.1.3 Rating definitions, policy for use, and rating criteria are to be explained to the rated entity before rating services are engaged.

In emerging financial markets, the entity that is being rated may not be well-versed in the nuances of the rating process. A DCRA should explain to them the scope and use of the ratings, as well as the broad credit assessment framework followed. This should be done before or at the time the DCRA is engaged to enable the entity to make an informed decision about that engagement. This may be communicated using

<sup>2</sup> The rating outcome refers to particular letter-grade rating in the case of bond ratings, and letter-grade rating alongside specified credit enhancement levels in the case of structured finance ratings.

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standard presentations, brochures, and other materials, and disclosed on the DCRA's Web site to minimize misinterpretation.

A DCRA should clearly communicate the rating definition and the rating scale. The DCRA should also make clear that the ratings do not constitute recommendations to buy, hold, or sell any security, and should inform the entity how to use the rating. Policies for use of ratings, conditions for withdrawal, and possible circumstances for rating actions should also be clearly communicated.

Box 3 presents a plan for adopting this practice.

#### Box 3

- **Steps for implementation.** *Personnel with business development responsibilities should, as a process, present necessary explanations to the entity that is being rated along with standard presentations covering these topics before the rating agreement is signed. If this is not already being done, it should be instituted as a process, backed by training if necessary.*
- **Expected timeline for implementation:** *Immediate*

#### 3.1.4 The basic policies, practices, and methodologies used for assignment of ratings shall be published and freely available in print and on the Web site.

The policies adopted by a DCRA for rating assignment, and strict adherence to them, are an indicator of DCRA transparency and independence. It is highly desirable that each DCRA make a well-defined rating policy and rating methodology freely available to entities being rated, investors, market intermediaries, regulators, and other interested parties. Such disclosure helps to develop—among investors and issuers—an understanding of the credit risk assessment framework and related policies and practices.

A DCRA's policy for assigning, revising, and withdrawing ratings should be clearly outlined and made public. The validity of the rating should be stated up front. Ideally, a DCRA should institute a policy of not withdrawing any rating until the instrument that is rated has been redeemed in full; this allows the agency to fulfill its role of communicating the credit quality of the rated instrument at all times to investors.

While not withdrawing ratings until redemption of a rated instrument is a recommended best practice, the next best alternative is for a DCRA to choose to withdraw ratings even if the rated instruments are not fully redeemed, subject to local market conditions and permission from regulators. But while doing so, it should notify the market about the withdrawal, the reason for it, and the rating outstanding on the instrument as of the date prior to withdrawal. It can also choose to keep

the rating on “notice of withdrawal” for some pre-specified period, and withdraw the rating once this period has expired. Such a practice will help a DCRA avoid a situation in which issuers seek to withdraw the rating when faced with a threat of downgrade. DCRAs are strongly urged to publish their withdrawal policies and ensure strict compliance with disclosed policies.

Box 4 presents a plan for adopting this practice.

#### Box 4

- **Steps for implementation.** If a DCRA does not have the policies, practices, and key methodologies publicly available, then these documents should first be consolidated in-house.
- **Action plan.** A DCRA should have finalized write-ups published in hard and soft copy, disseminating them over the Web and through CD-ROMs and printed handouts.
- **Expected timeline for implementation.** 12 months

### 3.1.5 Availability of adequate resources is essential.

A DCRA must devote sufficient resources to ensure the high analytical quality of all its credit risk assessments. These resources include personnel with adequate skills, and facilities such as access to required information and tools and software to analyze information. Moreover, a DCRA is required to invest regularly in personnel training. Paucity of resources may impact the quality of ratings assigned, damaging DCRA credibility. Further, a DCRA needs to allocate financial resources for business development functions, outreach activities, and surveillance processes.

Also, during its formative years, DCRA revenues tend to depend on just a few companies. Losing business from one client can significantly impact a DCRA's financial position. Such dependency has the potential to influence a DCRA's analytical independence, impacting its ability to assign unbiased ratings. However, DCRAs with adequate capital can withstand such pressures.

It is therefore necessary that a DCRA in the Asian region have a minimum net worth of \$3–5 million to conduct its operations. This is based on an analysis of the start-up capitalization of successful DCRAs in the region and elsewhere vis-à-vis the start-up capitalization of DCRAs that have not been able to significantly expand their scale of operations and influence despite several years of existence.

### 3.1.6 The organizational structure and design of the rating process should ensure that rating decisions are not influenced by rating fees, any other revenues or business potential from the rated entity, or the consequences of a rating action.

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**The Amount of Rating Fees Received by a DCRA.** The rating process must ensure that the final rating assigned is not influenced by the amount of rating fees received from the rated entity. The existence of such a process will instill confidence in users of a DCRA's credit rating to enhance the DCRA's credibility. Rating fees can be linked to the amount of debt rated or some other measure, but never to the rating assigned or to the success of the debt issue. Further, a DCRA should publicly disclose its broad fee structure, including the minimum and maximum rating fees charged for any issue or issuer, a best practice among GCRA's and also incorporated in regulations in some countries.

Separation of personnel with business development responsibility and analytical responsibility will ensure that business pressures do not influence ratings assigned. Compensation of a DCRA's rating analysts should be independent of rating fees and the final rating assigned. This will result in greater acceptance of the ratings by investors, enhancing credibility. In an ideal scenario, analytical staff and rating committee members should not know the rating fee charged for the specific issues that they rate.

**The Consequences of a Rating Action on DCRA Business Prospects.**

The business relationship of an entity with a DCRA should in no way influence the process of assigning a rating to that entity or any of its group entities. Business relationships should be kept completely isolated from the analytical process. This must be adopted by all DCRA's because it is possible that a few major clients do contribute to major DCRA revenues, especially during its formative years. Consideration of business prospects in the analytical process may secure immediate business, but such a short-sighted policy will have a major impact on DCRA credibility and affect its long-term prospects. All DCRA's should therefore remove employees with business development responsibility from the analytical process to prevent influence of the business development viewpoint on the credit risk assessment. This practice has been identified as an essential code of conduct in several national and international regulations.

Box 5 presents a plan for adopting the practice.

**Box 5**

- **Steps for implementation.** *A DCRA will conduct an internal due diligence exercise for assessing the influence of business relationships on the ratings assigned. Based on the findings of the exercise, measures to minimize the effect should be planned and adopted.*
- **Action plan.** *Specific aspects of influence should be tackled based on the level of severity. Certain sub-points may warrant adoption of duly formalized policy documents, for example, separation of any advisory activity from the rating business. Others may necessitate more discretion, for example, masking the actual amount of fees received from a rated entity such that operating personnel do not feel overt pressure to assign higher ratings to higher paying issuers.*
- **Expected timeline for implementation.** *4 months*

## 3.2 Rating Definitions and Recognition of Default

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### 3.2.1 A DCRA should disclose whether its ratings indicate the probability of default on the rated instrument, issuer, or expected loss (which factors in recoveries post-default).

Ratings can indicate either probability of default or expected loss. The underlying principles guiding each of these approaches are not similar, and probability of default ratings may not be directly comparable with expected loss ratings, especially at lower rating levels. Each DCRA should state publicly the approach it has adopted. Investors and market participants will therefore compare only those ratings based on similar approaches or make appropriate adjustments before comparison.

It is recommended that a DCRA adopt the probability of default approach for ease of operation and due to the lack of data and experience in assessing recoveries after default in most economies in the region. Regardless of the approach, the rating communication and all communications in relation to rating symbols should clearly state what the particular rating indicates. This will help users understand the significance of the ratings and to compare ratings across DCRA's after appropriate adjustments.

### 3.2.2 A missed payment on a debt obligation on a due date or after a pre-specified grace period (if any) should constitute default.

Given the increasingly important role of ratings, especially in light of the Basel II guidelines, a consistent and uniform default definition is critical because it has a significant impact on the reliability and comparability of ratings across DCRA's. A rigorous and transparent definition of default makes a DCRA's ratings more meaningful and accurate. Clear articulation of this definition is therefore critical to DCRA transparency. When strictly applied, the definition will underpin the validity of all DCRA ratings.

In most bond markets, investors have favored instantaneous recognition of default, in contrast to the relative forbearance of the bank loan market, in which 90 days overdue is typically construed as default. Because most DCRA's cater primarily to bond market investors, it is recommended that a missed payment on a debt obligation as on a due date or after a pre-specified grace period (if any) should constitute default. The filing of bankruptcy before any missed payment on debt obligations, and involuntary rescheduling of debt obligations that is harmful to investor interest (such as lower coupon, extension of maturity, and interest waiver), should also be considered default.

A DCRA should adhere to its disclosed definition of default without exception, ensuring easier recognition of default. Such a definition should not include any subjective grace period, and the resulting default statistics should therefore not be influenced by any subjective factors and may be used by investors as an important input for credit pricing and provisioning requirements.

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In case a DCRA adopts a default definition that is divergent from the recommendation above, such a divergence should be disclosed and highlighted in all DCRA communications relating to default. The DCRA should also provide the rationale for adopting a particular default definition; ensuring that investors are clear about the ideology behind the rating.

Irrespective of whether a DCRA adopts an expected loss or probability of default approach for the assessment of credit quality, it should adhere strictly to its objective default definition and ensure that default statistics are computed and published based on this definition.

Box 6 presents a plan for adopting this practice.

#### Box 6

- **Action plan.** A DCRA's governing body, in close conjunction with senior analysts and personnel with business development responsibility, should first assess the impact of a shift in the default definition, if the present definition is divergent from the recommended one. Similarly, a survey may be commissioned to obtain market feedback on this issue. Based on the result of the impact study and the market survey, the new definition can be adopted in its entirety or in phases. The announcement of the change should also be finalized and provide detailed information about its reasoning, benefits, and impact.
- **Expected timeline for implementation.** 6 months

### 3.3 Policies and Processes for Ratings

#### 3.3.1 It is highly desirable that robust rating policies and methodologies form a part of the operations manual and are consistently applied across ratings.

The credit rating process details the various steps and activities involved in assigning a credit rating, starting from the signing of the rating agreement, to the assignment of the rating and subsequent actions such as rating dissemination and surveillance. Policies and methodologies govern each step of this process, and strict adherence to the process will help maintain the credibility and integrity of the ratings. Further, it is highly desirable that every DCRA has an operations manual that provides step-by-step guidelines for rating analysts to conduct rating assignments and that formalizes the rating process. Each step in the process should also adhere to a strict timeline. While a lack of cooperation from the issuer can delay assignment execution, barring such exceptions, all DCRAs should adopt well-defined timelines for completion of each rating assignment.

The adherence to timelines is critical not only for new ratings, but also for subsequent rating actions. Credit ratings encompass market-sensitive information, and timely actions are essential. Delayed action adds no value for the investor, erodes the rating's value, may undermine DCRA credibility, and indirectly hurts debt market prospects.

However, a DCRA should not compromise analytical quality to arrive at quick rating decisions. It is desirable that a DCRA publicize the approximate timeline of the rating process to set market expectations.

Transparent dissemination of information about rating policies and methodologies is necessary. Awareness about the rating process, policies, and methodologies is not high in most markets in the region, and such disclosures will greatly help users.

Transparent disclosure will enhance DCRA credibility and integrity. Public scrutiny of DCRA for ethical conduct assures that they remain competent, objective, and fair.

Box 7 presents a plan for adopting this practice.

#### Box 7

- **Steps for implementation.** *A DCRA should conduct internal due diligence to assess the degree of divergence (if any) among the rating practices for individual rating products. Based on the findings of the exercise, measures for harmonization of the process, to the greatest extent possible, should be adopted.*
- **Action plan.** *Specific changes necessary for consistency in the implementation of policies and practices should be made in the operations manual, and all analysts should be informed and required to follow the guidelines. The robustness and comprehensiveness of the policies, practices, and methodologies should be tested by in-house process experts.*
- **Expected timeline for implementation.** *6 months*

### 3.3.2 A DCRA should have well-defined and updated credit rating criteria, which are uniformly applicable across companies.

Well-defined credit rating criteria enable analysts to analyze and interpret information appropriately. Every DCRA should refine its criteria and benchmarks proactively, taking into account changes in the market environment. Robust criteria assist in accurate assessment of credit risk for an entity. Ratings are subjective credit opinions based on various qualitative and quantitative factors; the robustness of ratings can be preserved only through consistent application of updated rating criteria.

Besides developing criteria for in-house use, it is highly desirable that DCRA publicize a broad criteria framework. Criteria transparency enhances the acceptance of ratings among users. Consistent application of criteria is also essential for comparing ratings and will result in meaningful default and transition statistics.

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### 3.3.3 A DCRA should have a well-planned training program for all its employees.

The skills of a DCRA's employees play an important role in the analytical quality of its assessments: continuous upgrading of skills is therefore a must. It is recommended that, each year, a DCRA target a minimum number of training days for all employees and centrally monitor them to ensure programs are fully implemented. DCRA's should ensure training programs are given high priority at all times. To ensure adequate funding, a DCRA should allocate a separate budget for training programs, monitoring it strictly for any underuse.

### 3.3.4 For interactive ratings, it is desirable that the rating process include a detailed meeting with the management of the issuer to gain a better perspective of the rated entity.

Open dialogue between a DCRA and an issuer is in the best interest of investors, offering deeper insight into the issuer's governance, policies, and corporate strategy. It helps the analyst to understand factors such as financial and business plans and management policies, which can have a critical bearing on the rating. It is also an important forum for analysts to arrive at a qualitative assessment of management competence; this again can influence the credit rating of the entity.

Although the issues discussed in a management meeting can vary, it would be good practice to list key issues for such management meetings to gain maximum advantage.

Insights that can emerge from management meetings for rating assignments in manufacturing and services sector include:

- the status and prospects of the issuer's industry;
- the issuer's financial policies and objectives, the reasoning behind them, and its plans for achieving them;
- a broad overview of the issuer's major business segments, and comparisons with competitors; and
- an issuer's capital expenditure plans and alternative financing options, both in its own right and as a means of assessing the management's risk appetite.

Although a DCRA should not be influenced by the financial projections of the issuer or the issuer's view of its prospects, these projections are a valuable tool in the rating process because they serve as a fair indicator of:

- management plans;
- management's assessment of possible challenges; and
- its planned solutions to deal with such problems.

These discussions are important in making the assessment forward-looking, rather than a reflection of past financial performance. Because the credit rating is used by investors for estimating future credit losses, an assessment based purely on past performance may not add value and can seriously undermine a DCRA's credibility.

Box 8 presents a plan for adopting this practice.

#### Box 8

- **Steps for implementation.** *If a DCRA does not interact with the issuer's management, it should start doing so.*
- **Action plan.** *This requirement should be built into the rating assignment process.*
- **Expected timeline for implementation.** *Immediate*

### 3.3.5 Policy relating to active dependence on third parties.

While executing rating assignments, analysts often rely on third-party certifications, such as the auditor's report on annual accounts, along with reports and representations from bankers, solicitors, valuers, actuaries, and other professionals. Each DCRA should adopt a uniform and consistent policy on the degree of reliance it will place on such third-party information and certification. It is also preferable that this aspect is disclosed in the rating rationale, to highlight the role clarity plays between a DCRA and such third parties.

### 3.3.6 Rating analysts should be competent to perform their tasks.

Analysts play very important roles in determining the credit rating, and their competence can impact ratings quality. It is important that analysts have the skills to perform their tasks and are well-versed in risk assessment methods. Additionally, a DCRA should not employ any analyst with a tainted reputation as it can impact credibility. It is preferable that a DCRA disclose the name of the analyst in its rating rationale, along with a declaration of any interests (such as shareholding) that the analyst may have in the rated entity.

### 3.3.7 Formal rating committees should decide ratings.

The existence of the rating committee as the final decision-making body is one of the most important safeguards for the independence of rating decisions. It is therefore imperative that all rating decisions be made by a duly constituted committee(s). The rating committee must comprise members who have the professional competence to assess credits and have no interest in the entities being rated. The members should have extensive experience in relevant areas in the domestic financial markets; global exposure will also help. The rating committee may also include outside experts provided they fully adhere to a DCRA's code of ethical

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conduct and sign a confidentiality agreement. All DCRA's should have formal rating committees determine accurate and consistent ratings. The name and personal credentials of the permanent rating committee members should be published on the DCRA's Web site.

The practice of a rating committee taking a final decision on assignment of ratings ensures objectivity, since the decision results from the collective thinking of a group of experts analyzing the risks pertaining to the particular entity. Analysts should prepare a written credit analysis report for the deliberation of the rating committee. A credit rating should be valid for a period decided by the rating committee. It is recommended that proceedings of the rating committee be minute and maintained for future reference.

Although voting rights in rating committee decisions should be limited only to members of the committee and the analytical team, discussions during the committee should be open to all DCRA analytical personnel to ensure knowledge and committee insights are widely disseminated within the organization and rating decisions are transparent. To keep the rating independent of any issuer influence, members with business development responsibilities should not have voting rights in the rating committee.

To avoid any bias from rating committee members, the rating decision should be based on voting by a minimum of three members. This practice enhances rating committee integrity and credibility.

**3.3.8 A credit rating announcement shall be accompanied by a report giving the principal reasons for the rating.**

A credit rating is an informed opinion resulting from in-depth analysis of various credit rating factors. The opinion takes account of information obtained from the issuer and secondary sources and a DCRA's in-house experts, which is assessed within clearly spelled out rating criteria. Each rating therefore has to be accompanied by a rating report that details the above.

A credit rating report should highlight the basis of a DCRA's rating decision. With every rating action accompanied by such a report, it should also reflect the quality and consistency of analysis. The report should highlight the key factors affecting the rating and provide forward-looking opinions on these factors. Because such a report is the only public document available to the investor, it is critical that the document represent the highest standards of quality in content, accuracy, and timeliness.

It is also recommended that each DCRA create and maintain a Web site for investors, issuers, and other stakeholders, and make credit rating reports available there, either free of charge or at a nominal fee. A credit rating and the rating report should be current and updated to reflect credit quality at any given point of time.

### 3.3.9 The rating committee's decisions should be subject to a clearly described review or appeal process.

In the event that the issuer disagrees with the initial rating, and has additional information that it believes can make a material difference to its rating, it is highly desirable that the issuer have recourse to an appeal process. A DCRA should clearly articulate the process in public and include it in the written rating agreement between the rated entity and the DCRA.

Upon receiving valid information, the rating committee will discuss the merits of the case and may or may not decide to modify the rating. A clearly-articulated and well-defined appeal process is recommended for each DCRA because appeals may bring about new or fresh perspectives with bearing on the rating. This will ensure that rating committee decisions are robust, accurate, and fair. While an appeal process is critical for the initial rating, a DCRA should ensure that such an appeal process is not misused by the issuer to delay a rating action in the case of rating reviews, especially rating downgrades.

In an ideal scenario, the committee that decides the appeal should have at least one member who did not participate in the original rating to bring in a fresh perspective.

Box 9 presents a plan for adopting this practice.

#### Box 9

- **Steps for implementation.** A DCRA's policies and procedures should be amended, if necessary, to enable an appeal process.
- **Action plan.** A review and appeal process that can re-refer the rating to the rating committee, along with new and previously untabled information, should be introduced in the operations manual.
- **Expected timeline for implementation.** 4 months

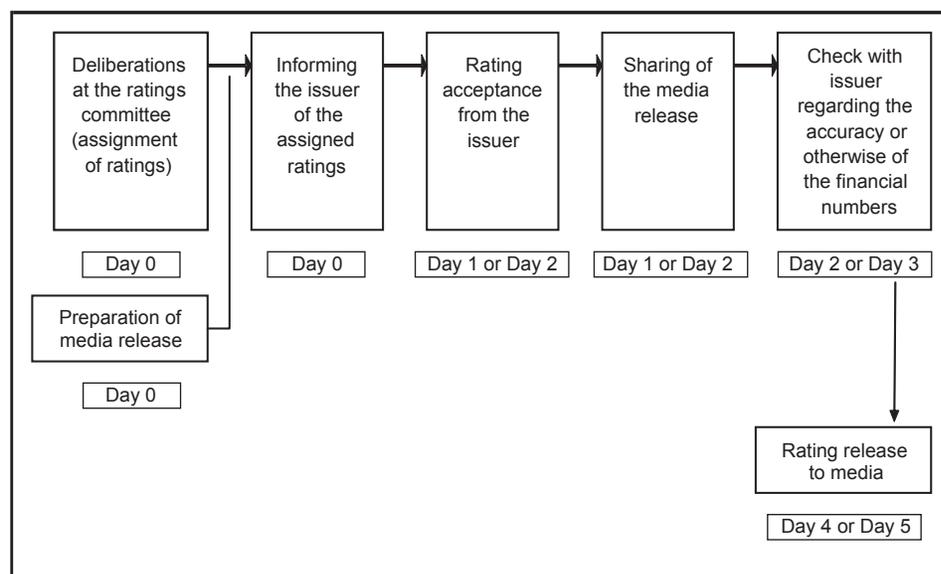
### 3.3.10 All rating actions should be announced promptly, and a list of outstanding ratings made freely available on a DCRA's Web site.

Ratings are time-critical. After the issuer accepts the rating, its dissemination should not be delayed. Acceptance from the issuer may be needed when the rating is assigned the first time; but no further acceptance is needed for subsequent rating actions. A DCRA should formulate a time-to-release procedure to be followed after the initial rating acceptance. Similarly, a time-to-release procedure has to be put in place for revisions of ratings that are already public.

Strict timelines are highly desirable in this time-to-release procedure for communicating the rating to the issuer, receiving acceptance, and preparing the media release and release of the rating. This assumes particular significance when bond markets become more liquid and rating information may affect trading prices. It is recommended that a

5-day time frame be adopted for the entire cycle. It is also recommended that a DCRA have a well-defined internal policy for public dissemination of rating information.

A brief media release countdown is exhibited in the following box.



When ratings are changed, delay by the issuer in responding should not hinder a DCRA from publicizing the revised rating.

Box 10 presents a plan for adopting this practice.

#### Box 10

- **Steps for implementation.** A policy for rating dissemination should be put in place, if not already present.
- **Action plan.** The required approvals and clearances from the governing body should be sought, such that the policy is finalized and published.
- **Expected timeline for implementation.** 3 to 6 months. The rating communication policy will be applicable to all outstanding rated instruments, and the press releases could be made in batches for existing ratings.

### 3.3.11 Every rating should be kept under surveillance until it is withdrawn.

A credit rating on an instrument must reflect credit quality throughout the period when the rating is outstanding. It is a DCRA's responsibility to ensure this objective is met. To this end, after the initial rating has been assigned, the issuer's performance and economic environment must be constantly monitored.

Steps in the rating surveillance process include:

- communicating with the entity at regular intervals to understand developments and trends in performance to help analysts compare company performance against their own and the company's expectations, as well as against peers;
- checking the status of issues that may affect the entity's credit quality (such as an initial public offering), exploring the probability of such issues arising in the near future, and assessing the management's perspective on such issues;
- discussing financial performance with the entity on the declaration of interim financial results; and
- understanding strategic plans or new initiatives that could have rating implications.

Surveillance also enables analysts to stay abreast of current developments, to discuss potential problem areas, be apprised of any changes in the issuer's plans, and to distinguish between realistic and over-optimistic management expectations.

### 3.3.12 A DCRA should conduct formal reviews involving meetings with issuers.

It is desirable that a DCRA adopt a formal policy of conducting continuous and periodic reviews. It is ideal to keep all rated credits under continuous surveillance until withdrawal of ratings. However, a DCRA can also choose to conduct periodic surveillance. Such a policy should ensure that every rated credit is tracked—at least annually—and the rating on such a credit continues to reflect the inherent credit quality.

For such a review to be effective, it should include meetings with the management. Such review meetings should focus on critical developments over the period since the last meeting and the outlook for the coming year. In between such annual reviews, a DCRA may also assess an entity's interim financial performance.

The broad outline of these reviews could involve:

- tracing the effects of various developments in the business;
- addressing any concerns on governance; and
- analyzing the impact of any change in management policy or stance.

In addition, immediate rating reviews should be undertaken whenever any event or development takes place (such as an acquisition or merger) that may affect the credit quality of the rated entity or instrument. Such immediate reviews may be mostly event-driven and be performed as the need arises.

Possible causes for such a review include:

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- significant changes in top management;
  - significant corporate action such as merger, acquisition, equity offering, or buyback;
  - significant differences between actual and projected performance;
  - new developments in the industry; and
  - changes in applicable criteria.

At times, the issuer may not provide sufficient information for surveillance. If so, it is recommended that wherever possible, surveillance should be done on a best-effort basis and all rating communications should prominently disclose this fact. But if a DCRA feels constrained in its rating view, even on a best-effort basis, it can suspend the rating until such time that the issuer furnishes information. This suspension should be made public.

The requirement of ensuring periodic surveillance until the rating withdrawal and the publication of surveillance reports signals to the market that the rating is current and accurate, and can be relied upon for investment decisions.

Box 11 presents the plan for implementation of this important requirement.

#### Box 11

- **Action plan.** *The requirement of having a surveillance and review process should be introduced in the operations manual, if not already present. For the inclusion of such a condition, the required approvals and clearances from the governing body should also be sought.*
- **Expected timeline for implementation.** *3 to 6 months. Thus, in the year following the implementation of the recommendations, all new ratings as well as the existing ratings will have been reviewed and review reports published.*

### 3.3.13 If a rating is assigned to a related entity,<sup>3</sup> this should be adequately disclosed in all rating communication.

If a rating is assigned to an entity in which any member of a DCRA's board or senior management has a direct or indirect interest or involvement, such a person should be excluded from voting on the rating, even if he or she is part of the rating committee. The relevant details about the involvement should also be adequately disclosed in every rating communication. This is to avoid any possible influences or biases and to signal that the rating has been arrived at through an unbiased process.

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<sup>3</sup> I.e., part or full owner, a common board member, or under common management.

### 3.3.14 Maintenance of records

A DCRA should maintain all records pertaining to a rating exercise for a reasonable period of time, or as warranted by regulations. Such records have to be maintained for all ratings, including unaccepted ones. Maintenance of records of the rating assignments and the related working papers will be visible proof that the DCRA exercised abundant caution and requisite due diligence.

### 3.3.15 Rating disclaimers

Ratings are forward-looking assessments and provide a broad sense of an issuer's expected performance. This makes them more prone to misunderstanding than any other financial indicator. Some market participants can take an assigned rating as an absolute indicator, and others may ignore rating transitions. A DCRA has a very important role to play with such investors, making them aware that ratings are not the last word on a company's track record or its future performance. A DCRA should therefore accompany its ratings with sufficient description of the meaning and limitations of ratings. Such descriptions, by way of disclaimers, should specifically refer to what factors ratings do not address and the proper perspective for looking at ratings.

### 3.3.16 A DCRA should have separate functional groups, each having specific responsibilities in the rating process.

It is desirable that separate functional groups be formed within a DCRA to ensure that the execution and follow-through of the rating assignment is smooth and efficient. It is recommended the following groups be established:

**Business development group.** Responsible for obtaining mandates from prospective entities, this group will handle all business communication and finalize the commercial terms of the rating assignment. A DCRA's business development group should be separated from its analytical group.

**Analytical group.** This group handles all analytical responsibilities for a rating assignment and for assessing credit risk for the relevant entity. Ideally, it should not be involved in any commercial discussions with the entity. This group will be responsible for the rating process from receipt of written consent for a rating until the time the rating is made public. It will also be responsible for surveillance and review of ratings.

**Rating administration.** The existence of a separate functional group for the administration of the rating process will ensure it is followed, and that timelines are strictly respected. This group will look after the progress of a rating assignment from the initiation stage until the dissemination of the final rating to the public. This

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group will also maintain a list of all outstanding ratings and proper documentation to support credit opinions, and will handle external dissemination of ratings and rating reports.

**Criteria group.** This group will be responsible for formulating, maintaining, and refining the criteria framework under which the various types of issuance will be rated. This group will ensure, before implementation, that any new criteria proposed are thoroughly discussed from both an analytical and market impact perspective.

These functional groups, although separate, are collectively responsible for the successful implementation of the rating process. They will help a DCRA build up a substantial base of information on its ratings, present a transparent approach to the financial markets, and help the DCRA if it is subjected to regulatory inspection.

Box 12 presents a plan for adopting this practice.

#### Box 12

- **Action plan.** *The analytical group, business development group, criteria group, and the rating administration are to be separated. This is expected to be done after proper deliberation and approval from the governing authority.*
- **Expected timeline for implementation.** *6 to 12 months. Additional staffing and hiring and training of resources may warrant additional time.*

### 3.4 Confidentiality Requirements

#### 3.4.1 All information submitted by a rated entity or an issuer in connection with a credit rating assignment is presumed confidential and shall be kept so at all times.

The information provided by the company may be highly sensitive and confidential and may be provided by the issuer to a DCRA only for the purpose of arriving at the ratings. Every DCRA must maintain such information in strict confidence and cannot use it for any purpose other than rating. When the assigned rating is made public, the DCRA should ensure that the rating report accompanying the rating and the other information about the entity present in the report should not breach this confidentiality. Contact with bankers, auditors, and others—if made as part of rating process—should be with the ratee’s consent.

Every DCRA must have a confidentiality policy to ensure that the confidential information shared by the issuer is not disclosed outside of the ratings business. The fact that an issuer has sought a rating is in itself confidential information, and is to be made public only when

an accepted initial rating is released. In case the initial rating is not accepted, the assignment should remain confidential and should be disclosed only to regulatory or government organizations (if required). However, in all such cases, the ratee should be informed in advance about the disclosure.

**3.4.2 The confidentiality requirement must be binding on all company officers and employees who have or may have access to such confidential information, and acknowledged in writing.**

Confidentiality of information is of paramount importance to a DCRA, and relevant measures and processes must be in place in the organizational structure to maintain confidentiality of such information at all points in time. All employees who may have access to such confidential information must, without exception, acknowledge compliance with the code of confidentiality in writing. Such an affirmation by way of self-certification should be obtained from the employees on a periodic basis as a legally binding undertaking, and should be enforced even after termination of employment or association with the DCRA.

**3.4.3 Members of the board of directors shall not have access to confidential information submitted by the rated entity unless a director is a member of the rating committee.**

To ensure confidentiality is not breached, a DCRA's policy should hold that even members of the DCRA board of directors will not have privileged access to a ratee's confidential information, unless they are part of the rating committee.

**3.4.4 Confidentiality of information is a contractual obligation and should be formally documented in the agreement to perform credit rating services.**

Confidentiality of information should be part of the contractual obligations of a DCRA and documented in rating agreements.

Box 13 presents a plan for adopting these practices.

**Box 13**

- **Steps for implementation.** *In the absence of a formalized policy for ensuring confidentiality, a draft policy should be formulated with inputs from the legal counsel and senior management.*
- **Action plan.** *The required approvals and clearances from the governing body should be sought such that the debated draft policy is finalized and publicized.*
- **Expected timeline for implementation.** *4 to 6 months. This policy will be applicable to all outstanding rated instruments, rating assignments that are in the pipeline, and all future rating assignments.*

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### 3.5 Independence and Avoidance of Conflicts of Interest

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In Asia and around the globe, all credit rating agencies have adopted the “issuer pays” business model, under which rating fees are paid by the rated entity. This model presents inherent conflicts of interest that cannot be eliminated but must be managed to preserve the integrity of rating operations. To manage such conflicts of interest and communicate proactively to the market, a DCRA must have a clearly articulated policy and a public stance on the conflicts of interest that it may face and the efforts that the management will take to control them. Ideally, this policy should cover the following:

- 3.5.1 A DCRA should not refrain from taking a rating action because of the potential effect of the action on the DCRA, an issuer, an investor, or other market participant.
- 3.5.2 The determination of a credit rating should be influenced only by factors relevant to the credit assessment.
- 3.5.3 A DCRA should adopt a definition of what constitutes a conflict of interest, publish it, and all company officers and employees should avoid such conflicts. Clarity on conflicts of interest will help ensure rating decisions are without bias and personal influence.
- 3.5.4 DCRA disclosures of actual and potential conflicts of interest should be complete, clear, and prominent.
- 3.5.5 Rules for avoiding conflicts of interest should be applied to all employees who participate directly or indirectly in the credit rating process, particularly to analysts and rating committee members. Such rules can also be made applicable to the board of directors. It is recommended that the board of directors, upon election, affirm its adherence to the DCRA’s code of conduct.
- 3.5.6 Any potential conflicts of interest from any member of the rating team must be declared before participating in a credit rating engagement. Where a conflict of interest exists as defined by company policy and rules, the employee concerned shall refrain from participating in the rating assignment and rating committee proceedings.
- 3.5.7 In order to maintain analysts’ neutrality and to prevent employees from making gain through misuse of confidential information, a DCRA should adopt a trading and investment declaration policy. This could categorize possible investment avenues into classes: acceptable, acceptable with prior permission, and unacceptable. The securities that fall into each of these categories should be based on an articulated policy that is well disseminated within the organization.

- 3.5.8 Ratings assigned by a DCRA to an issuer or issue shall not be affected by the existence of, or potential for, a business relationship between the DCRA and the issuer (or its affiliates) or any other party, or the absence of such a relationship.
- 3.5.9 In instances where rated entities (for example, governments) have, or are simultaneously pursuing oversight functions related to a DCRA, the DCRA should deploy different employees (than those involved in oversight issues) to conduct its rating exercise.
- 3.5.10 No DCRA employee should participate in or otherwise influence the determination of a rating of any particular entity or obligation if the employee:
- has had recent employment or another significant business relationship with the rated entity that may cause or be perceived as causing a conflict of interest;
  - has an immediate relation (such as a spouse, partner, parent, child, or sibling) currently working for the rated entity; or
  - has or had, any other relationship with the rated entity or any related entity thereof that may cause or may be perceived as causing a conflict of interest.
- 3.5.11 All DCRA employees should be prohibited from soliciting money, gifts, or favors from anyone with whom the DCRA does business and should be prohibited from accepting gifts in cash or gifts exceeding minimal monetary value (as specified by the DCRA).
- 3.5.12 A DCRA should periodically and publicly disclose its ownership pattern, including the details of promoters and other shareholders along with the extent of their shareholding. A DCRA should also clearly and unequivocally disclose affiliations and technical partnerships it has with any international rating agency.
- 3.5.13 A DCRA analyst who becomes involved in a personal relationship, creating the potential for real or apparent conflict of interest, should be required to disclose that relationship to the appropriate manager or officer of the DCRA, as determined by DCRA compliance policies.
- 3.5.14 DCRA employees should take all reasonable measures to protect all property and records belonging to or in possession of the DCRA from fraud, theft, or misuse.
- 3.5.15 A DCRA or its employees should not selectively disclose non-public information about its rating opinions or possible future rating actions, except to the issuer or its designated agents.

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- 3.5.16 DCRA employees should not share confidential information entrusted to the DCRA with employees of affiliated entities.
  - 3.5.17 A DCRA should ensure that compensation for analytical personnel is not linked to revenues earned from the ratings that are executed by the analysts concerned. This will nurture a neutral analytical atmosphere in which revenues earned on the assignment will not influence ratings.
  - 3.5.18 A DCRA should disclose whether any issuer, originator, arranger, subscriber, or other client and its affiliates make up more than 10% of total DCRA revenue.
  - 3.5.19 Each DCRA should adopt a formal policy of disclosure when it rates securities issued by its promoter. The policy in such cases should ensure that adequate disclosure of the shareholding is made in all rating communication so the market is aware of the potential conflict of interest.
  - 3.5.20 A DCRA should establish policies and procedures for reviewing the past work of analysts that leave the employ of the DCRA and join an issuer.
  - 3.5.21 A DCRA should periodically review analyst remuneration policies to ensure they do not compromise the objectivity of the rating process.
  - 3.5.22 A DCRA should define what is considered ancillary business and reasons for the same.

Box 14 presents a plan for implementation.

#### Box 14

- **Action plan.** *With additional inputs from the compliance department and legal team, the recommendations should be integrated into the existing operations policy.*
- **Expected timeline for implementation.** *The perusal and integration of these additional recommendations are expected to be completed in 1–2 months from the date of formal adoption. The process of gathering affirmations and declarations from DCRA employees is expected to be completed within 3 months of the date of implementation.*

### 3.6 Policies for Private, Unsolicited, and Unaccepted Ratings

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#### 3.6.1 Private ratings

A DCRA may be requested, either by issuers or by third parties, to assign private ratings. In such cases, the DCRA shall not publicly disclose the ratings. To formalize this, and to ensure that the facility is not misused,

it is highly desirable that a DCRA adopt a specific policy of complete confidentiality in such cases. The policy will clearly articulate the non-publication and non-dissemination of the private rating. At the same time, because the rating is private, no specific public debt may be raised using the private rating because the DCRA will not be able to disclose any subsequent change in credit quality through public release.

### 3.6.2 Unsolicited ratings

Unsolicited ratings are those that the rated entity does not consent to or participate in. Wherever a DCRA assigns unsolicited ratings, it should distinguish them—using some sort of notation—from interactive ratings. A clear distinguishing prefix or suffix (such as “pi” to denote public information rating) will help the user make an informed judgment about using the rating.

Although the International Organization of Securities Commissions (IOSCO) Code for Credit Rating Agencies accommodates unsolicited ratings as long as they are identified as such, these ratings are often based on less-than-exhaustive information and are therefore perceived as less thorough, accurate, and fair than interactive ratings.

A DCRA that assigns unsolicited ratings that are not directly revenue generating should have adequate justification for doing so. More specifically, a DCRA should not resort to conservative unsolicited ratings as a way of coercing issuers to obtain higher interactive ratings for which they will need to pay. A minimum of 2 years between initiating coverage through an unsolicited rating and the first interactive rating of the same issuer is ideal.

### 3.6.3 Unaccepted ratings

Initially, in an interactive rating, the issuer will normally be given the choice of accepting or not accepting the rating. In such cases, it is wrong to disclose the rating without obtaining written consent. But once the rating is accepted for the first time, a DCRA should not seek acceptance before publicizing changes in the rating.

It is highly desirable that a DCRA have a published policy regarding the non-disclosure of unaccepted ratings. Where the rating is interactive and the rated entity has not accepted the initially assigned rating, it is recommended the information pertaining to the entity be held in the strictest confidence and not be disclosed in DCRA rating lists. Such unaccepted ratings may only be shared with regulators or a court of law, upon specific request to provide such information.

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## 3.7 General Code of Conduct

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### 3.7.1 A DCRA should adopt its own code of ethical conduct, applicable to all employees and board members.

It is desirable that a DCRA adopt a code of conduct, drafted and modified as per DCRA requirements and scope of operations. This code, with assurance of rigorous compliance, should be published on the DCRA's Web site.

### 3.7.2 A DCRA should formally adopt the IOSCO Code of Conduct and the prescribed code of conduct.

The IOSCO Code of Conduct (see Appendix 2) is a yardstick against which progress in self-regulation by a DCRA can be measured, subject to the constraints of its stage of evolution and the markets in which it operates. The adoption of an internationally recognized code will showcase the DCRA's commitment to the establishment and maintenance of consistently high standards.

To the extent that current legislation, policy, regulatory arrangements, or prevalent market practices may impede adherence to these principles, a DCRA should strive to make appropriate changes. There is often no single correct approach to such changes, and they should reflect local market conditions and historical development. Wherever these principles cannot be adopted verbatim due to specific market conditions or existing practices, a DCRA should highlight the extent of non-adoption along with specific reasons for such deviation.

### 3.7.3 The chief executive officer or president and all other employees of the company will be required to affirm in writing their compliance with the company's code of ethical conduct.

An affirmation must be obtained from all employees, legally binding them to the company's code of ethical conduct. All DCRA employees must ensure strict adherence.

Box 15 presents a plan for adopting this practice.

#### Box 15

- **Steps for implementation.** Each DCRA should draft a code of conduct if it does not already have one.
- **Action plan.** Required approvals and clearances from the governing body as well as legal counsel should be sought such that the draft policy is finalized and published on the DCRA's Web site. Regulatory considerations should also be incorporated.
- **Expected timeline for implementation.** 4 to 6 months. The affirmation of the code of conduct in spirit and substance should be made mandatory for all employees and publicly disclosed.

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## 3.8 Compliance with Policies and Processes

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### 3.8.1 Process audit

Each DCRA should set up rigorous audit checkpoints to ensure adopted best practices, policies, and procedures are carried out. Such checkpoints must be manned by independent professionals with extensive knowledge and experience in credit ratings. It is also recommended that such an audit group be headed by a senior professional who reports directly to the chief rating officer or to an equivalent position.

The need for this process audit arises because even the best of intentions, in the form of rigorous policies and comprehensive guidelines for best practice adherence, will remain on paper only unless implementation is meticulous and continually tracked. The audit group should also provide feedback to operating groups such that any corrective action can be taken on a periodic basis.

### 3.8.2 Compliance officer

It is strongly recommended that a DCRA have an officer to ensure compliance with all code of conduct provisions. The compliance officer should report to the DCRA board or chief executive officer or president. This officer would continuously monitor for violations of the code by any employee and be expected to prepare and submit regular status reports on compliance with DCRA regulations and the code of ethical conduct.

### 3.8.3 Whistle-blower policy

A DCRA must have detailed whistle-blower policies encouraging all employees to report (with complete confidentiality) any unethical practice or grave misconduct to a designated authority. All reported events should be taken seriously and investigated promptly. The investigation report should be submitted within a stipulated time frame (as specified by the DCRA) from the receipt of the complaint. There should be provisions to prevent discrimination, retaliation, or harassment against any whistle-blower or participant in the investigation process. A transparent whistle-blower policy encourages and supports disclosure by employees; active compliance with it will go a long way in preventing wrongdoing in the DCRA.

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## 3.9 Conducting Outreach

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A DCRA should publish articulate reports on matters of industry-wide importance with the broad objective of educating and enhancing the depth of the markets in which it operates. Ratings consistency studies, financial comparative studies such as median analysis, and other data-mining studies can be pursued and possibly made into regular featured publications.

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DCRAs should also undertake outreach initiatives such as discussion forums for investors, conference calls after major rating actions to provide additional clarity to investors, periodic publication of criteria, frequently asked questions, analytical opinion pieces, and research articles. These measures can enhance DCRA credibility among investors, issuers, and regulators.

### **3.10 Relations with the Regulator and Other DCRAs**

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A DCRA should comply with all rules and regulations promulgated by industry regulators. It is also expected to inform regulators about new developments on issues related to its oversight functions.

**It is strongly recommend that a DCRA encourage fair dealing and competition with other DCRAs and jointly promote credit rating discipline in the local capital market. This will greatly help the development of regional bond markets.**

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## 4. Desirable Best Practices

This section describes practices a DCRA can follow to enhance its market credibility. A DCRA can choose to implement these best practices subsequent to or simultaneous with implementation of essential best practices.

### 4.1 Computation of Default Statistics

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**4.1.1 Every rating agency should publish, at least annually, a default and transition study, along with the methodology used for calculating default rates.**

Default studies are central to evaluating the capability of a credit rating agency and whether its ratings can predict default over a period of time. Even the new capital accord (Basel II) recommends publishing default rates on a periodic basis and suggests use of these default rates for mapping risk weights to various rating categories. It therefore becomes important that a DCRA publish such studies periodically to let investors, regulators, and other market participants evaluate its performance. If there is a high correlation between ratings and default rates, the ratings are clearly effective in discerning the creditworthiness of the issue or issuer and are a valuable tool for financial markets. On the other hand, if such correlation cannot be clearly established, then the rating process is not robust enough, and measures to make it more robust are required.

The default study should provide details of at least the following:

- annual default rates for each rating category;
- 3-year average cumulative default rates;
- 1-year transition rates; and
- predictive ability of the assigned ratings (Gini coefficient).

The publication of default and transition rates will help investors quantify the credit risk of their debt exposure. Transition rates are particularly useful for investors holding instruments for time horizons shorter than their maturities. Apart from these advantages, because the structuring, rating, and pricing of credit-enhanced products depend heavily on default and transition rates of the underlying entities, timely and regular publication will help the market structure and price such deals accurately.

**4.1.2 In the methodology employed for calculation of the default rates, the following common features are recommended.**

Default rates should be computed by taking into account long-term ratings outstanding on an issuer basis. It is very important that the media release announcing the default study describes exactly which type of ratings have been considered (and excluded along with rationale for exclusion) while computing the default rates. Default and transition rates for subcategories of ratings such as structured finance securities, public sector issuers, and sovereign issuers (if assigned), or default and transition rates based on the amount of exposure, could also be published as complements (and not as a substitute) to the main study.

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Wherever relevant, default rates could also be computed and published according to industry or region. However, not all DCRA's would have equal or comparable reach in every sector, coupled with the nuances of individual geographies that may render such statistics not entirely comparable. The base dataset of the study should be well-defined, that is, a clear description of the constituents of the dataset should be mentioned along with the study.

The time horizon for the study can be as long as the period of operations of a DCRA. This is especially desirable because, with greater age, the robustness of default rates increases, and the advantage of incorporating one or more economic cycles can also be incorporated. If the DCRA uses a time period less than the period of its operations, then it would be desirable that the study specify the reason for using a shorter time period. This will help dispel any notion that the DCRA has not covered all the defaults. Moreover, if the DCRA has omitted any period of high defaults (with or without assigning specific reasoning for such exclusion), investors will be aware of the same and they can factor it into decisions.

Publishing both the withdrawal-adjusted and -unadjusted numbers is ideal, but it should be discretionary rather than compulsory. If withdrawal-unadjusted rates are higher, then rating withdrawals may represent hidden defaults.

The static pools or cohorts of ratings should be formed on specific dates, and it is desirable that the practice be consistently followed to ensure comparability. Static pools (cohorts) should be formed such that an issuer newly rated in the year is only considered in the pool (cohort) of the next year. In addition to forming annual cohorts, it is desirable to form monthly cohorts and publish defaults for a rolling 12-month period to give more timely information to the market, wherever data sets are meaningful and computation at such frequency is practical. This is in line with international best practice.

The cumulative default rates should be published as an average of all the static pools (cohorts). Additionally, the different types of cumulative default rates, that is, marginal default rates, average cumulative default rates, and weighted average cumulative default rates could also be published; they are complements rather than substitutes.

Specific measures of rating accuracy should be published; that is, accuracy ratio (Gini coefficient) and the Lorenz curve.

In the absence of a default study due to a paucity of historical data, proxy information such as the number of ratings, number of upgrades and downgrades, and others, should be published as an interim measure.

Irrespective of the rating approach, the default statistics should be computed based on recognition of default on the first date of missed payment or filing for bankruptcy, whichever is earlier. This is an unambiguous approach and does not factor in assumptions of recovery and loss.

### 4.1.3 Transition rates should ideally be calculated and published on the basis of a 1-year observed transition.

Such transition matrices calculate the probability that issuers in a specific rating class at the beginning of a time period have remained in their class of origin at the end of the time period. This is known as “stability”, and is the inverse of “transition”, or the likelihood of moving between rating levels because of upgrades or downgrades. A lower probability of transition between rating classes is a proxy for the stability of ratings. Ideally, the level of transition rates should be moderate, and higher rating categories should have lower transition rates.

Box 16 presents an action plan for implementation.

#### Box 16

- **Steps for implementation.** *First, a thorough understanding of static pool methodology with withdrawal adjustments should be developed. Second, the team working on the computation of default statistics should also be made familiar with the recommended method and international best practices through training.*
- **Action plan.** *Default statistics should be calculated under the static pool methodology.*

## 4.2 Dedicated Advanced Functional Groups

While constitution of some key functional groups has been included as an essential best practice, further division is desirable. Some functions have also been discussed, but the responsibilities of these groups can extend far beyond these.

**Industry focus group.** This group will be primarily responsible for tracking the performance of various industries within the economy. It will formulate bird’s-eye views of industries, which could then be used as reference points while evaluating individual credits.

**Quality assurance group.** This group will be responsible for ensuring internal processes are fine-tuned to consistently deliver high quality output. The quality assurance group can also be made responsible for tracking default rates, measuring cross sector consistency in ratings, and conducting post mortem analysis of defaults.

**Library and data management group.** This group will be responsible for providing all background financial and non-financial information to the operations team as well as to the industry focus group. It can also be entrusted with overall data archival and retrieval responsibilities, including confidential information obtained from clients.

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Dedicated advanced functional groups ensure that rating analysts are provided adequate support in the areas of industry status, quality control, and data collation.

Box 17 presents an action plan for implementation.

#### Box 17

- **Steps for implementation.** *An overall organizational blueprint should be drawn up for setting up the advanced functional groups as recommended. The schedule for setting up the groups should be based on the degree of importance of each.*

### 4.3 Conflicts of Interest between Other Businesses

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Globally, credit rating agencies have diversified into related businesses such as research and advisory and consulting services. This phenomenon occurs both as a natural progression of the ratings business, and also as a means to provide growth opportunities for well-trained manpower. The danger of developing such related businesses is a possible conflict of interest in which the DCRA giving the rating is itself—directly or indirectly—providing the entity some financial or management advice.

Where advisory- or a consultancy-based business coexists alongside a ratings business, firewalls should be set up during the course of operations. Ideally, these business lines should be in separate legal entities, with minimum operational links; the operating staff, officers, and analysts of the distinct business lines should be maintained separately.

Box 18 presents a plan for implementation.

#### Box 18

- **Action plan.** *Detailed due diligence should be undertaken in areas where commingling of diverse DCRA business lines poses a conflict of interest. In such cases, operational firewalls should be put in place and should be fully adhered to.*

### 4.4 Use of Rating Enhancers as Early Warning Indicators

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Owing to the in-depth rating experience of some DCRA, it is desirable that they provide indication of the possible direction of movement in the ratings on existing credits on a medium-term horizon of 1–2 years. Such rating enhancers, typically referred to as rating outlooks, would offer investors an early warning indicator of the rated credit. Outlooks do not necessarily mean that existing ratings are bound to change in the indicated direction; they indicate the possible trajectory of the rating.

#### 4.5 Publishing Rating Criteria

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A DCRA should publish all key rating criteria and benchmarks to enhance the transparency of the rating process. While publication of rating methodologies is recommended as an essential best practice, a DCRA should aim to enhance the transparency of their rating criteria.

Rating assessments should be forward-looking on the credit quality of the issue or issuer and should be based on methodologies that combine both quantitative and qualitative approaches, rather than merely derived from a few financial ratios.

Published rating criteria, because any deviation may be subject to market scrutiny, ensure that implementation is uniform and rigorous for all assignments. The scope for deviation is narrowed significantly by rigorous adherence to published criteria. They also act as guiding principles for analysts, rating committee, issuers, and investors.

#### 4.6 Market Feedback before Major Policy Changes

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It is highly desirable that a DCRA seek feedback from market participants (issuers, investors, regulators, and academic institutions) whenever it contemplates major changes in rating criteria or key rating policies. Such feedback should, to the extent feasible, be incorporated in the contemplated change. A DCRA should also publish the results of impact studies before implementing changes in criteria so that market participants appreciate the need for the change. A DCRA must make a conscious effort to ensure operations are transparent and open to public scrutiny.

Box 19 presents an action plan for the above aspects of DCRA operations with expected timelines.

##### *Box 19*

- **Steps for implementation.** *A detailed, time-bound plan should be prepared for organization-wide implementation of each of the recommendations. Based on the relative priority of individual recommendations, and with the aim of complete compliance, resources should be judiciously deployed.*

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## 5. Implementation Schedule for Domestic Credit Rating Agencies

For all DCRAs, a comprehensive implementation schedule has been prepared for essential best practices. The implementation schedule has been divided into three parts. Initiatives that do not require significant policy changes and focus mostly on increasing stakeholder awareness are expected to be executed in the first part, which should be completed within 3 months. Implementation of these initiatives is critical and should be done immediately.

In the second part, which is expected to be completed in 3–6 months, policy level changes have been included. This part also includes organizational changes and compliance with general codes of conduct. Because implementing policy-level changes would entail discussions, approvals, and a certain amount of “un-learning” of old policies, a slightly longer time frame has been recommended.

In the third part, DCRAs are expected to complete key policy and process changes such as revision of organizational structure and rating processes and formation of functional groups. Implementation of these changes will involve even greater discussion and approval because they cover a larger area and implementation is expected to be completed within 1 year (a 6–12 month time frame).

DCRAs are expected to implement all essential best practices in 1 year, while no specific time frame is stipulated for desirable best practices. For these practices, DCRAs are expected to plan their own schedule based on local market conditions, practicality of implementation, and regulators’ expectations.

The following table describes the implementation schedule discussed.

Recommendations		Implementation Timelines			
		Essential Best Practices	Within 3 Months	3–6 Months	6–12 Months
<b>1</b>	<b>Pre-Rating Requirements</b>				
1.1	Written contract between DCRA and ratee		Full compliance		
1.2	Non-assurance of particular rating		Full compliance		
1.3	Explanation of critical policy and process issues to issuer		Immediate compliance		Full compliance
1.4	Publication of policies and processes				Full compliance
1.5	Availability of adequate financial resources				Full compliance
1.6	Revision in organizational structure and rating process				Full compliance
<b>2</b>	<b>Rating Definitions and Recognition of Default</b>				
2.1	Disclosure whether rating indicates probability of default or expected loss		Immediate compliance		
2.2	Preparation of concrete definition of default			Full compliance	
<b>3</b>	<b>Policies and Processes for Ratings</b>				
3.1	Consistency in application of rating policies			Full compliance	
3.2	Use of updated criteria and management meetings for ratings assignments		Immediate compliance		
3.3	Initial rating assignment and appeal process			Full compliance	
3.4	Publication of ratings			Full compliance	
3.5	Surveillance policy			Full compliance	
3.6	Withdrawal policy			Full compliance	
3.7	Formation of functional groups				Full compliance
3.8	Training plan		Full compliance		
3.9	Preparation of operations manual				Full compliance

Recommendations		Implementation Timelines		
		Within 3 Months	3–6 Months	6–12 Months
<b>Essential Best Practices</b>				
3.10	Policies for dependence on third party		Full compliance	Full compliance
3.11	Miscellaneous other activities			
<b>4</b>	<b>Confidentiality Requirements</b>			
4.1	Confidentiality of ratee's information		Full compliance	
4.2	Applicability of confidentiality to all employees		Full compliance	
4.3	No access to those not involved in the rating assignment		Full compliance	
4.4	Contractual arrangement to ensure confidentiality		Full compliance	
<b>5</b>	<b>Analytical Independence and Avoidance of Conflicts of Interest</b>			
5.1	Policies to manage conflicts of interest		Full compliance	
5.2	Policies on trading and investment declaration	Full compliance		
5.3	Formulation of other policies to ensure independence and avoidance of conflicts of interest			Full compliance
<b>6</b>	<b>Private, Unaccepted, and Unsolicited Ratings</b>			
6.1	Formulation and adherence to policies	Full compliance		
<b>7</b>	<b>General Code of Conduct</b>			
7.1	Adoption of internal code		Full compliance	
7.2	Affirmation of compliance with code		Full compliance	
<b>8</b>	<b>The IOSCO Code of Conduct</b>			
8.1	Adherence to the code of conduct			Full compliance
<b>9</b>	<b>Process audit and compliance officer</b>			
9.1	Institution of audit process		Full compliance	
9.2	Appointment of compliance officer		Full compliance	
9.3	Whistle-blower policy		Full compliance	

Recommendations		Implementation Timelines		
		Within 3 Months	3–6 Months	6–12 Months
<b>Essential Best Practices</b>				
<b>10</b>	<b>Outreach Initiatives</b>			
10.1	Initiation of outreach activities			
<b>11</b>	<b>Relation with Regulator and Other DCRA</b>			
11.1	Formulation of relevant policies and compliance	Immediate compliance		
		Immediate compliance		

DCRA = domestic credit rating agency, IOSCO = International Organization of Securities Commissions.

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# Appendix 1: Mapping of Rating Scales for Domestic Credit Rating Agencies Compliant with Best Practices

Domestic credit rating agencies (DCRAs) are expected to comply with essential best practices in 1 year. This will enhance credibility with domestic investors and boost their acceptance of ratings, helping to deepen the bond market.

However, the same cannot be said about global investors. To a great extent, global investors rely upon global credit rating agency (GCRA) ratings. For instance, an investor operating from the United Kingdom might find it difficult to interpret a credit rating assigned by an agency in Bangladesh and refrain from participating in the Bangladeshi financial market. Even within Asia, an investor in Japan would find it difficult to interpret ratings assigned by a DCRA in Bangladesh and would probably not invest in Bangladeshi corporate bonds. As a result, the investor may miss out on a return and diversification opportunity, and markets may suffer from a lack of depth and from the homogeneity of the investor population.

To increase penetration and enhance acceptance in the global market, it is critical that DCRA ratings be well understood by a large section of investors. This can only be achieved if a DCRA's ratings can be compared across DCRAs and with GCRA ratings. Therefore, it is necessary to explore methods to compare DCRA ratings to take adequate steps to enhance their comparability. Mapping of the rating scales of DCRAs and GCRAs is critical to taking full advantage of the adoption of best practices.

Three methodologies, discussed below, can be used to assess the correlation between DCRA and GCRA ratings.

## 1. Dual Rating Methodology

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In the dual rating analysis, entities rated by both DCRAs and GCRAs (local currency rating on global rating scale) are identified, and their ratings compared to explore likely correlation between them. Based on the comparison, notch differences between ratings are estimated, and, if these are not significant, it is assumed there are no significant differences in the ratings. However, if notch differences are significant, then the dual rating analysis identifies the most frequent mapping of a rating level and establishes that as the standard mapping for that particular rating.

The dual rating analysis is very useful in the following situations:

- when a comparison has to be made between ratings assigned by two different rating agencies based in the same economy; and
- when ratings assigned by a DCRA and GCRA have to be compared (provided that the sovereign rating of the country is high; otherwise the ratings assigned by GCRAs tend to be constrained by country risk elements that typically do not feature among the key drivers of ratings assigned by DCRAs).

The preconditions to apply dual rating analysis are as follows:

- the population of companies with common ratings should be large; and
- the sovereign rating should be high, if the rating comparison involves a GCRA.

## **2. Comparison of Commonly Used Financial Ratios**

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Rating agencies use financial benchmarks or medians to assess a company's relative financial risk profile. These benchmarks or medians vary across rating agencies, depending upon their assessment of credit quality and sample size. Though benchmarks are essentially used to assess financial risk profiles, their comparison provides a good indication of correlation in the overall rating across rating agencies.

In this methodology, the financial indicators used to determine ratings are mapped among DCRA's or with those of GCRA's. Mapping is based on the identification of the median intervals of the reference rating agency in which a DCRA's financial medians lie.

This methodology can be used in the following situations:

- financial indicators used by the DCRA's and GCRA's are common; and
- other methodologies for comparison do not yield meaningful results due to data constraints or a limited track record.

## **3. Comparison of Rating Agencies' Default Statistics**

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This methodology works on the principle of closest distance between two default rates for a particular rating category. The mapping is based on the defaults experienced over a period of time across rating categories for various DCRA's.

Default statistics of each DCRA are separately mapped to those of other DCRA's or a GCRA, using a tool for mapping that calculates the distance between default statistics of a DCRA and those of the reference GCRA. Among the three methodologies discussed in this section, this is technically the most powerful method of establishing comparability. However, there are some preconditions to applying this methodology, which are as follows:

- the default rates capture at least one full economic cycle;
- the definition of default is similar across DCRA's to be compared;
- default is recognized strictly according to the definition, without exceptions; and
- there is a reasonably large sample size of both defaulted and non-defaulted companies.

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Of the methodologies discussed above, comparison of rating agencies' default statistics should be the first choice for assessing the correlation, provided that the key preconditions are met without exception. The dual rating methodology gives an accurate mapping for two DCRA in the same economy and a reasonably good mapping between a DCRA and a GCRA when the sovereign rating is high. In all other cases, one can choose a comparison of financial benchmarks or medians to explore the correlation between ratings assigned by two different rating agencies.

#### **4. Publication of Mapping of Rating Scales**

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Using these three methodologies, a DCRA should draw a correlation between its rating scale and that of other GCRA. To begin with, this mapping can be done at the rating category level (for example, AAA/AA/A). This will give a good indication of the correlation and will help global investors. Subsequently, an attempt can be made to map at the modifier level (for example, A+/A/A-). A DCRA can disclose such mapping optionally. This will ensure that a global investor can have access to the mapping at all points of time, which in turn will help in making investment decisions on debt that is traded in Asian markets.

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# Appendix 2: The International Organization of Securities Commissions' Code of Conduct

## 1. Quality and Integrity of the Rating Process

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### A. Quality of the Rating Process

- 1.1 The credit rating agency (CRA) should adopt, implement, and enforce written procedures to ensure that the opinions it disseminates are based on a thorough analysis of all information known to the CRA that is relevant to its analysis according to the CRA's published rating methodology.
- 1.2 The CRA should use rating methodologies that are rigorous, systematic, and, where possible, result in ratings that can be subjected to some form of objective validation based on historical experience.
- 1.3 In assessing an issuer's creditworthiness, analysts involved in the preparation or review of any rating action should use methodologies established by the CRA. Analysts should apply a given methodology in a consistent manner, as determined by the CRA.
- 1.4 Credit ratings should be assigned by the CRA and not by any individual analyst employed by the CRA; ratings should reflect all information known and believed to be relevant to the CRA, consistent with its published methodology; and the CRA should use people who, individually or collectively, have appropriate knowledge and experience in developing a rating opinion for the type of credit being applied.
- 1.5 The CRA should maintain internal records to support its credit opinions for a reasonable period of time or in accordance with applicable law.
- 1.6 The CRA and its analysts should take steps to avoid issuing any credit analyses or reports that contain misrepresentations or are otherwise misleading as to the general creditworthiness of an issuer or obligation.
- 1.7 The CRA should ensure that it has and devotes sufficient resources to carry out high-quality credit assessments of all obligations and issuers it rates. When deciding whether to rate or continue rating an obligation or issuer, it should assess whether it is able to devote sufficient personnel with sufficient skill sets to make a proper rating assessment, and whether its personnel likely will have access to sufficient information needed in order make such an assessment.
- 1.8 The CRA should structure its rating teams to promote continuity and avoid bias in the rating process.

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## B. Monitoring and Updating

- 1.9 Except for ratings that clearly indicate that they do not entail ongoing surveillance, once a rating is published, the CRA should monitor on an ongoing basis and update the rating by:
- (i) regularly reviewing the issuer's creditworthiness;
  - (ii) initiating a review of the status of the rating upon becoming aware of any information that might reasonably be expected to result in a rating action (including termination of a rating), consistent with the applicable rating methodology; and
  - (iii) updating on a timely basis the rating, as appropriate, based on the results of such review.
- 1.10 Where a CRA makes its ratings available to the public, the CRA should publicly announce if it discontinues rating an issuer or obligation. Where a CRA's ratings are provided only to its subscribers, the CRA should announce to its subscribers if it discontinues rating an issuer or obligation. In both cases, continuing publication by the CRA of the discontinued rating should indicate the date the rating was last updated and the fact that the rating is no longer being updated.

## C. Integrity of the Rating Process

- 1.11 The CRA and its employees should comply with all applicable laws and regulations governing its activities in each jurisdiction in which it operates.
- 1.12 The CRA and its employees should deal fairly and honestly with issuers, investors, other market participants, and the public.
- 1.13 The CRA's analysts should be held to high standards of integrity, and the CRA should not employ individuals with demonstrably compromised integrity.
- 1.14 The CRA and its employees should not, either implicitly or explicitly, give any assurance or guarantee of a particular rating prior to a rating assessment. This does not preclude a CRA from developing prospective assessments used in structured finance and similar transactions.
- 1.15 The CRA should institute policies and procedures that clearly specify a person responsible for the CRA's and the CRA's employees' compliance with the provisions of the CRA's code of conduct and with applicable laws and regulations. This person's reporting lines and compensation should be independent of the CRA's rating operations.

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- 1.16 Upon becoming aware that another employee or entity under common control with the CRA is or has engaged in conduct that is illegal, unethical, or contrary to the CRA's code of conduct, a CRA employee should report such information immediately to the individual in charge of compliance or an officer of the CRA, as appropriate, so proper action may be taken. A CRA's employees are not necessarily expected to be experts in the law. Nonetheless, its employees are expected to report the activities that a reasonable person would question. Any CRA officer who receives such a report from a CRA employee is obligated to take appropriate action, as determined by the laws and regulations of the jurisdiction and the rules and guidelines set forth by the CRA. CRA management should prohibit retaliation by other CRA staff member or by the CRA itself against any employees who, in good faith, make such reports.

## **2. Credit Rating Agency Independence and Avoidance of Conflicts of Interest**

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### **A. General**

- 2.1 The CRA should not forbear or refrain from taking a rating action based on the potential effect (economic, political, or otherwise) of the action on the CRA, an issuer, an investor, or other market participant.
- 2.2 The CRA and its analysts should use care and professional judgment to maintain both the substance and appearance of independence and objectivity.
- 2.3 The determination of a credit rating should be influenced only by factors relevant to the credit assessment.
- 2.4 The credit rating a CRA assigns to an issuer or security should not be affected by the existence of or potential for a business relationship between the CRA (or its affiliates) and the issuer (or its affiliates) or any other party, or the nonexistence of such a relationship.
- 2.5 The CRA should separate, operationally and legally, its credit rating business and CRA analysts from any other businesses of the CRA, including consulting businesses that may present a conflict of interest. The CRA should ensure that ancillary business operations, which do not necessarily present conflicts of interest with the CRA's rating business, have in place procedures and mechanisms designed to minimize the likelihood that conflicts of interest will arise.

### **B. CRA Procedures and Policies**

- 2.6 The CRA should adopt written internal procedures and mechanisms to identify, eliminate, manage, and disclose, as appropriate, any actual or potential conflicts of interest that may influence

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the opinions and analyses the CRA makes or the judgment and analyses of the individuals the CRA employs who have an influence on ratings decisions. The CRA's code of conduct should also state that the CRA will disclose such conflict avoidance and management measures.

- 2.7 The CRA's disclosures of actual and potential conflicts of interest should be complete, timely, clear, concise, specific, and prominent.
- 2.8 The CRA should disclose the general nature of its compensation arrangements with rated entities. Where a CRA receives from a rated entity compensation unrelated to its ratings service, such as compensation for consulting services, the CRA should disclose the proportion such non-rating fees constitute against the fees the CRA receives from the entity for ratings services.
- 2.9 The CRA and its employees should not engage in any securities or derivatives trading presenting conflicts of interest with the CRA's rating activities.
- 2.10 In instances where rated entities (e.g., governments) have, or are simultaneously pursuing, oversight functions related to the CRA, the CRA should use different employees to conduct its rating actions than those employees involved in its oversight issues.

### C. CRA Analyst and Employee Independence

- 2.11 Reporting lines for CRA employees and their compensation arrangements should be structured to eliminate or effectively manage actual and potential conflicts of interest. The CRA's code of conduct should also state that a CRA analyst will not be compensated or evaluated on the basis of the amount of revenue that the CRA derives from issuers that the analyst rates or with which the analyst regularly interacts.
- 2.12 The CRA should not have employees who are directly involved in the rating process initiate, or participate in, discussions regarding fees or payments with any entity they rate.
- 2.13 No CRA employee should participate in or otherwise influence the determination of the CRA's rating of any particular entity or obligation if the employee:
  - (i) owns securities or derivatives of the rated entity, other than holdings in diversified collective investment schemes;
  - (ii) owns securities or derivatives of any entity related to a rated entity, the ownership of which may cause or may be perceived as causing a conflict of interest, other than holdings in diversified collective investment schemes;
  - (iii) has had a recent employment or other significant business relationship with the rated entity that may cause or may be perceived as causing a conflict of interest;

- (iv) has an immediate relation (e.g., a spouse, partner, parent, child, or sibling) who currently works for the rated entity; or
- (v) has or had any other relationship with the rated entity or any related entity thereof that may cause or may be perceived as causing a conflict of interest.

- 2.14 The CRA's analysts and anyone involved in the rating process (or their spouse, partner, or minor children) should not buy or sell or engage in any transaction in any security or derivative based on a security issued, guaranteed, or otherwise supported by any entity within such analyst's area of primary analytical responsibility, other than holdings in diversified collective investment schemes.
- 2.15 CRA employees should be prohibited from soliciting money, gifts, or favors from anyone with whom the CRA does business and should be prohibited from accepting gifts offered in the form of cash or any gifts exceeding a minimal monetary value.
- 2.16 Any CRA analyst who becomes involved in any personal relationship that creates the potential for any real or apparent conflict of interest (including, for example, any personal relationship with an employee of a rated entity or agent of such entity within his or her area of analytic responsibility), should be required to disclose such relationship to the appropriate manager or officer of the CRA, as determined by the CRA's compliance policies.

### **3. CRA Responsibilities to the Investing Public and Issuers**

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#### **A. Transparency and Timeliness of Ratings Disclosure**

- 3.1 The CRA should distribute in a timely manner its ratings decisions regarding the entities and securities it rates.
- 3.2 The CRA should publicly disclose its policies for distributing ratings, reports, and updates.
- 3.3 The CRA should indicate with each of its ratings when the rating was last updated.
- 3.4 Except for "private ratings" provided only to the issuer, the CRA should disclose to the public, on a non-selective basis and free of charge, any rating regarding publicly-issued securities or public issuers themselves, as well as any subsequent decisions to discontinue such a rating, if the rating action is based in whole or in part on material non-public information.
- 3.5 The CRA should publish sufficient information about its procedures, methodologies, and assumptions (including financial statement adjustments that deviate materially from those

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contained in the issuer's published financial statements) so that outside parties can understand how a rating was arrived at by the CRA. This information will include (but not be limited to) the meaning of each rating category and the definition of default or recovery, and the time horizon that the CRA used when making a rating decision.

- 3.6 When issuing or revising a rating, the CRA should explain in its press releases and reports the key elements underlying the rating opinion.
- 3.7 Where feasible and appropriate, prior to issuing or revising a rating, the CRA should inform the issuer of the critical information and principal considerations upon which a rating will be based and afford the issuer an opportunity to clarify any likely factual misperceptions or other matters that the CRA would wish to be made aware of in order to produce an accurate rating. The CRA will duly evaluate the response. Where in particular circumstances the CRA has not informed the issuer prior to issuing or revising a rating, the CRA should inform the issuer as soon as practical thereafter and, generally, should explain the reason for the delay.
- 3.8 In order to promote transparency and to enable the market to best judge the performance of the ratings, the CRA, where possible, should publish sufficient information about the historical default rates of CRA rating categories and whether the default rates of these categories have changed over time, so that interested parties can understand the historical performance of each category and if and how rating categories have changed, and be able to draw quality comparisons among ratings given by different CRAs. If the nature of the rating or other circumstances makes a historical default rate inappropriate, statistically invalid, or otherwise likely to mislead the users of the rating, the CRA should explain this.
- 3.9 For each rating, the CRA should disclose whether the issuer participated in the rating process. Each rating not initiated at the request of the issuer should be identified as such. The CRA should also disclose its policies and procedures regarding unsolicited ratings.
- 3.10 Because users of credit ratings rely on an existing awareness of CRA methodologies, practices, procedures, and processes, the CRA should fully and publicly disclose any material modification to its methodologies and significant practices, procedures, and processes. Where feasible and appropriate, disclosure of such material modifications should be made prior to their going into effect. The CRA should carefully consider the various uses of credit ratings before modifying its methodologies, practices, procedures, and processes.

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## **B. The Treatment of Confidential Information**

- 3.11 The CRA should adopt procedures and mechanisms to protect the confidential nature of information shared with them by issuers under the terms of a confidentiality agreement or through mutual understanding that the information is shared confidentially. Unless otherwise permitted by the confidentiality agreement and consistent with applicable laws or regulations, the CRA and its employees should not disclose confidential information in press releases; through research conferences; to future employers; or in conversations with investors, other issuers, other persons, or otherwise.
- 3.12 The CRA should use confidential information only for purposes related to its rating activities or otherwise in accordance with any confidentiality agreements with the issuer.
- 3.13 CRA employees should take all reasonable measures to protect all property and records belonging to or in possession of the CRA from fraud, theft, or misuse.
- 3.14 CRA employees should be prohibited from engaging in transactions in securities when they possess confidential information concerning the issuer of such security.
- 3.15 In preservation of confidential information, CRA employees should familiarize themselves with the internal securities trading policies maintained by their employer, and periodically certify their compliance as required by such policies.
- 3.16 CRA employees should not selectively disclose any non-public information about rating opinions or possible future rating actions of the CRA, except to the issuer or its designated agents.
- 3.17 CRA employees should not share confidential information entrusted to the CRA with employees of any affiliated entities that are not CRAs. CRA employees should not share confidential information within the CRA except on an as needed basis.
- 3.18 CRA employees should not use or share confidential information for the purpose of trading securities, or for any other purpose except the conduct of the CRA's business.

## **4. Disclosure of the Code of Conduct and Communication with Market Participants**

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- 4.1 The CRA should disclose to the public its code of conduct and describe how the provisions of its code of conduct fully implement the provisions of the International Organization of Securities Commissions (IOSCO) Principles Regarding the Activities of Credit

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Rating Agencies and the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies. If a CRA's code of conduct deviates from the IOSCO provisions, the CRA should explain where and why these deviations exist and how any deviations nonetheless achieve the objectives contained in the IOSCO provisions. The CRA should also describe generally how it intends to enforce its code of conduct and should disclose on a timely basis any changes to its code of conduct or how it is implemented and enforced.

- 4.2 The CRA should establish a function within its organization charged with communicating with market participants and the public about any questions, concerns, or complaints that the CRA may receive. The objective of this function should be to help ensure that the CRA's officers and management are informed of those issues that they would want to be made aware of when setting the organization's policies.

Recently, IOSCO has made the following amendments to the Code of Conduct:

### **Quality and Integrity of the Rating Process, Code of Conduct Section 1**

This section will be modified such that CRAs should:

- Prohibit CRA analysts from making proposals or recommendations regarding the design of structured finance products that the CRA rates.
- Adopt reasonable measures so that the information they use is of sufficient quality to support a credible rating. If the rating involves a type of financial product with limited historical data upon which to base a rating, the CRA should make clear, in a prominent place, the limitations of the rating.
- Establish and implement a rigorous and formal review function responsible for periodically reviewing the methodologies and models and significant changes to the methodologies and models it uses.
- Take steps that are designed to ensure that the decision-making process for reviewing and potentially downgrading a current rating of a structured finance product is conducted in an objective manner.
- Ensure that CRA employees that make up CRA rating committees have appropriate knowledge and experience in developing a rating opinion for the relevant type of credit.

- Establish new products review functions to review the feasibility of providing a credit rating for a type of structure that is materially different from the structures a CRA currently rates.
- Assess whether existing methodologies and models for determining credit ratings of structured products are appropriate when the risk characteristics of the assets underlying a structured product change materially.
- Ensure that adequate resources are allocated to monitoring and updating its ratings.

### **CRA Independence and Avoidance of Conflicts of Interest, Code of Conduct Section 2**

This section will be modified such that CRAs should:

- To discourage “ratings shopping,” disclose in their rating announcements whether the issuer of a structured finance product has informed the CRA that it is publicly disclosing all relevant information about the product being rated.
- Disclose whether any one issuer, originator, arranger, subscriber, or other client and its affiliates make up more than 10% of the CRA’s annual revenue.
- Establish policies and procedures for reviewing the past work of analysts that leave the employ of the CRA.
- Conduct formal and periodic reviews of remuneration policies and practices for CRA analysts to ensure that these policies and practices do not compromise the objectivity of the CRA’s rating process.
- Define what it considers and does not consider to be an ancillary business and why.

### **CRA Responsibilities to the Investing Public and Issuers, Code of Conduct Section 3**

This section will be modified so that CRAs should:

- Publish verifiable, quantifiable historical information about the performance of its rating opinions, organization, and structure, and, where possible, standardized in such a way to assist investors in drawing performance comparisons between different CRAs.
- Differentiate ratings of structured finance products from other ratings, preferably through different rating symbols.

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- Indicate the attributes and limitations of each credit opinion and the limits to which it verifies information provided to it by the issuer or originator of a rated security.
  - Provide investors and/or subscribers (depending on the CRA's business model) with sufficient information about its loss and cash-flow analysis of structured finance products so that an investor allowed to invest in the product can understand the basis for the CRA's rating. CRAs should also disclose the degree to which they analyze how sensitive a rating of a structured financial product is to changes in the CRA's underlying rating assumptions.
  - Disclose the principal methodology or methodology version in use in determining a rating.

**Disclosure of the Code of Conduct and Communications with Market Participants, Code of Conduct Section 4**

- A CRA should publish, in a prominent position on its Web site, links to the CRA's code of conduct, a description of the methodologies it uses, and information about its historic performance data.

## Handbook on International Best Practices Credit Rating

The Asian Development Bank (ADB) and ASEAN+3 in recent years have been promoting the development of regional bond markets under the Asian Bond Markets Initiative. Among the measures, ADB has supported the capacity development of domestic credit rating agencies (DCRAs), helping them adopt international best practices and enhance the credibility of their ratings.

As part of this assistance, the Office of Regional Economic Integration presents this *Handbook on International Best Practices in Credit Rating*.

The guide—based on extensive consultations with a wide spectrum of industry experts—will not only enhance rating practices but also pave the way toward regional harmonization of ratings. This will help domestic and global investors better understand credit ratings by DCRAs and enable them to compare the risks of different issuers. This will boost the credibility of DCRA ratings and help investors better participate in Asia’s bond markets, a critical measure in building well-functioning bond markets. We sincerely believe this guide will play a big role in this process.

### About the Asian Development Bank

ADB’s vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region’s many successes, it remains home to two thirds of the world’s poor. Nearly 1.7 billion people in the region live on \$2 or less a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance. In 2007, it approved \$10.1 billion of loans, \$673 million of grant projects, and technical assistance amounting to \$243 million.

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