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# XXXVIth Annual Monetary Studies Conference

# Catalyzing A Regional Bond Market in the Caribbean

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***Central Bank of Trinidad & Tobago***
***Conference Facilities, 16th Floor***
***November 1-4, 2004***

# Catalyzing a regional bond market in the Caribbean

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## ABSTRACT

Functioning capital markets are an important part of any modern economy. While equity markets provide companies with risk capital, bond markets support the capital structure of companies by providing debt funds. The importance of bond markets is further enhanced by the fact that they are the exclusive funding source for governments in the capital markets.

Bond markets provide a platform for the most efficient allocation of debt funds by ensuring that market forces are brought to bear on a large portion of the financial transactions in the economy, something which is not typically evident in financial systems dominated by bank financing. This is particularly useful in the case of government borrowings and goes a long way towards reducing the likelihood of the economy being subjected to the sudden shocks that were seen in the Asian currency crisis. In this sense, domestic bond markets significantly reduce the risk of macroeconomic volatility.

Rating agencies are almost universally recognized as an essential part of the development of the capital market in fixed income securities. They meet the market's need for research and credible, independent analysis thereby increasing the speed and efficiency with which capital markets develop. It is this need for regional credit information for a regional capital market that CariCRIS seeks to meet.

## Introduction

This paper discusses the place of bond markets in any modern economy, the role of credit ratings in developing bond markets and the appropriateness of regional capital markets for the Caribbean. It then goes on to explain the contribution that the Caribbean Information & Credit Rating Services Limited (CariCRIS) can make towards developing a vibrant regional debt market in the Caribbean.

### *The economic role of bond markets*

Functioning capital markets are an important part of any modern economy. While equity markets provide companies with risk capital, bond markets support the capital structure of companies by providing debt funds. The importance of bond markets is enhanced by the fact that they are the exclusive funding source for governments in the capital markets.

Functioning bond markets provide the platform for the most efficient allocation of debt funds across any economy. In other words, large bond markets ensure that market forces are brought to bear on a large portion of the financial transactions in the economy, something which is not typically evident in financial systems dominated by bank financing. This is particularly useful in the case of government borrowings and goes a long way towards reducing the likelihood of the economy being subjected to the sudden shocks that were seen in the Asian currency crisis. Closer home, we have observed how more developed domestic bond markets in Jamaica helped it manage what could have become a foreign exchange payment problem. In contrast, the absence of a domestic bond market in the Dominican Republic provided it with few alternatives to avert its recent financial crisis. In this sense, domestic bond markets significantly reduce the risk of macroeconomic volatility.

### *The imperative for regional bond markets*

Capitals markets, in general, and bond markets, in particular, require a fairly sophisticated infrastructure and a fairly large number of suppliers and consumers of money to be functional enough to deliver economic benefits. However, many small national economies, such as those in the Caribbean are unable to access the economic benefits that can be delivered by bond markets, simply because they are too small to provide all the necessary components that an effective bond market demands. To get around this constraint and ensure that even small nations can enjoy the economic benefits that can flow from a modern financial system, the idea of regional bond markets has gained ground in recent times. The most notable efforts at exploring this idea of regional bond markets have been made by the APEC (Asia-Pacific Economic Cooperation) and the CSME (Caribbean Single Market and Economy).

*The role of rating agencies in bond market development*

Bond markets bring together buyers and sellers of credit risk, which in turn raises the issue of pricing credit risk in bond markets. This issue has been best addressed in financial markets across the world by using credit ratings. Credit ratings are informed opinions on the credit worthiness of borrowers, expressed in a readily understandable and comparable manner. Thus, credit ratings reduce the information asymmetry between borrowers and lenders and provide a basis for pricing credit risk. In so doing, credit ratings play a crucial facilitating role in the development of the bond market.

**Bond markets and rating agencies in some emerging economies** [1]

At the end of 2002, the value of bond markets in emerging-market Asian countries exceeded US $1.2 trillion, more than half the total for emerging markets. This is a vast shift from the early 1990s, when commercial banks dominated the financial scene. However, despite a series of difficulties during the past decade such as the Asian crisis, domestic bond markets have grown rapidly to become an important feature of financial markets across Asia. However, with the exception of Brazil and Chile, bond markets in Latin America are considerably smaller, with most bond market sizes accounting for less than 20% of respective Gross Domestic Product (GDP). Caribbean bond markets would be even smaller. In contrast, by 2001, in Asian economies such as South Korea and Malaysia, the bond market size was in excess of 50%.

In the developing world, the Asian bond markets have exhibited the largest growth in recent years. The Malaysian bond market grew from 18% of GDP in 1992 to 52% of GDP in 2002. The Indian and Chinese bond markets sizes were estimated to be of the order of 35 - 40% of respective GDP in 2002. It is not coincidental that CRISIL Ltd, India's largest rating agency, established in 1987, and Rating Agency Malaysia, established in 1990, have also established itself among the more successful rating agencies in Asia. CRISIL is the largest rating agency in Asia and across any emerging market.

[1] Sources:

1. Issues in Building Corporate Money and Bond Markets in Developing Economies, Inter-American Development Bank, 2002
2. Developing Bond markets in the Latin American & Caribbean, Pietro Masci and Benjamin M. Rowland
3. Bank For International Settlements Publications – Guorong Jiang, Robert McCauley

*A brief history of Credit Ratings*

Credit rating agencies have existed for over a century, providing opinions on the creditworthiness of issuers of securities and other financial obligations. The origin of credit ratings can be traced to the late 1800s when the 'wild west' in the USA threw up opportunities for railroad companies. These companies sought to borrow from both domestic and overseas investors who had no useful information with which to discern between "good" and "not so good" credits. Henry Varnum Poor and John Moody were among the enterprising pioneers who began to collate and publish the financial data and debt service record of railroad companies. The statistics were gradually supplemented with rudimentary grading schemes and opinions, and finally evolved into credit ratings as financial markets recognize them today.

During the 1930s, demand for credit ratings increased, as investors became concerned about high bond default rates and credit risk following the crash of 1929. Nevertheless, this was short lived as by the 1940s and on through to the 1960s, the agencies were contracting and the demand for credit rating was stagnant. The most critical period of expansion in the business of credit rating followed Penn Central's default in 1972. Since then there has been phenomenal growth in employment, as well as issues and issuers rated.

Today, the four largest rating agencies in the world are Standard and Poor's (S&P), Moody's, Fitch, and CRISIL. While the first three are US-based global rating agencies, CRISIL provides national scale ratings in India.

Today, credit ratings affect bond markets in a number of important ways, including

- an issuer's access to and cost of capital,
- the structure of financial transactions, and
- the ability of fiduciaries and others to invest in particular investments.

*Defining Credit Ratings*

While specific definitions and nomenclature followed by different rating agencies vary, a credit rating can generally be defined as current opinion on the relative creditworthiness of borrowers. A rating is not an audit or a general-purpose certification of goodness of a company. It is also not a recommendation to invest in the rated security. For easy understanding it is usually expressed in alphanumeric symbols such as AAA, AA, BBB, etc.

*CariCRIS in the current Caribbean environment*

There is a current trend across the Caribbean towards the development of domestic capital markets as well as cross border capital flow. Bond markets are an important means by which the economic benefits of a modern financial system can be realized as seen above. In the Caribbean, the size of local economies and markets limits the extent of capital market development that single economies can achieve on their own. These limitations can be lifted and the benefits enhanced by participation in an integrated, regional capital market. Caribbean governments and regulators have recognized these benefits and there has been a concerted effort in the Caribbean towards economic integration in general and the integration of capital markets in particular.

Rating agencies are almost universally recognized as an essential part of the development of the capital market in fixed income securities. They meet the market's need for research and credible, independent analysis thereby increasing the speed and efficiency with which capital markets develop. It is this need for regional credit information for a regional capital market that CariCRIS seeks to meet. To do this, CariCRIS will assign credit ratings on a Caribbean regional scale where borrowers from the region would be compared to other borrowers from the region on a 'regional rating scale'.

*Rationale for regional agency and ratings on a Caribbean regional scale*

Traditionally, rating agencies have assigned ratings with respect to two different comparison sets - a global scale and a national scale. A global scale credit rating is assigned in comparison to all debt issues and issuers across the world. A national scale credit rating is assigned in comparison to debt issues and issuers in the financial markets of individual nations.

However, for regions such as the Caribbean, which comprise many small national economies, global and national scale ratings are inadequate. Assigned global scale ratings tend to be bunched at the lower end of the scale and the coverage by global scale ratings of debt issues and issuers is not extensive[2]. For these reasons, a regional scale comparison is more useful and relevant - particularly where, as is the case in the Caribbean, the region's economies are similar in economic, political and demographic structure.

Moreover, a regional rating includes far more locally and regionally contextual issues than can a global scale rating. By focusing on the Caribbean alone, CariCRIS regional scale ratings and national scale ratings seek to enhance the quality of information and extent of differentiation across local and regional credits.

A CariCRIS credit rating will provide an accurate indication of the relative creditworthiness of Caribbean entities. Investors will be able to easily and directly compare credit quality within Caribbean nations and across the region based on independent, objective methodologies. This will aid efficient pricing. Furthermore, enhanced knowledge of relative credit quality will facilitate the development of a viable secondary market for fixed income securities.

For borrowers, a CariCRIS rating will enhance credibility in the wider financial market by expressing their creditworthiness in the widely accepted language of credit ratings. This will be useful not only in negotiations with bankers, but also allows the borrower to more easily raise lower cost debt directly from the capital market - both local and regional.

[2] See Appendix 1

A CariCRIS rating, as an objective, reliable risk assessment, will also enable regulators to work together with institutional investors such as pension plans to broaden the range of eligible investments thereby widening participation and deepening the regional bond market. The increased information and transparency afforded by CariCRIS credit ratings will significantly improve overall market efficiency.

### *Conclusion*

Bond markets can make an important economic contribution to the development of nations. However, smaller nations are unable to provide all the components that bond markets need to be functional enough to deliver economic benefits. Such nations can realize the economic benefits that bond markets offer by coming together to set up regional bond markets. The Caribbean, with its small national economies can derive significant benefits from such a regional bond market.

Bond markets develop faster in the presence of information providers who can provide credit related information that is most relevant and contextual to investors. CariCRIS, as the Caribbean's regional rating services company, is perhaps the most important provider of credit information to the prospective regional bond market. Moreover, the innovative concept of a regional scale that CariCRIS has introduced can go a long way in fostering the development of this regional bond market that the Caribbean needs and seeks.

## APPENDIX 1

## SUMMARY RATING TABLE
## CARIBBEAN SOVEREIGNS

(Long-Term Foreign Currency)

| COUNTRIES | S&P | MOODY'S | FITCH |
|---|---|---|---|
| Bahamas | A-<br>stable | A3<br>stable | ... |
| Barbados | BBB+<br>stable | Baa2<br>stable | ... |
| Belize | B-<br>negative | B2<br>stable | ... |
| Costa Rica | BB<br>negative | Ba1<br>negative | BB<br>negative |
| Dominican Republic | CC<br>negative | B3<br>negative | CCC+ |
| Grenada | B-<br>watch<br>negative | ... | ... |
| Jamaica | B<br>negative | B1<br>stable | ... |
| Panama | BB<br>negative | Ba1<br>stable | BB+<br>stable |
| Suriname | B-<br>stable | B1<br>stable | B |
| Trinidad & Tobago | BBB+<br>positive | Baa3<br>stable | ... |

... means unrated.

Source: Websites/publications of Standard & Poor's Ratings Services, Moody's Investor Service and Fitch Ratings

CariCRIS

# XXXVI$^{th}$ Annual Monetary Studies Conference

November 02, 2004

**S. Venkat Raman**

**Chief Executive Officer**

**Caribbean Information & Credit Rating Services Limited**

## Why CariCRIS

CariCRIS

- Need for a vibrant bond market
  - Efficient financial intermediation and credit allocation
  - Alternate funding source to banks
  - *Liquidity & financial crises management*
- Elements of a successful debt market:
  - Deep & Liquid Government Bond Market
    - A benchmark Yield curve
  - Legal and Operational Infrastructure
    - Efficient clearing and settlement
    - Rules of trading
  - Adequate market participants
    - Market makers, investors, issuers
  - Transparent and adequate information
    - Standard of auditing and accounting
    - Credit Ratings

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## Why CariCRIS

CariCRIS

- Caribbean
  - Small sized economies limiting local bond market development
  - Credit research in public domain relatively scarce
  - Sizeable regional economy
  - Increasing evidence of cross border financing ✓
  - Conducive business & regulatory environment ✓
- Existing Global Scale Ratings
  - Low penetration
  - Bunching
- A regional rating services company
  - Relevant credit comparison for investors in the region
  - A more granular assessment of credit risk



## Credit Rating- some fundamentals

CariCRIS

- A Credit rating is a current opinion on the relative creditworthiness of debt
- Ratings are:
  - Always relative
  - Within a defined frame of reference
- Ratings Frames of Reference can be:
  - Global
  - National
  - **Regional**

## CariCRIS – Ratings Products

CariCRIS

- Regional Scale Ratings
  - Opinion on creditworthiness relative to other entities in a defined Caribbean region
    - Foreign currency ratings
    - Local currency ratings
- National Scale Ratings
  - Opinion on creditworthiness relative to other entities within a specific nation
    - Local currency ratings

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## Illustration

CariCRIS

| *You want to compare …* | | *Use …* |
|---|---|---|
| [redacted] US$ | [redacted] US$ | CariCRIS Regional Scale Foreign Currency |
| [redacted] J$ | [redacted] TT$ | CariCRIS Regional Scale Local Currency |
| [redacted] J$ | [redacted] J$ | CariCRIS National Scale Local Currency |

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# CariCRIS Rating Scale

**Long Term Rating Scale**

| Regional | National | Definition |
|---|---|---|
| *Cari*AAA | **AAA | Highest |
| *Cari*AA (+/-) | **AA (+/-) | High |
| *Cari*A (+/-) | **A (+/-) | Above Average |
| *Cari*BBB (+/-) | **BBB (+/-) | Average |
| *Cari*BB (+/-) | **BB (+/-) | Below Average |
| *Cari*B (+/-) | **B (+/-) | Weak |
| *Cari*C(+/-) | **C(+/-) | Poor |
| *Cari*D | **D | Default |

**Short Term Rating Scale**

| Regional | National | Definition |
|---|---|---|
| *Cari*P1 / P1+ | **P1 / P1+ | Highest |
| *Cari*P2 / P2+ | **P2 / P2+ | High |
| *Cari*P3 / P3+ | **P3 / P3+ | Average |
| *Cari*P4 / P4+ | **P4 / P4+ | Below Average |
| *Cari*P5 / P5+ | **P5 / P5+ | Default |

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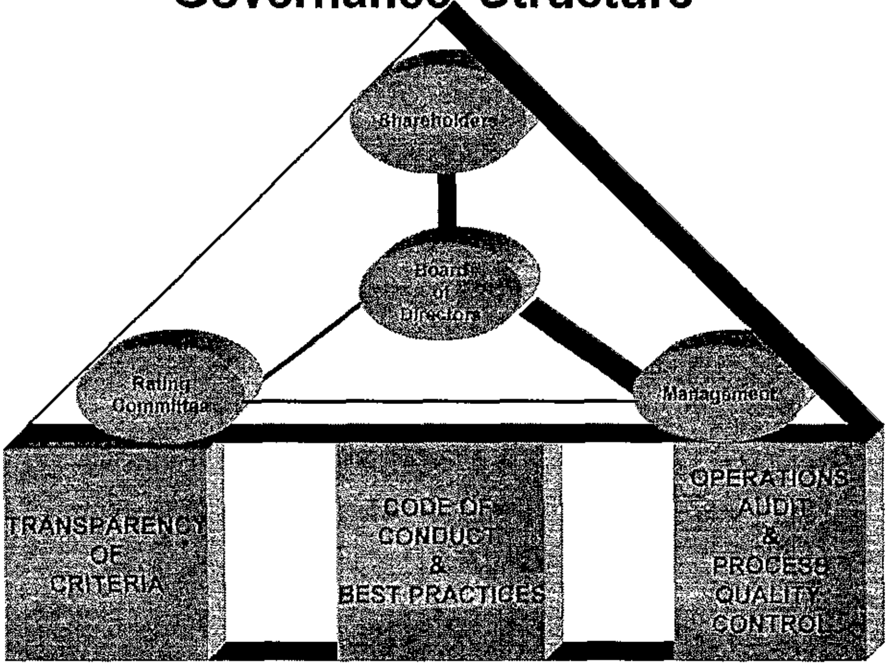
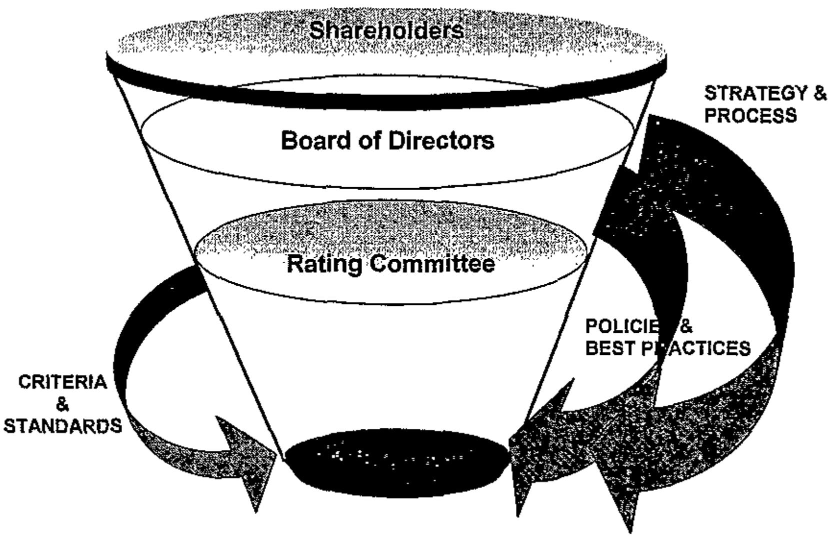
# Governance Structure



## Governance Process




## Benefits of a CariCRIS rating

CariCRIS

**Issuers**
- A proactive step towards transparency
- An independent, unbiased assessment
- Enhances credibility & acceptability
- Increases access to funding
- Encourages financial discipline

**Investors**
- Eases risk identification and diversification
- Risk based pricing of Investments
- Greater depth of research, being locally based

**Regulatory authorities**
- Investor protection
- Market discipline

**Intermediaries**
- Fixing coupon rates
- A second opinion

## A Catalyst

CariCRIS

A rating agency's role in a developing economy is much wider than in a developed one

⇩

**CariCRIS**
would need to play an important role in strengthening debt markets for its own benefit

⇩

- Providing independent and credible benchmarking and valuation tools
- Engaging in policy level work with local governments, multilateral agencies, central banks, SEC, etc. in areas like infrastructure policy formulation, financial sector regulation
- Imparting training to the various constituents in the market place

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## CariCRIS – Business Ready

CariCRIS

- Company formation
  - Initial equity offering completed successfully ✓
  - Broad-based regional ownership ✓
- Organisation
  - Analysts recruited & trained
  - Rating Committee in place
  - CRISIL : resident technical consultant

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## Our Mission

CariCRIS

To contribute to the development of a vibrant, integrated Caribbean capital market by setting the highest standards of credible independent analysis and opinion to enable informed financial decisions.

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CariCRIS

**THANK YOU**

Caribbean Information & Credit Rating Services Limited

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