

INTERNATIONAL PRACTICES – NOT ALWAYS “BEST” PRACTICES

Since launching its business more than 12 years ago as BankWatch Ratings de Colombia, BRC Investor Service's rating activities have been supported by individuals with long experience in international credit markets. Initially those persons were employees of Thomson BankWatch, the rating company's original strategic partner and co-owner until it was acquired by a competitor. Subsequently, when its ownership was restructured and its name changed to BRC, the non-Colombians actively involved have either been shareholders or other persons that management believes have valuable insights to offer. More recently, BRC has been able to tap into the analytical methods of Moody's Investor Services through a technical service affiliation.

Given that rating activity in Colombia only has a history of some 15 years, compared with almost 100 in the United States and at least 30 in Europe, it is reasonable to think that Colombian rating agency executives and analysts can learn some things from their more experienced international counterparts. For its part, BRC has been proud to claim that from its very beginnings it adopted a number of “best” international practices in its rating activities. These have to do both with rating processes and with analytical methods.

Among the more important “best” international rating processes are those related to rating reviews. With certain limited exceptions, Colombian regulation requires that every rating be formally reviewed once a year. Nonetheless, BRC reviews all its ratings at least semi-annually and most quarterly. In addition, analysts are charged to be alert to developments of any type that might affect the credit quality of their assigned ratings and to initiate an extraordinary review process whenever such an event is observed. However, actual rating changes are point-in-time events; i.e. they can change from one minute to the next. So, given that one of the main purposes of ratings is to serve as a tool for investors and others to fully understand the credit-related risks of transactions they might initiate or have already undertaken, BRC enhances its ratings with two information tools: “CreditWatch” and “Rating Outlooks”. Both of these are meant to advise rating users that particular ratings may be raised or lowered in the foreseeable future depending on the course of events or other factors. The difference between the two tools is a time perspective; “CreditWatch” changes will usually occur in a time frame of six months or less, while “Rating Outlooks” consider the possibilities of changes one to two years ahead.

BRC's analytical methods have also benefited from international experience and perspective. As a “national” credit rating agency, BRC's rating universe primarily includes obligors domiciled in Colombia or doing meaningful business there¹. When peer group comparisons are drawn, it is usually to organizations and entities with a similar Colombian presence. But there is considerable risk of tunnel vision when one's focus is narrow, and since many Colombian financial and real sector businesses have direct or

¹ In contrast to “global” credit rating agencies like Moody's Investors Service and Standard & Poor's, whose rating universe cuts across national borders.

indirect international exposures, “national” rating agencies cannot afford to ignore the larger world. In order to avoid either too narrow or too broad a focus, BRC follows international “best” practice by utilizing detailed templates for each specific type of rating that encourage consistent and cohesive analyses. Among the risk factors analyzed in depth are “industry characteristics and outlook” and “competitive position”, in which international influences weigh importantly wherever relevant.

Also, in accordance with international “best” practice as detailed in the Basel accords, BRC’s credit risk rating system consists of two separate and distinct dimensions. The first considers the risk of borrower default; i.e. the likelihood of default, and the second evaluates transaction-specific risk factors that may impact the degree of loss should there be default.² When BRC makes judgments about the creditworthiness of specific debt issues, the resulting rating is a combination of conclusions about each of the two dimensions. As a result, although the likelihood of default of the obligor may not change, differences in transaction specific risk factors may result in different ratings being assigned to its various debt issues.

The past year has been a very active one for Colombian debt markets, distinguished by a healthy diversity of issuers from the real, financial and public sectors. This positive development is somewhat muted by the market’s continued fixation with issues only rated in the top two categories; i.e. “AAA” and “AA+”. Fortunately, there are some signs that this market-limiting characteristic is moderating. Certainly over time, implementation of new pension investment regulations mandating age and risk appropriate fund offerings should change the investment landscape considerably. In any event, the current situation strongly encourages potential issuers and their investment bankers to propose a variety of issue structures and protective covenants in order to achieve an issue rating that investors will find acceptable. In that regard, it isn’t unusual for BRC to be told it should assign the desired “AAA” or “AA+” rating because the proposed transaction includes terms or conditions that are “internationally accepted” or are “standard practice” for international placements. While, as mentioned earlier, BRC is quick to adopt international practices that make sense, it refuses to do so blindly. It is well known that over the past decade or so there has been a marked weakening of the covenants typically included in investment grade deals sold in the U.S. and Europe. In fact, market observers have coined the term “covenant light” to describe this phenomenon. While this development didn’t cause the crisis in international financial markets that is still playing out, it was certainly symptomatic of the ever-optimistic thinking that fueled the bubble economy.

Another lesson from international practice that Colombian markets could learn from is overuse of “event triggers,” particularly those tied to credit rating changes.³ The widespread risk of both intended and unintended consequences associated with such

² Usually called Loss Given Default or LGD.

³ In these arrangements, a rating reduction below a specified threshold will “trigger” a consequence such as a higher interest rate, funding of a cash reserve, or an acceleration of the debt maturity.

triggers was sorely felt when the Enron scandal unraveled at the end of 2001. International credit agencies subsequently sharply reduced the allowable use of their ratings as triggers, but even today BRC is asked to use its rating for such purposes. In our view, event of default triggers and other protective covenants should be tied to actual company performance, since management can at least reasonably anticipate how it will perform on such tests going forward and can make appropriate business and financial choices or take preventive actions. Allowing one's self to be too dependent on the decisions of an outside force such as a rating agency is not, in BRC's opinion, good financial practice.

As clearly stated in its Code of Corporate Governance, BRC's job is to provide the market with professional opinions about credit risk. To accomplish that purpose, it draws upon all relevant experience. Now, however, having provided credit ratings to a diverse range of issues and issuers in Colombia for over 12 years, BRC believes it has developed a significant skill set that allows it to thoughtfully and selectively take "best" international practice and apply it to the Colombian circumstance.

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