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When Capital Markets Function Well

Portions of the following remarks from Moody's President and CEO, Raymond McDaniel, were provided to delegates of the Moody's & Shanghai Advanced Institute of Finance (SAIF) 2014 Credit Market Research Conference, Shanghai, 17 May 2014

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Welcome to the 2014 Credit Market Research Conference, sponsored by Moody's and SAIF. I'm delighted to be part of an event that is host to such a distinguished group of thought leaders, covering a broad range of issues that are shaping the modern global capital markets. The topics we intend to debate will include bank risk in the Euro Zone, corporate credit risk in China, and the role played by innovative structured financings in the context of overall market-based finance.

Let me state at the outset that our goal for today is not to offer simply a glimpse at one or another feature of the capital markets; but rather, to invite an integrated discussion about issues that can either promote or hinder the growth and development of an economy. Consequently, as each individual topic is considered, I hope you will view it as part of a mosaic that forms a more comprehensive picture of how markets succeed or fail.

Against this backdrop, I would like to begin our discussion by offering three capital-market principles.

» First, capital markets are effective only when they **efficiently** bring together buyers and sellers of debt or equity securities, in order to **suitably** channel the wealth of savers for productive use, for example, by companies or governments making long-term investments.

» Second, the capital market is a **system**. How well – or poorly – each part operates inevitably depends on how the rest of the system is working.

» Third, "credit" – which in its simplest form is the **trust** that enables one party to temporarily provide resources to another – is a crucial ingredient for the overall effectiveness of markets.

Benefits of Well-Functioning Capital Markets

Developed capital markets have sometimes been analogized to the engine of a growing economy. They are good at mobilizing, directing and allocating local and international savings. To be effective, however, capital markets must try and ensure that investors get the best returns, given their specific risk appetites, and that competitive businesses can readily access finance and respond to opportunities. That is to say, they must offer a menu of risk/return options that is both suitable and useful to various types of investors and investments.

It is generally agreed that when capital markets function well, they provide a great number of benefits, some of which include:

» **A safety valve when bank lending is constrained.**

By directing surplus funds to productive opportunities, capital markets can help create a diverse menu of saving and investment options: some at higher risk, some at lower risk, some shorter term, some longer term. As a result, a better-developed market can facilitate direct financial interactions between households, corporations, banks, and governments. This process creates an important safety valve in the system for instances where banks are constrained to lend.

» **A counterpoint to the concentration in financial power sometimes held by the largest banks.**

In many developing countries, banks are the primary source of financing. Excessive reliance on bank finance, however, can create situations in which a potentially small number of decision makers control the allocation of capital.

» **Market discipline regarding capital allocation.**

Economies with sizable capital markets (which are less reliant on banks) benefit from the discipline of market forces on credit decisions and risk assessment, which increases the efficiency of financial intermediation, and may also reduce the likelihood of market distortions.

» **Strong market-based signals.**

The financial system plays an important role in collecting, aggravating and conveying information to savers (with excess resources) to select investment projects. In addition, a more developed system can enable investors to continue to monitor the use of their funds, ensuring that they remain productive. In this process, capital markets can serve a number of functions, including increasing liquidity and deepening the secondary market.

These benefits are essential to the growth of capital, the increase in productivity and the ultimate viability of the markets. Yet, when left to themselves, the financial systems do not always do a very good job in organizing to deliver these benefits.

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Key Ingredients for Establishing Well-Functioning Capital Markets

Public policy has an important role to play in establishing the rule sets that make markets fulfill their functions better – as well as in correcting market failures. Without appropriate government regulations, the sector simply does not function well. There is, however, limited consensus on the appropriate degree and combination of government action that will ultimately create efficient markets.

From our perspective, there are some ingredients that are crucial.

» **Appropriate economic reforms, macro-prudential oversight.**

Aspects of a macroeconomic package may include measures that control inflation, reduce the size of the current account deficit, stabilize output, and promote long-term growth and reinvestments.

» **A sound legal framework.**

Where possible, authorities should endeavor to put in place clear and stable rules that are implemented consistently. A market that runs according to understandable rules and predictable oversight is one in which participants more willingly engage. Areas such as bankruptcy, tax and accounting are of particular relevance.

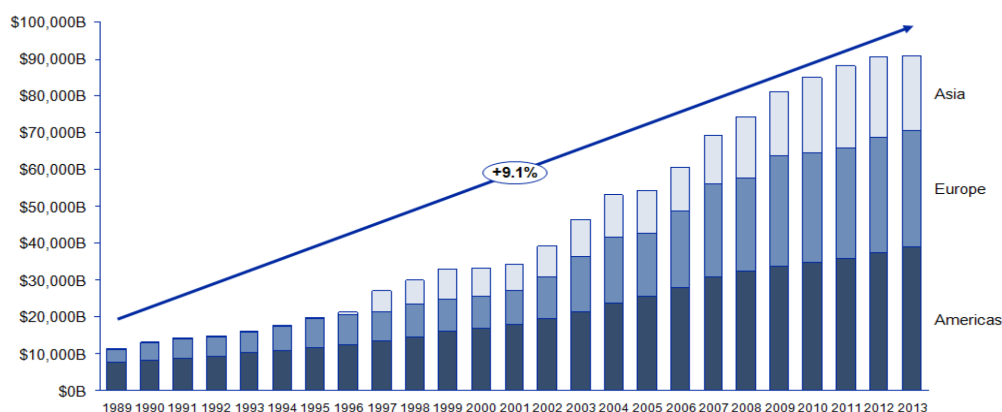
» **Broad availability of information.**

Increasing the availability of information facilitates healthy scrutiny of that information. The more widely available information is, the easier it is for market participants to independently analyze it. Thus, broad public disclosure of information can reinforce confidence in the market's integrity.

The Role of Credit

The credit markets are an integral part of the broader financial markets. They are where participants can issue new debt – the primary market; or buy and sell debt securities – the secondary market. This is usually in the form of bonds, but may also include other forms of securities. Traditionally, the bond market was largely dominated by the United States, but today the US represents approximately 40% of overall global issuance. Initiatives that have made the bond markets a viable source of financing and a destination for investors, therefore, have been impressive.

EXHIBIT 1
Total Debt Securities by Residence of Issuer



Source: BIS

But areas for improvement remain. For example, within emerging market economies, a common theme is the lack of liquidity. Market participants point to the limited diversity in the investor base and the dominance of local institutional investors with buy-and-hold investment strategies. One potential avenue to improve the functioning of local bond markets would be to broaden the investor base. The overall market design concepts discussed earlier can attract and encourage participation by both domestic and foreign investors.

The international credit rating agencies can also play a role in deepening liquidity. By assigning credit ratings on a globally consistent rating scale, Moody's provides a framework under which investors can compare the relative credit risk of debt securities of varying types from different geographies. For example, two credits each rated Baa by Moody's should be of similar risk, and both should be riskier than any single-A credit and less risky than any single-B credit. That should be true if the securities are those of non-financial corporations, financial institutions or public sector entities. It should also be true regardless of the geographic domain of the issuers.

Because international credit rating agencies can provide a globally consistent rating system, they can help bridge the geographical, cultural and language divide so that investors in one country – for example, Brazil – can reference our ratings when comparing and contrasting debt securities issued in a different country – for example, Malaysia. Stated differently, credit ratings are useful tools in promoting secondary market liquidity because ratings are a readily available and globally comparable point of reference that can encourage a deeper understanding of credit risk.

This usefulness only holds, however, so long as ratings are truly unbiased measures of credit risk and do not exhibit any form of preferential treatment to specific classes of issuers, investors, countries or regions.

Are Ratings Geographically Consistent?

One question that has been actively debated over the past several years, and which may be of particular interest to today's discussion, is whether owing to Moody's origins in the United States, our analytical approach, or our deployment of analytical resources may be biased in favor of the US, or English-speaking countries more generally. Given the importance of this question, not only for the legitimacy of our rating system, but more fundamentally for its usefulness as a capital markets tool, we have closely scrutinized the data.

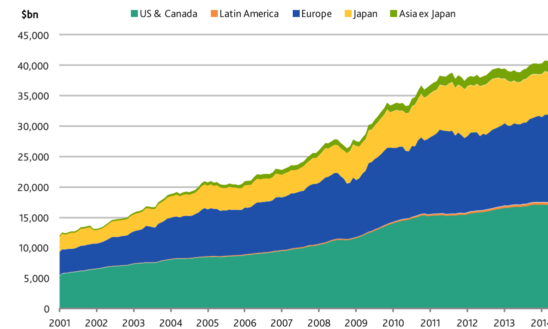
We compared the performance of our ratings in the US to performance in the rest of the world. We also compared the ratings performance of issuers in English-speaking countries to those of non-English-speaking countries. We used both cardinal and ordinal measures of ratings performance and also compared the volatility of Moody's ratings between regions.

The results show that for nearly 30 years, Moody's ratings have behaved consistently across geographic regions. There is no indication that credit ratings are inflated in some regions relative to others, and no evidence that credit ratings are more discriminatory in the US, or among English-speaking countries. In particular, we find that:

- **In step with the expansion of the global credit markets, our non-US ratings have grown rapidly.** Currently, among more than 7,600 rated corporate issuers, a majority are outside the US. We also rate more than 120 sovereigns, a number that has grown three-fold in the last 20 years.

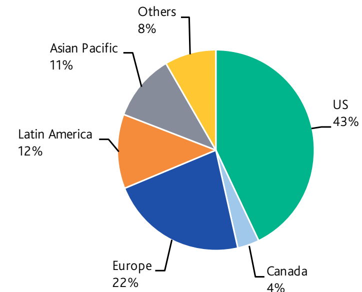
EXHIBIT 2

Global Rated Fixed-Rate Public Market Debt by Region



Source: Barcap Indices

Geographical Distribution of Moody's Ratings on January 2014



Source: Moody's Investors Service

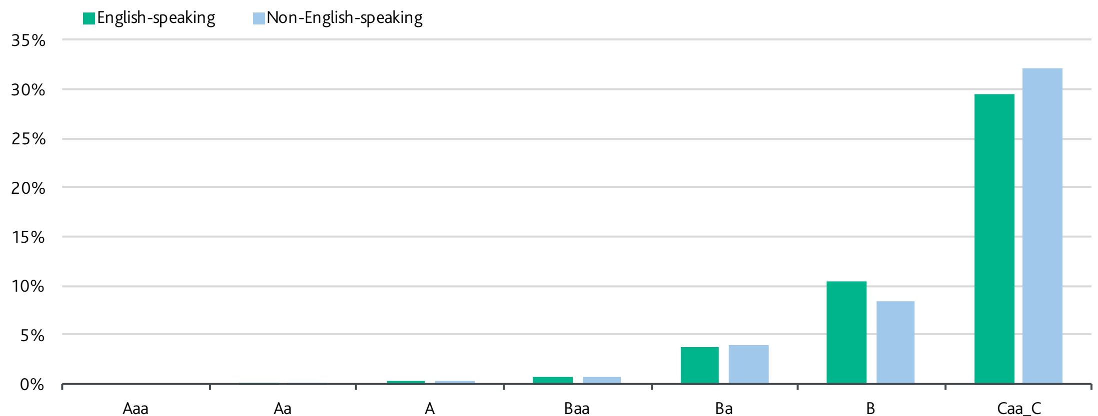
» **US and non-US default rates are comparable.** The long-term default rates by rating category for US and non-US issuers are closely aligned. The default rates are also very similar for issuers in English-speaking and non-English-speaking countries.

» **Ratings volatility is equally low across geographies.** There is no systematic difference in the frequency of our large rating changes across geographies. That result extends to rating transitions across the investment-grade/speculative-grade threshold.

» **Historical rating accuracy, as defined in Moody's published performance studies, is higher for non-US issuers.** Historically, rating accuracy has been somewhat better for non-US issuers compared to US issuers. However, in recent years the accuracy gap between regions has closed.

EXHIBIT 3

Default Rate Comparison

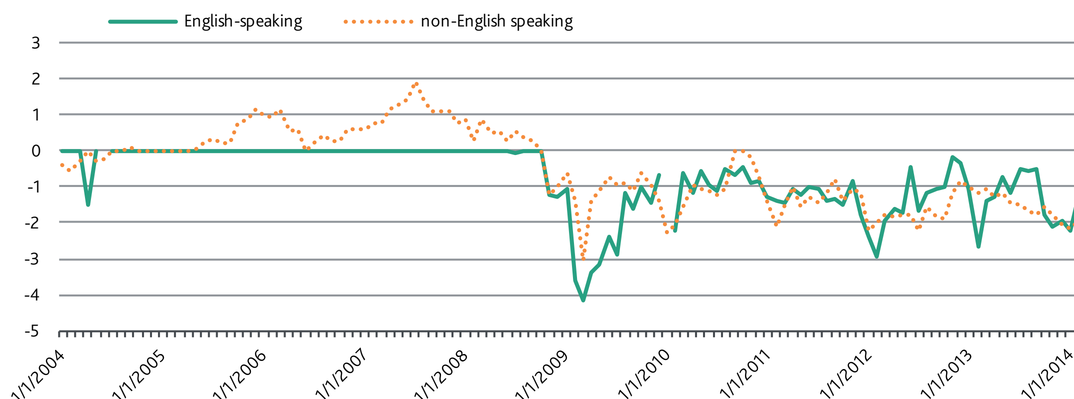


Source: Moody's Investors Service

» **The credit default swap (CDS) market is closely aligned with our assessment of relative sovereign risk.** A comparison of our sovereign ratings with the view of the CDS market shows that historically, the market's ordering of sovereign credit risk has been largely in sync with our ratings. While there has been some divergence between Moody's ratings and CDS pricing since the global financial crisis, the differences in opinion have no clear geographical or cultural component.

EXHIBIT 4[1]

Median Gap Between Moody's and CDS-Implied Ratings for Sovereigns*



Source: Moody's Investors Service & MarkIt

* A negative (positive) gap for a credit indicates that the CDS market-implied rating is lower (higher) than Moody's.

Conclusion

In recent years, the availability of and access to liquidity and capital has been considered one of the main hindrances to growth in many economies. While public policy agendas have focused squarely on growth, the global recovery is still fragile, and despite improved prospects, significant downside risks, both old and new, remain. In this context, getting financial markets to work well becomes increasingly important. They can help foster macroeconomic stability, access to financial services and the overall development of economies.

There are some fundamentals – such as visibility on credit risk – that simply must be 'gotten right' in all capital markets. There are, however, many successful ways of creating the right environment for savers, companies, banks and governments. The critical thing is that all the design features work together.

Here, the public sector has proven to be an effective catalyst. Its actions establish the rules of the system and help solve problems. But once the catalyst role has been played, the public sector should enable the private sector to act so that it can generate wealth and promote development. In this respect, the creation and operation of well-functioning capital markets is a shared responsibility of both the public and private sectors. Both have important, though different, parts to play; but by working effectively together, they can help economies build and grow.

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[1] In Exhibit 4, we plot the time series of the median gap between Moody's ratings and CDS-implied ratings for English-speaking and non-English-speaking sovereigns. A negative (positive) gap indicates that a CDS-implied rating is lower (higher) than the Moody's credit rating. If Moody's is favorably biased towards English-speaking sovereigns, that would manifest itself as a negative median gap. We note that until the mid-2008, our ratings and CDS ratings were typically in agreement for English-speaking countries, with a median gap of 0. The CDS-implied ratings for non-English-speaking sovereigns were more optimistic than our ratings for periods of time. With the onset of the financial crisis in 2008 and the start of the Great Recession, it appears that the CDS market has grown somewhat more pessimistic than we have about all sovereigns. However, we note that the magnitude of the gap between our and CDS-implied ratings is similar for both English-speaking and non-English-speaking sovereigns. This suggests that there is no geographical or cultural component to the difference in our and the market's opinion of sovereign credit risk.

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