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Does Europe Need Its Own Rating Agencies?

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by

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ABSTRACT

Monetary unions generally boost financial markets. But European private capital markets have progressed at an unsatisfactory pace even with the euro. What accounts for this? We focus on an increasingly key financial infrastructure: Rating Agencies (RAs). Taking an international perspective, we show that: (i) financial market development increases with the presence of national RAs; (ii) in four studied Asian countries, smaller-sized companies disproportionately hold a rating from national RAs, while disregarding the global RAs (Moody's, S&P, Fitch). We argue that the absence of European RAs may currently limit the extent of rated companies and financial market evolution in Euroland.

JEL classification codes: G2, G3

Key words: national vs. global credit rating agencies, financial market development.

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Introduction

There are only three traditional Global Rating Agencies (GRAs): Moody's, Standard & Poor's (S&P) and Fitch. Though originated in the USA, in recent years, GRAs have come to play a key role in the functioning of international financial markets. All across the world, their ratings are one of the main worries of sovereigns, municipal authorities, banks and non financial companies. To each of them, any downgrade would negatively impinge on their capitalization and increase financial outlays. GRAs' ratings have even been adopted as the keystone of financial regulation, e.g. they play a part in the regulatory revision, which G-10 countries have recently agreed to introduce by 2008 in terms of banks' minimum capital requirements (Basel 2; BCBS, 1999 and 2000).

Though their activity has proved useful in the evaluation of borrowers' creditworthiness, in many instances the reputation of the GRAs has been put at stake. On one hand, according to many observers – even disregarding the recent accusations relating to the sub-prime crisis – GRAs proved laggard and procyclical during the Asian crisis (IMF, 1999; Bongini, Laeven and Majnoni 2002) and failed to timely predict mega-bankruptcies such as Enron, WorldCom and Parmalat. These errors, the agencies' growing importance, the low degree of competition among them and the absence of outside scrutiny have made the financial community and regulators increasingly nervous in the USA, the biggest market for ratings. This called for more thorough oversight of the agencies. On the other hand, the activity of GRAs in developing countries does not appear as punctual as in developed countries. S&P, Moody's and Fitch were, in fact, so oblivious to Asia's gathering financial problems in the mid-1990s; they made repeated downgrades but only once the problems were widely known. The implication in these cases is that the agencies seem reluctant to face the broader consequences of their decisions. By moving slowly, they may avoid the accusation that their actions might lead to financial turmoil of one kind or another. Rating agencies argue that speed is not their job-only accuracy. Nevertheless, when they promptly move their rating they frequently tend to behave pro-cyclically (Ferri, Liu and Stiglitz, 1999; Bhatia, 2002). In addition, especially in developing countries, the evidence suggests that ratings are excessively tied to sovereign ratings (Ferri, Liu and Majnoni, 2001) and that the information content of the ratings is less accurate with respect to what observed in developed countries (Ferri, 2004; Ferri and Liu, 2003 and 2005). Perhaps the biggest shadow hanging over the rating industry is its perceived lack of competition (Partnoy, 1999; White, 2002). The business functions as an oligopoly or almost so. Upstarts have a hard time breaking in rating markets because it takes years, even decades, to build sufficient reputation.

Ironically, the only power which America's SEC really has over rating agencies is to designate which ones are acceptable – and for three decades that has effectively impeded competition. Plenty of pension funds and other investors stipulate that their bond investments must have a rating from a "Nationally Recognized Statistical Rating Organization", the SEC's designation. The fact that the SEC recently designated four more agencies – Dominion Bond Rating, A.M. Best, R&I and JCR – as "nationally recognized" may be misleading. S&P and Moody's still dominate the market, there and worldwide. The industry remains a duopoly or, at best, an oligopoly in important new areas such as structured finance (i.e., repackaged pools of assets). In such a context, sometimes GRAs try to acquire new markets by issuing unsolicited ratings – based solely on public information – but such practice is perceived as "an extortion" by issuers who are forced to pay to obtain a more accurate rating based not only on public information.

Another problem to deal with is that there is little price competition among agencies. And yet the rating agencies share some of the problems of the analysts. The most obvious is

conflicts of interest. Not only are they beholden for their fees to companies whose securities they rate; they often sell the same clients a parcel of advisory services. Just as for audit firms, which did likewise until Sarbanes-Oxley prevented them, the temptation is to keep up ratings in return.

In spite of these unsatisfactory aspects of the rating industry is essential to improve financial markets. Rating agencies' activity is precious to reduce information asymmetries. Collecting information is expensive, and rating agencies are able to re-organize information in an efficient way. Thus, an improvement in rating agencies functioning could have far reaching positive effects. In this context, we must evaluate whether countries contemplating a faster development of their financial markets should rely only on GRAs or whether they can also benefit from having national rating agencies (NRAs), independent from the "big three". The solution is not obvious. For example, Europe and Asia have a different track record in this respect: the few NRAs started in Europe were soon acquired by GRAs, while Asia still holds on to several independent NRAs, though none of them covers the whole of Asia.

But why some issuers should prefer obtaining a rating from NRAs rather than from GRAs? On one hand, NRAs could have a comparative advantage in accessing more appropriate knowledge of the local environment in which issuers operate and also NRAs could have more incentives to deal with local entities. Also, as cursory evidence suggests, NRA ratings might be supplied at lower fees. On the other hand, NRAs could be less independent than GRAs, being the former more subject to influence by national issuers. Instead GRAs tend to apply the same standardized methodology in attributing ratings, regardless the environment in which firms operate. Thus, GRA ratings could be more informative and valuable for investors. In all, companies might face a trade-off between obtaining a less costly – but possibly less valuable – rating from NRAs or opting for a higher-reputation – but more costly – GRA rating. Following this reasoning, companies would select GRAs or NRAs depending on their objectives. Larger/global companies interested in gaining international recognition and aiming at paving the global financial market might be willing to pay more to obtain GRA ratings. On the contrary, smaller/domestic-focused firms might lean on NRAs. As a result, rather than fierce competition we might expect a division of labor to prevail with GRAs focusing on the former companies and NRAs concentrating on the latter ones.

Indeed, the presence of both NRAs and GRAs could improve the rating market by enlarging the number of rated companies and, as consequence, boosting financial market development.

According to the argument above, the fact that Europe lacks its NRAs may help explain why the progress of private securities markets in Euroland after the Monetary Union has been lower than expected (Hartmann et al. 2003; Cappiello et al. 2006). Europe features, in fact, so many unrated domestic-focused/small-sized companies probably interested in NRAs – where available – which could so become potential issuers. Thus, the question whether Europe would stand to benefit from having its own NRAs is a cogent policy issue, more so now that Basel 2 appears to offer an important window of opportunity for new actors to enter this business.

Our paper tries to make two contributions to this debate by shedding light on some of the key hypotheses put forward above. Our starting point is testing whether countries endowed with NRAs enjoy deeper financial markets. As we will state, even a positive result of this test should be interpreted with caution, since what appears a causal link between NRAs and financial market development might depend on omitted third factor. This is the reason why we use an instrumental variable approach to check whether the NRA impact is robust. The

second contribution of our paper consists in studying Asia where the contemporaneous presence of NRAs and GRAs allows us to tell apart whether the two types of rating agencies do specialize in different clientele. To this end, in particular, it will be interesting to verify whether there is evidence that NRAs specialize in issuing ratings to smaller/domestic-focused entities.

In the remainder of the paper, Section 2 provides some detail on the structure of the rating industry. We then turn to test whether the presence of NRAs associates with more developed financial markets (Section 3). Section 4 is devoted to shed light on the hypothesized division of labor between GRAs and NRAs. We accomplish this based on evidence from Asia, the region of the world where a significant number of NRAs do business alongside with GRAs. Section 5 recapitulates our main results and discusses their policy implications.
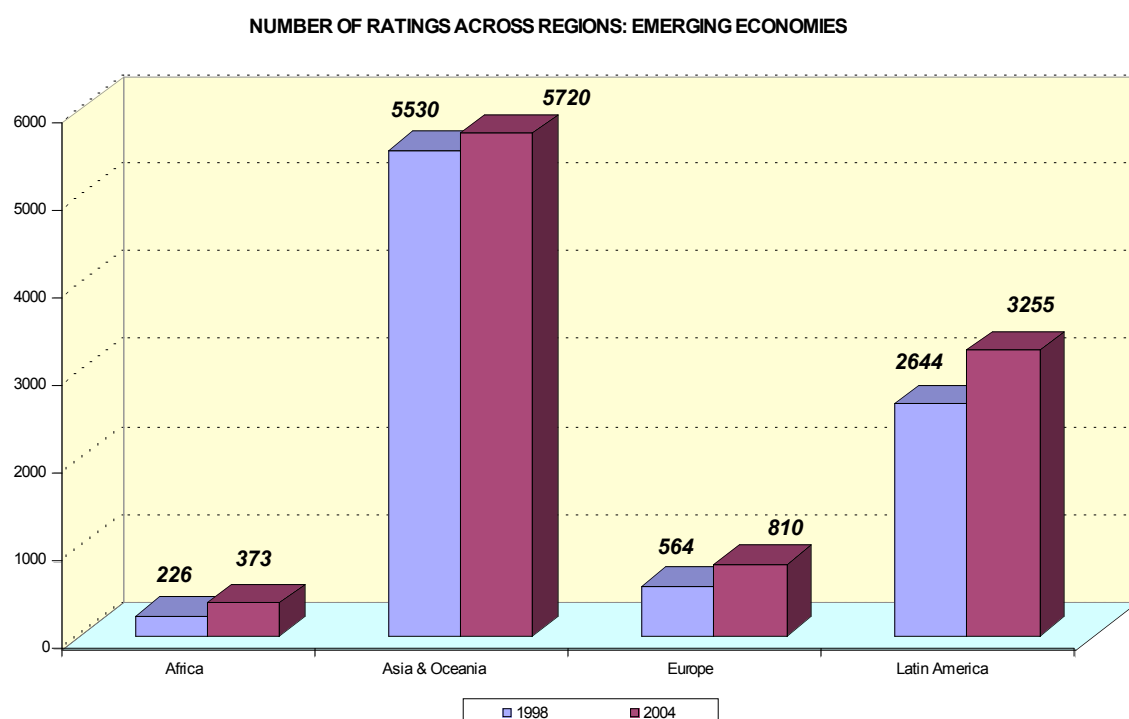

NUMBER OF RATINGS ACROSS REGIONS: EMERGING ECONOMIES

Figure 1 Source: Our calculations on Financial Times Interactive data for Winter 1998-99 and Winter 2004.

1. The Structure of the Rating Agency Industry With a Focus on Asia

The rating industry has a very peculiar structure; it is characterized by the presence of three big-global players (the global rating agencies; GRAs): Moody's, Standard and Poor's (S&P) and Fitch-IBCA.[2] The rating activity originated in 1909 when John Moody's issued its first rating and since then it has expanded all over the world. GRAs have acquired a consistent coverage and market power: their ratings are perceived as the most reliable and accurate opinion on issuers and financial instruments. Though rating banks is also important, the bulk of GRAs' business is in rating corporates and structured finance, GRAs' business is for

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[2] The US Department of Justice labeled Moody's and S&P as "*partner monopoly*", Fitch and DCR as distanced followers. Consistently with this, Norden and Weber (2004) find that reviews for downgrade by S&P and Moody's have the largest impact on credit default swaps and shares.

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almost ¾ US based with bank ratings more geographically widespread. In addition, various mergers and acquisitions by GRAs of other small local rating agencies has increased the industry concentration (e.g., in 2000 Fitch bought DCR and Thomson BankWatch). GRAs' coverage differs across the various regions of the world. Outside the US, GRAs' penetration is highest in Europe, smallest in Asia, intermediate in Latin America and Africa. But, conversely to market coverage, the number of ratings is much larger in Asia (and Latin America), where GRAs' penetration is lower, than in Europe (Figure 1).

This is because, Asia can rely upon several national rating agencies (NRAs), which – as we will argue – could represent a valuable opportunity to boost financial markets (Figure 2). NRAs' coverage is most significant in Japan, South Korea, Malaysia and India. In such countries NRAs' activity is considerable.[3]

MARKET SHARE (%) OF NATIONAL RAs
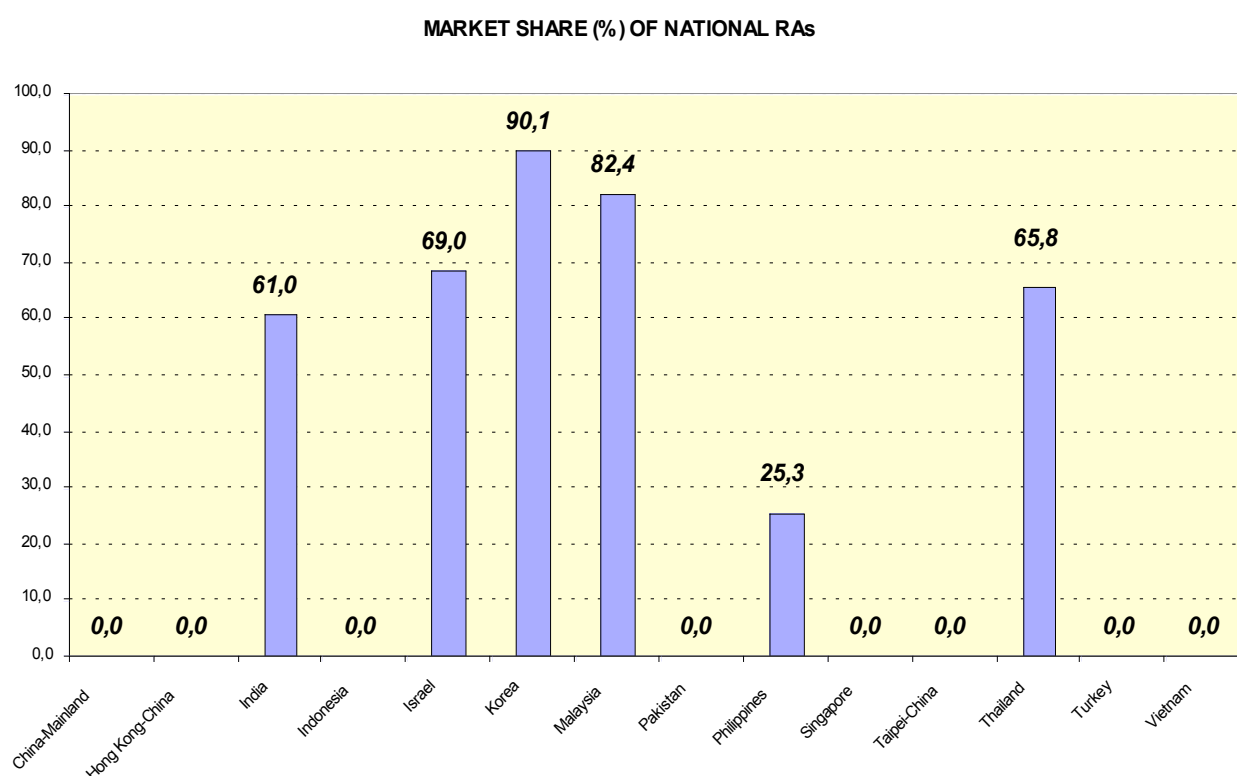
Figure 2 Source: Our calculations on Financial Times Interactive data for Winter 2004

In particular, Japan has three rating agencies: two of them are relatively well structured (Japan Credit Rating Agency, JCR; and Japan Rating and Investment Information, R&I) and a third one is less structured (Mikuni). South Korea features four NRAs, beside the activity performed there by JCR and R&I: Korea Investment Service (KIS), Korea Rating (KR), National Information and Credit Evaluation (NICE) and AM Best. Malaysia has two NRAs: Malaysian Rating Corporation Berhad (MARC) and Rating Agency Malaysia (RAM). In India there are three NRAs: Investment Information and Credit Rating Agency (ICRA), Credit Rating Information Services of India (CRISIL) and Credit Analysis & Research (CARE). None of these several Asian NRAs, yet, can be considered regional because their business is

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[3] See also Ferri, Kang and Lee (2006).

mostly tied to their nation of origin (only JCR and R&I have some non trivial business out of their nation of origin).

Though, these NRAs originated recently (none of them was established before 1985), in these countries they issue numerous ratings compared to GRAs (Figure 3) and they are very active also in revising previously issued credit rating.
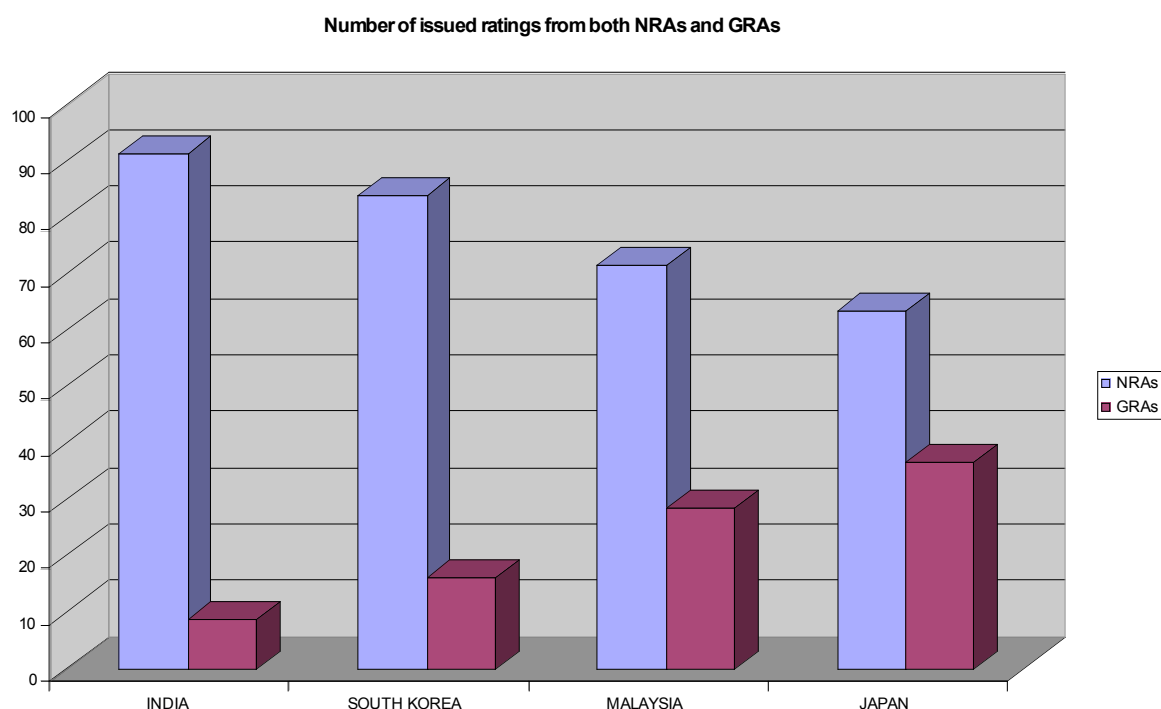
Number of issued ratings from both NRAs and GRAs

Figure 3 Source: Our calculations on Bloomberg data for 2004.

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Differently from the US tradition, NRAs in Japan originated with a strong support from regulation. Ratings were a necessary tool to obtain regulatory approval to issue bonds. After 1985, many Japan corporate bonds were required to have a minimum credit rating in order for the issue to be approved. While this requirement was abolished in January 1996, other regulatory obligations remained tied to credit rating.

Some of the Asian NRAs are owned, at least in part, by consortia of financial institutions (e.g. ICRA is mainly owned by Indian banks; RAM is owned by 49 financial institutions) which may receive credit ratings of their own from the controlled NRA and may also have important business relationships with borrowers that receive ratings from the controlled NRA in turn. This ownership structure – probably stemming from the need to rely on private sector assistance in developing credit analysis – poses potential conflicts of interests, which should require greater efforts to ensure the integrity of the rating process.

Based on the scant literature addressing this issue, the growing coverage of NRAs seems a positive signal because the market seems to take into account both NRA and GRA ratings when pricing securities. For instance, Packer (2000) shows that a combination of NRA and GRA ratings predicts spreads on securities secondary market trading more accurately than any of the two classes taken separately. JCIF (2001) survey finds that, in the opinion of Japanese corporations, NRAs do not differ from GRAs in terms of market influence and recognition

but NRAs get a strong minus as regards global activity while they are reputed somewhat better than GRAs in terms of: (i) placing more importance on factors relating to Japanese business practice (industrial specialization); (ii) providing more persuasive reasons as to the level of the assigned rating and/or of the subsequent changes (rating fairness)[4] (Figure 4).

5 Factors Viewed As Most Important (in %) In Selecting Rating Agency (average; data for 2001)
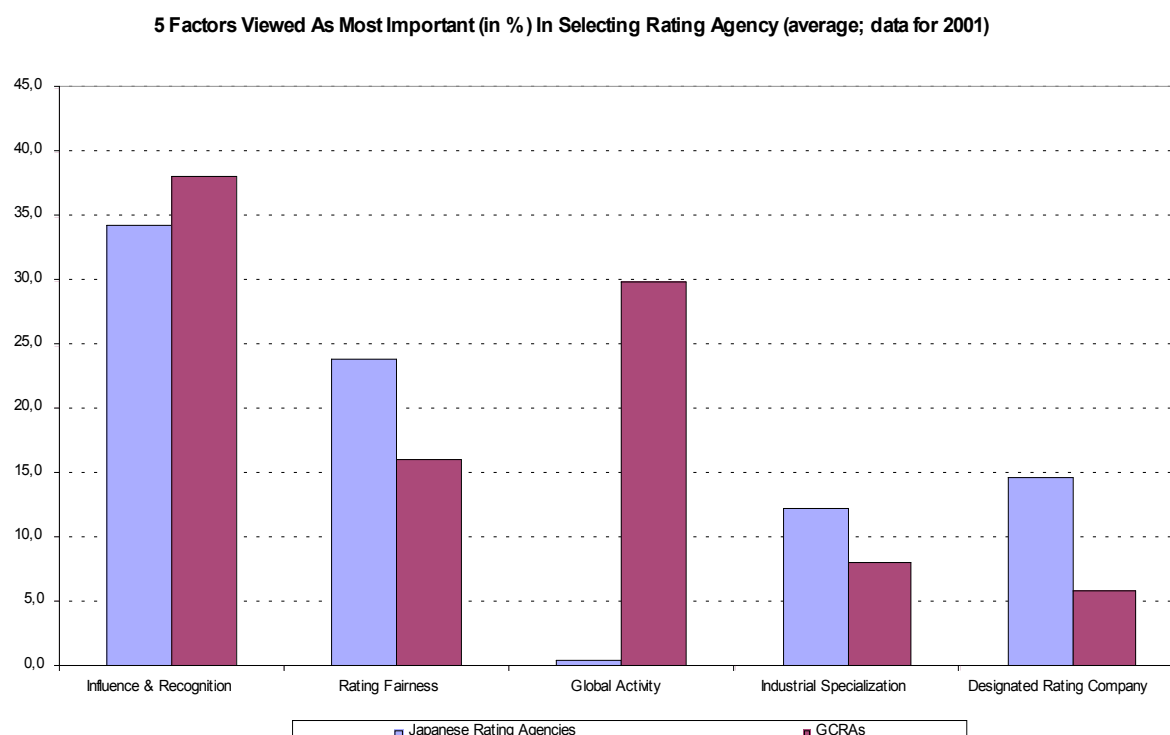

Figure 4 Source: Our calculations on JCIF (2001).

Thus, issuers may benefit obtaining ratings both from GRAs and from NRAs. Possibly, NRAs' judgment on issuer reliability places a larger weight on the local environment and business practice, which depends on idiosyncratic aspects of the specific country. On the contrary, GRAs may be keener to use standardized rating criteria for all issuers in the world, regardless of local business practice, and this could sometimes deliver an under-estimation of issuers' creditworthiness.[5] Indeed, studying the case of Japan, Packer (2000) documents that the ratings assigned by NRAs are, on average, 3.5 notches higher than GRA ones. However, he also shows that, this notwithstanding, NRA ratings are more related to rated companies' financial ratios than GRA ratings. By the same token, running an event study on the stock

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[4] There is a third aspect where NRAs outperform GRAs according to the JCIF survey: the fact that they are designated rating agencies. Of course, this has to do with institutional decisions and not with economic efficiency.

[5] A remarkable example that it may take an extra effort for GRAs to capture local business practice is offered by Yamaoka and Fukutomi (2003). These two S&P analysts show that, at some point, S&P started factoring loan waivers in its ratings assigned to Japanese corporations. The study concludes that the loan waiver practice should remain popular in Japan in the near future. One may observe that loan waivers in Japan depend – to a large extent – on the role of the main bank, which, in case of distress of a related company, will choose to suffer haircuts on its own loans and keep the company's debt payments to third parties going as scheduled, rather than loosing its face. Thus, it seems that the loan waiver business practice was at work in Japan well before S&P accounted for it in its corporate ratings. This exemplifies two aspects. On the negative, GRAs ratings may be biased as they do not give enough weight to local business practice. On the positive, over time also GRAs can have the incentive/ability to tailor their ratings to the specificities of the country.

market impact of rating changes in Japan, Lacitignola (2007) finds that the impact is generally larger for rating changes enacted by NRAs vis-à-vis those enacted by GRAs.[6]

To conclude, the evidence discussed in this Section supports the hypothesis that both NRAs and GRAs give a value added with their ratings. Since GRAs operate (virtually) everywhere in the world while only some countries have their NRAs, we can thus imagine that financial markets could grow more in the countries enjoying the presence of both types of rating agencies. Now we turn to test this hypothesis.

2. Presence of National Rating Agencies and Financial Market Development

In this Section we analyze the possible effects deriving from the presence of national rating agencies (NRAs) on the development of financial markets. To control for whether the presence of NRAs is just proxying for some other factor, we instrument the NRA variable using an index of the quality of information and other variables relating to the functioning of financial markets. , so to disentangle whether the presence of NRAs is just proxying for better information quality or whether it has an independent effect – by expanding the number of rated entities, we argue – on financial market development. Should the impact of the NRAs survive after instrumenting, this would suggest some causal link might be at work.

We base our analysis on the approach proposed in the widely cited papers by La Porta et al. (1997 and 1998). As a proxy for financial market development we use two different dependent variables: (i) the ratio of stock market capitalization to GNP in 1994 scaled by a rough measure of the fraction of the stock market held by outside investor (EXTKGNP), in this we just replicate La Porta et al.'s key regression by adding additional explanatory variables; (ii) the ratio of private bonds/GDP (PB/GDP), to capture an additional dimension of financial market development not studied by La Porta et al., which is potentially affected even more by the availability of credit ratings. Indeed, the agencies specialize in debt issues and the impact of rating changes is larger/more common for bonds rather than stocks (Holthausen and Leftwich, 1992; Kliger and Sarig, 2000; Gropp and Richard, 2001; Steiner and Heinke, 2001). As independent variables we use the GDP growth (GDPGR), the rule of law (RLAW), the presence of national rating agencies (NRA) for which we focus on the sub-classification of the significant and old rating agencies (SONRA), i.e. those rating agencies that were established early on (OLDNRA) – by 1990 four years before the year in which EXTKGNP was measured by La Porta et al. – and show significant activity. In addition, we consider dummy variables which indicate the type of legal system of countries; La Porta et al. (1997) find that such variables influence the development of financial markets. Such variables are FRELO for the French civil law countries, GERLO for German civil law countries and SCALO for the Scandinavian countries, while ENGLO – for common law countries – will be the omitted dummy in our regressions. Variables are summarized in Table 1. The countries

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[6] Li, Shin and Moore (2006) reach opposite conclusions. They evaluate the effect of rating changes by Moody's, S&P, R&I and JCR on the Japanese stock market with a sample period from the 1990s through early 2003. They find that the GRAs' rating changes are more influential than the NRAs for rating downgrades and that, consistently with previous research, upgrades are benign events and this holds true for GRAs as well as NRAs. While such different results could be due to various factors – e.g. the fact that Lacitignola disregards financial firms, while Li et al. (2006) do; the fact that Lacitignola's sample is 2 years longer that that used by Li et al. (2006); the fact that Lacitignola's market model is built on industry market returns rather than on average stock market returns as in Li et al. (2006) – it is worth noticing that Li et al. (2006) present results only up to an unusually short t+3 window while, according to Lacitignola (2007) the most noticeable differences between GRAs and NRAs materialize only over a longer time window.

considered are 49.[7] Table 2 offers some descriptive statistics on the variables. Regression results are presented in Tables 3 and 4.

Table 1. Definition and Description of the Variables

Variable	Description
EXTKGNP	Ratio of the stock market capitalization held by minorities to gross national product for 1994 (source: La Porta et al., 1997)
GDPGR	Average annual percent growth of per capita gross domestic product for the period 1970-1993. Source: *World Development Report* 1995 (from: La Porta et al., 1997)
LGNP	Log of GNP (from: La Porta et al., 1997)
RLAW	Assessment of the law and order tradition in the country. Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores for less tradition for law and order. Source: International Country Risk Guide (from: La Porta et al., 1997)
NRA	National Rating Agencies, this variable considers Moody's, S&P and Fitch for the USA and all the other rating agencies for the other countries. This dummy takes value 1 for: Argentina, Chile, India, Israel, Japan, Malaysia, Pakistan, Peru, Philippines, Portugal, South Africa, South Korea, Taiwan, Thailand, USA. (source: our calculations on Financial Times Interactive)
OLDNRA	Old NRA (established by 1990). This excludes from NRA the following countries (for which we report in parenthesis the year of establishment of their NRA) Argentina (1992), Israel (1992), Pakistan (1994), Peru (certainly after 1992, year of establishment of the Argentinian nother company), Taiwan (1998), Thailand (1993).
SONRA	Significant OLDNRA. This captures the countries which satisfy OLDNRAs and whose NRAs have significant activity. This excludes from OLDNRA two countries: Philippines (whose NRA had only 51 issue ratings in Winter 1988-89, the oldest information we could recover from Financial Times Interactive) and Portugal (whose NRA had only 13 issue ratings in Winter 1988-89, the oldest information we could recover from Financial Times Interactive).
FRELO	French civil law countries (from: La Porta et al., 1997)
GERLO	German civil law countries (from: La Porta et al., 1997)
SCALO	Scandinavian countries (source: La Porta et al., 1997)
ANTIDR	An index aggregating shareholder rights. The index is formed by adding 1 when: (1) the country allows shareholders to mail their proxy vote; (2) shareholders are not required to deposit their shares prior to the General Shareholders' Meeting; (3) cumulative voting is allowed; (4) an oppressed minorities mechanism is in place; or (5) when the minimum percentage of share capital that entitles a shareholder to call for an Extraordinary Shareholders' Meeting is less than or equal to 10% (the sample median). The index ranges from 0 to 5. Source: Company Law or Commercial Code (from: La Porta et al., 1997).
ONESHV	Equals one if the Company Law or Commercial Code of the country requires that ordinary shares carry one vote per share, and 0 otherwise. Equivalently, this variable equals one when the law prohibits the existence of both multiple-voting and non-voting ordinary shares and does not allow firms to set a maximum number of votes per shareholder irrespective of the number of shares she owns, and 0 otherwise. (Source: Company Law or Commercial Code (from: La Porta et al., 1997).
DFIRM	Ratio of the number of domestic firms listed in a given country to its population (in millions) in 1984 (from: La Porta et al., 1997).
CREDR	An index aggregating creditor rights. The index is formed by adding 1 when: (1) the country imposes restrictions, such as creditors' consent or minimum dividends, to file for reorganization; (2) secured creditors are able to gain possession of their security once the reorganization has been approved (no automatic stay); (3) the debtor does not retain the administration of its property pending the resolution of the reorganization; (4) secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm. The index ranges from 0 to 4. (from: La Porta et al., 1997).
PB/GDP	Ratio of private bonds issued in the country to GDP (source: Chan-Lee & Ahn, 2001)
QOI	information quality of national financial systems (source: Chan-Lee & Ahn, 2001)

Focusing on stock market capitalization, we adopt the preferred specification estimated by La Porta et al. (1997), where the pivotal role is played by the One-Share-One-Vote variable. Furthermore, we consider two additional estimates beside the original one by La Porta et al..

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[7] Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, Colombia, Denmark, Egypt, Finland, France, Germany, Greece, Hong Kong, India, Indonesia, Ireland, Israel, Italy, Japan, Malaysia, Mexico, Netherlands, New Zealand, Nigeria, Norway, Pakistan, Peru, Philippines, Portugal, Singapore, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Taiwan, Turkey, UK, USA, Venezuela, Zimbabwe.

The first one includes the dummy SONRA, capturing the possible effects for countries having old NRAs with a considerable activity. Finally, we re-estimate this last regression by means of the instrumental variables approach. This is done in order to address the potential endogeneity between SONRA and the dependent variable. In other words, one cannot exclude that an omitted variable – e.g. early financial market reform – causes both the early establishment of an NRA and also a high value of the dependent variable capturing financial market development. Here, we use as instruments QOI – the quality of information variable derived from Chan Lee and Ahn (2001) – DFIRM – the ratio of the number of domestic firms listed in a given country to its population derived from La Porta et al. (1997) – and CREDR – the index aggregating creditor rights also derived from La Porta et al. (1997).

Table 2. Basic Descriptive Statistics

Variable	Mean	Median	Min	Max
EXTKGNP	0.3960	0.2500	0.0600	1.4800
GDPGR	3.7876	3.2700	0.3000	11.5600
LGNP	11.7255	11.6800	8.4900	15.6700
RLAW	6.8465	6.7800	1.9000	10.0000
NRA	0.3061	0.0000	0.0000	1.0000
OLDNRA	0.1837	0.0000	0.0000	1.0000
SONRA	0.1429	0.0000	0.0000	1.0000
FRELO	0.4286	0.0000	0.0000	1.0000
GERLO	0.1224	0.0000	0.0000	1.0000
SCALO	0.0816	0.0000	0.0000	1.0000
ANTIDR	2.4286	2.0000	0.0000	5.0000
ONESHV	0.2041	0.0000	0.0000	1.0000
DFIRM	2.1405	1.3180	1.1500	12.760
CREDR	2.2978	2.0000	0.0000	4.0000
PB/GDP	0.1693	0.0870	0.0000	1.0590
QOI	4.8971	5.0695	0.9280	9.5778

We do not comment the results of column 1 which is the same as in La Porta et al. (1997).

GDP growth is significant in 3.1 and 3.2 but not in 3.3. Our results in 3.3 (but not in 3.1 and 3.2) confirm the expectation that the presence of NRAs associates with deeper stock markets: SONRA is positive and significant at the 10% level while the R^2 decreases considerably (Table 3). The R^2 for the OLS model is much higher than that for the instrumented model but this is due to endogenous matter. Besides, the Rule of Law variable is always significant and the One-Share-One-Vote variable is barely significant at the 10% level in 3.1 and 3.2 but not in 3.3. Hansen's J overidentification test confirms that SONRA may be treated as endogenous in the estimate, while the F test rejects the hypothesis that the instruments are jointly significant in explaining SONRA. Thus, after controlling for the correlation of SONRA with errors we find that the development of rating agencies with the rule of law variable are able to explain the development of stock markets.

Table 3
External Market Capitalization of Equity/GNP Regressions

Ordinary least squares regressions of the cross-section of 49 countries around the world- The dependent variable is "External Cap.". The independent variables are (1) GDP Growth; (2) Log GNP; (3) Rule of law; (4) French origin; (5) German origin; (6) Scandinavian origin; (7) Antidirector Rights; (8) One-share=One-vote; (9) Significant Old Rating Agencies. T-stats are shown in parentheses. * stands for 10% significance level, ** stands for 5% significance level,*** 1% significance level.

Independent Variables	Dep.var.:External Cap/GNP		
	Sp. 3.1	*Sp. 3.2*	*Sp. 3.3*
GDP Growth	.0529***	.0463*	.0222
	(2.15)	(1.98)	(0.52)
Log GNP	.0034	-.0222	-.1166
	(0.10)	(-0.53)	(-1.31)
Rule of law	.0438***	.0527**	.0853**
	(2.35)	(2.71)	(2.06)
French origin	-.3415*	-.2849***	-.0722
	(-3.72)	(-2.96)	(-0.34)
German origin	-.3520***	-.3339*	-.2646
	(-2.11)	(-1.91)	(-1.01)
Scandinavian origin	-.2901***	-.2816*	-.2567
	(-2.22)	(-2.02)	(-1.37)
Antidirector rights			
One share = one-vote	.3731*	.2885*	-.0167
	(3.10)	(1.98)	(-0.06)
Significant & Old National Rating Agencies		.2562	1.1616*
		(1.38)	(1.91)
Intercept	-0.0202	0.2012	1.0239
	(-0.06)	(0.49)	(1.30)
Observations	45	45	44
Adjusted R²	0.5401	0.5815	0.533
F test for joint insignificance		5.84***	3.08***
Hansen J overidentification test instruments			4.494
F test for instruments			0.20

Now we move to the second equation on the determinants of private bond issuance, we adopt also here the specification estimated by La Porta et al. (1997) and we include as independent variable also SONRA, as already done before. We firstly estimate the 4.1 equation without the inclusion of SONRA, then we take into account the impact of SONRA on private bond issuance (4.2); finally we estimate the equation 4.3 where SONRA is instrumented in the same way as above to control for it being endogenously determined.

Specifically, it turns out that the GDP Growth variable is significant in 4.2 and 4.3 (whenever we include SONRA) and – something not really intuitive – bears a negative sign (Table 4). Both Log GNP and Rule of Law have the expected positive sign and are significant (even though log GNP is not significant in 4.3). Interestingly, we record some visible change in the legal origin variables. The French origin dummy is no longer significant but the German origin and the Scandinavian origin dummies turn positive and are weakly significant. The variable One-Share-One-Vote is no longer significant. Whenever included in the estimation, SONRA is highly significant (1%) and still remains highly significant in the instrumented estimation (5%). Hansen's J overidentification test confirms that SONRA may be treated as endogenous in the estimate, while the F test rejects the hypothesis that the instruments are jointly significant in explaining SONRA. Thus, it turns out that NRAs bestow large effects on the development of national private bond markets. Indeed, it seems that ratings contribute even more in private bond markets development than in the development of

stock markets. However, we cannot drastically conclude in this way because may be that the problem is in choice of an adequate measure of the development of financial markets.

Incidentally, this evidence suggests that the determinants of financial market development may change depending on whether we measure this development on the stock market or on the private bond market. Thus, further thoughts should be given to whether measuring financial market development exclusively in terms of stock market is appropriate.

Table 4
Private Bonds/GDP Regressions

Ordinary least squares regressions of the cross-section of 49 countries around the world- The dependent variable is "PB/GDP". The independent variables are (1) GDP Growth; (2) Log GNP; (3) Rule of law; (4) French origin; (5) German origin; (6) Scandinavian origin; (7) Antidirector Rights; (8) One-share=One-vote; (9) Significant Old Rating Agencies. Standard errors are shown in parentheses. * stands for 10% significance level, ** stands for 5% significance level,*** 1% significance level.

Independent Variables	Dep.var.:PB/GDP		
	Sp. 4.1	*Sp. 4.2*	*Sp. 4.3*
GDP Growth	-1.6052	-2.0971**	-3.1414**
	(-1.52)	(-2.38)	(-2.51)
Log GNP	4.4613**	2.8858**	-.5149
	(2.72)	(2.22)	(-0.17)
Rule of law	2.0232*	2.6650**	3.8779**
	(1.95)	(2.57)	(2.32)
French origin	-1.0910	2.9220	11.3716
	(-0.23)	(0.76)	(1.41)
German origin	12.7182	13.5761*	16.2683*
	(1.62)	(1.94)	(1.80)
Scandinavian origin	31.1575	32.1905*	33.4861*
	(1.65)	(1.70)	(1.76)
Antidirector rights			
One share = one-vote	4.1410	-1.8259	-13.3269
	(0.68)	(-0.40)	(-1.23)
Significant Old Rating Agencies		19.9000***	55.3193**
		(3.13)	(2.31)
Intercept	-48.1702**	-35.8232***	-6.5600
	(-3.09)	(-2.86)	(-0.24)
Observations	48	48	46
Adjusted R^2	0.5609	0.6253	0.4213
F test for joint insignificance	9.16***	8.24***	6.65***
Hansen J overidentification test instruments			1.892
F test for instruments			0.20

3. The Business Specificity of National Rating Agencies: Evidence From Asia

The evidence above suggests that National Rating Agencies (NRAs) may be an important factor to promote financial market development. The basic intuition behind this runs as follows. Financial markets will develop more strongly if, ceteris paribus, a country increases the number of rated companies. The availability of more rated companies will, in fact, improve the information available to intermediaries and investors. In turn, market failures depending on information asymmetries will be reduced and financial markets will be boosted by expanding both demand and supply. Indeed, nourishing NRAs can be key to increasing the number of rated companies in the country. This is because the presence in the country of the three big players (Moody's, S&P, Fitch, the global rating agencies; GRAs) may be not

enough. By and large, the GRAs tend to specialize in the top rank of companies, i.e. the country's companies which are larger/more internationalized. In part, this depends on demand: larger/more internationalized companies are more inclined to get a rating from the GRAs as this rating will be more reputed in the international financial markets, where they may wish to issue debt. For another part, however, GRAs may chose to rate larger/more internationalized companies because these are the typical companies they do business with all over the world. By the same token, NRAs are likely more cost effective – and charge lower fees – at rating smaller/less internationalized companies, whose assessment depends more on getting local – often soft – information and understanding the local business practice. All in all, it appears that GRAs might have a comparative advantage in rating larger/more internationalized companies while NRAs might have a comparative advantage in rating smaller/less internationalized companies. This configures the possibility that GRAs and NRAs, rather than engaging in fierce competition across the board, might largely be complementary and specialize in different clientele. If so, a country lacking NRAs will have fewer rated companies and, consequently, less developed financial markets.

While the econometric evidence in Section 3 is supportive of this argument, it is now time to verify whether, in fact, NRAs are more specialized in domestic-focused corporations. We investigate this hypothesis using rating data[8] for Japan, South Korea, India and Malaysia for non financial corporations only.[9] As already mentioned, we focus on Asia because this is the area of the world where the presence of NRAs is largest and this allows identifying any NRAs' company specialization pattern. We consider all issuers obtaining a rating either from GRAs or from NRAs or from both. In addition, we consider issuers' size along with as a proxy of their degree of internationalization. if they have shares are quoted in other market other than their domestic market (this is a proxy for internationalization). We measure issuers' size as the mean total asset in 2002. As a proxy for a company's degree of internationalization we distinguish whether a company is listed in a foreign stock market, beside being listed on its own domestic market. Naturally, one could think of many alternative ways to capture internationalization but our proxy is particularly valuable to convey that form of internationalization which could make GRA ratings more appealing. A firm which is also listed abroad is, in fact, the best potential candidate to issue securities in the international market and, as such, the most interested in obtaining a GRA rating, well recognized by global investors.

Among the companies obtaining a rating (also) from GRAs the share of companies listed also internationally is significantly larger than among companies receiving a rating only from NRAs. In India and Malaysia this share is 100.0% for the former group and, respectively, 69.1 and 77.4 for the latter group (Figure 5). The two figures for Japan are, respectively, 94.6 and 69.3%. only in the case of Korea we find the opposite: respectively, 48.3 and 65.2%.

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[8] Source: Bloomberg data base.
[9] In further work we intend analyze the impact of financial ratios on credit ratings and financial ratios of financial firms have a particular structure that needs to be controlled for.
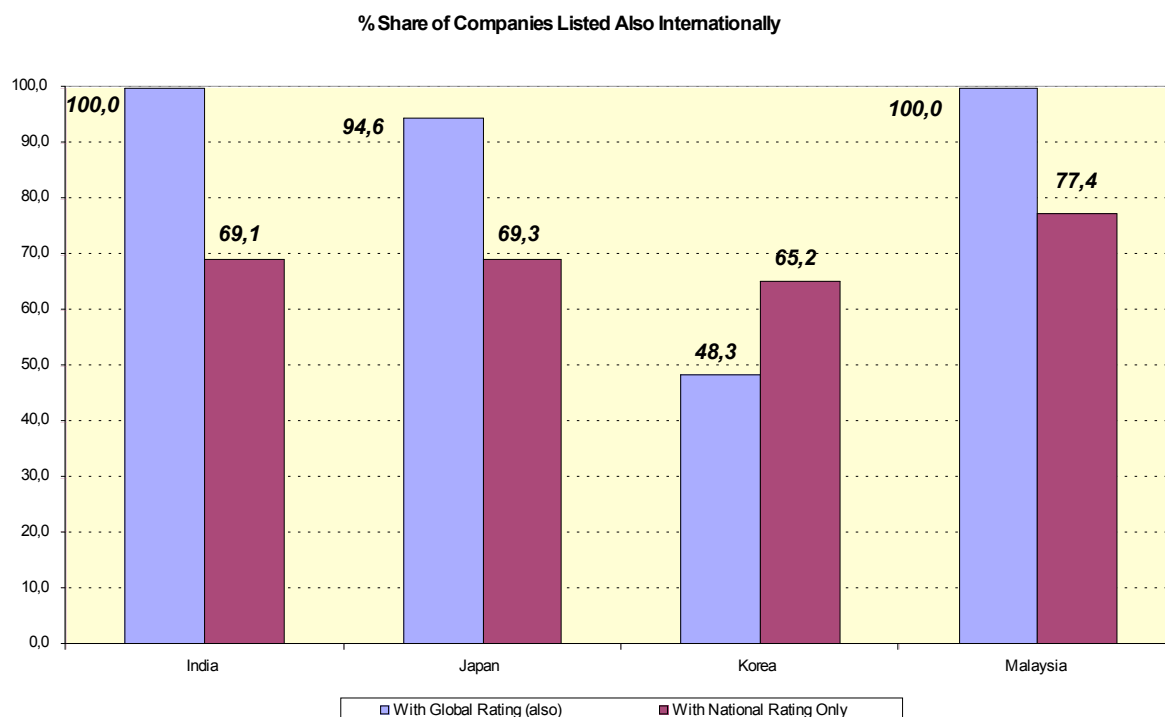
% Share of Companies Listed Also Internationally

Fig. 5 Source: Our calculations on Bloomberg data between 1990 and may 2005.

The difference between GRAs' clientele and NRAs' one is even more blatant when we look at company size. The average size of the companies obtaining a rating only from NRAs is much smaller than that of those companies receiving a rating (also) from GRAs. The ratio of the average size of the former group to the average size of the latter group is 5.5% in Malaysia, 9.7% in Japan, 12.8% in India and 25.9% in Korea (Figure 6).

Our evidence on Asia, thus, supports the view that GRAs and NRAs do specialize in rating different clientele. In other words, there seems to be a division of labor between GRAs – specializing in larger-sized/internationalized companies – and NRAs – concentrating on smaller-sized/domestic-focused companies. Consequently, this evidence supports the view that the presence of NRAs may boost the extent of rated companies in a country and, through this, favor financial market development.
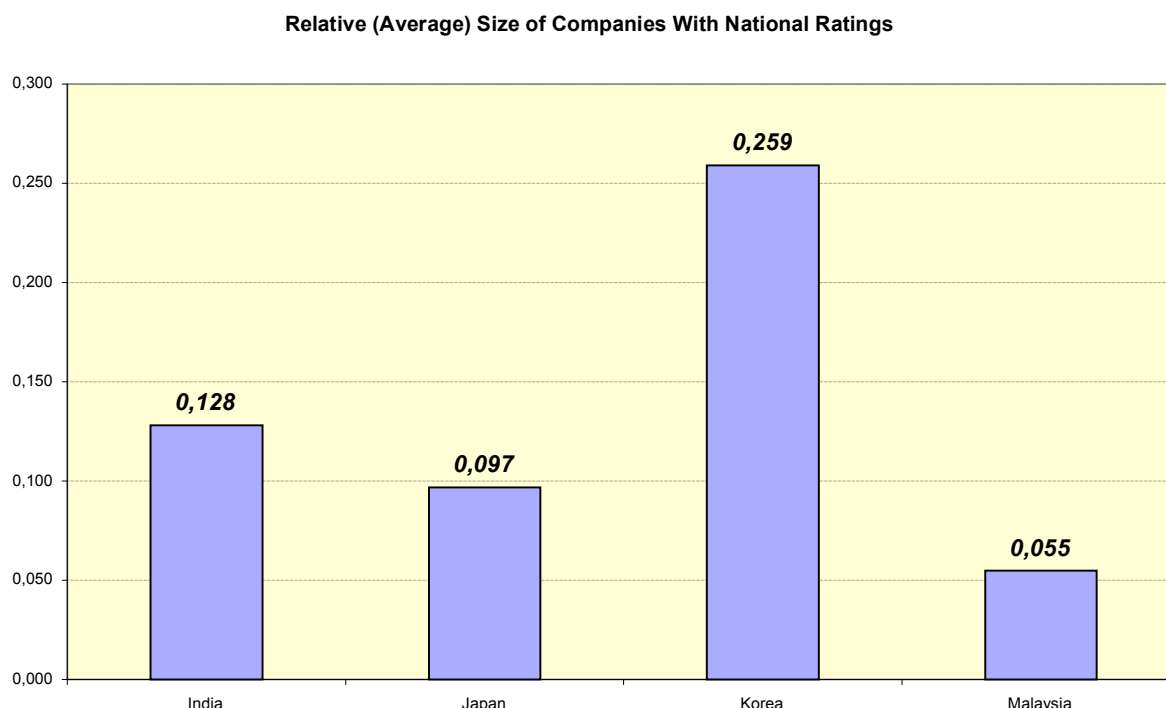
Relative (Average) Size of Companies With National Ratings

Fig. 6 Source: Our calculations on Bloomberg data between 1990 and may 2005

4. Conclusions

The introduction of the Euro was expected to deliver a buoyant expansion of private financial markets in Europe. Nevertheless, according to several observers, the progress of European private financial markets has not matched such optimistic expectations.

In this paper, we asked whether this unsatisfactory outcome may be explained by the fact that Europe lacks a potentially important piece of financial infrastructure: namely, it lacks its own rating agencies. To make our point, we argued that more certified information on companies is a prerequisite for financial market development and that the presence of national rating agencies (NRAs) can help in this respect. Our conjecture was that NRAs do not substitute but rather complement the presence of the three big players (Moody's, S&P, Fitch, the global rating agencies; GRAs). Specifically, we speculated that GRAs might have a comparative advantage in rating larger/more internationalized companies while NRAs might have a comparative advantage in rating smaller-sized/domestic-focused companies.

To prove our hypothesis, we first presented supportive cursory evidence. Our main contribution was, however, to show that: (i) in a La Porta et al. (1997) framework, the presence of NRAs associates with more developed financial markets (in terms of both stock market capitalization and extent of private bond issuance); (ii) focusing on Asia – the area of the world where the presence of NRAs is largest and also the activity of GRAs is considerable – we can clearly identify a specialization pattern whereby NRAs concentrate on rating smaller-sized/domestic-focused companies while GRAs dedicate themselves to rating larger/more internationalized companies.

To conclude, our results support the view that NRAs contribute to the development of financial markets. In this light, it is worth noticing that, in spite of the introduction of the Euro, private financial market development was much below expectations in Euroland, while there was some progress in Asia. Namely, in spite of the potential boost to financial markets exerted in Europe by the adoption of a common currency, the progress regarded mostly government securities and not so much private financial markets. Perhaps there are other possible explanations of this, but this outcome seems consistent with the evidence in our paper. Specifically, private financial market development is promoted also by the presence of NRAs, something (most of) Asia has and Europe lacks.

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