



Projects to Facilitate the Introduction of Local Credit Ratings

The Egypt Capital Markets Development Project

Standard & Poor's



CHEMONICS INTERNATIONAL INC.

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EXECUTIVE SUMMARY

This report, by the Capital Markets Development (CMD) project's subcontractor Standard & Poor's, proposes four projects to assist Egypt with the introduction of independent credit ratings. The four projects are

- A survey of regulations pertaining to credit ratings and rating agencies
- A feasibility study for establishing a local credit-rating agency
- Market education and training on credit-risk analysis
- Benchmarking an Egyptian national rating scale

The report proposes that the CMD project undertake the first three projects during the current year and include the fourth in its year-2000 Work Plan.

The survey of existing regulations pertaining to credit ratings and rating agencies should analyze selected emerging and mature national markets where regulations mandate or encourage the use of independent credit ratings for certain financial market activities. This study will provide a comparative basis upon which to formulate policies and guidelines for the Egyptian program.

The second project proposed by the subcontractor is a feasibility study for establishing local credit-rating agencies. Establishing such agencies in Egypt presents a number of challenges, primarily resulting from the small size and lack of development of the market. A market survey is proposed in order to determine local demand for rating services and determine if agencies providing those services can be self-sufficient. The study should also be designed in such a way as to provide background and insights for regulators in establishing internal procedures for licensing local rating agencies and developing new policies and regulations pertaining to the use of credit ratings in new types of financing and investment activities.

The report argues that training is a necessary element of introducing credit ratings to Egypt's capital markets, as there is insufficient knowledge about the purpose of these ratings and the methodologies and procedures that underlie them. In order to overcome these problems, the report proposes both a seminar, to which major capital-markets participants would be invited, and a series of training courses taught in Egypt or a convenient international financial center.

Finally, the report proposes a benchmarking study in order to overcome some of the potentially disruptive impacts of introducing independent credit ratings into the Egyptian market. Such a study would provide context for the new ratings and establish benchmarks to help guide local rating agencies.

PROJECTS TO FACILITATE THE INTRODUCTION OF LOCAL CREDIT RATINGS

Standard and Poor's

A Introduction

Based on information and opinions gathered during initial orientation meetings in Cairo, it is clear that the Egyptian government and major market participants attach great importance to the use of independent credit ratings in the development of the country's capital and other financial markets. Reflecting these views, this report proposes three initial projects for 1999:

- 1 Survey of regulations pertaining to credit ratings and rating agencies*
- 2 Feasibility study for establishing a local credit-rating agency*
- 3 Market education and training on credit-risk analysis and ratings*

In addition, reflecting the significant resource requirements that would be placed on the subcontractors, we propose that the following project be undertaken as part of the year-2000 Work Plan:

- 4 Benchmarking an Egyptian national rating scale*

In theory, the initial three projects could be undertaken in tandem or could overlap with one another. However, the key personnel for some projects might be the same, thus requiring more time. In addition, project 3 ("market education and training on credit risk analysis and ratings") could be better customized for the Egyptian market with the findings of project 2 ("feasibility study for establishing a local credit-rating agency"). In turn, project 3 could be repeated in a more rigorous and highly customized fashion under the year-2000 Work Plan, after the completion of project 4 ("benchmarking an Egyptian national rating scale").

The preliminary resource and timing figures provided for each proposed project are good-faith estimates that may change as individual projects are refined based on further research as well as developments in the Egyptian market.

B Survey of Regulations Pertaining to Credit Ratings and Rating Agencies

B1 Background

The Egyptian government is committed to the development of local rating agencies as part of its broader efforts to promote the development of domestic capital markets. In October 1998, the government implemented new regulations requiring credit ratings for all publicly listed bond issues and any private bond issues exceeding the net worth of the issuer. Reflecting the mandated use of ratings for certain types of capital market activities, the government wishes to develop standards for official recognition or approval of credit-rating agencies serving the local market. The government's objective is to safeguard the quality, independence, and integrity of rating agencies that fulfill local regulatory requirements. In addition, the government and market participants are interested in learning how the use of credit ratings can be extended to a broader range of financial market activities, thereby enhancing the efficiency and transparency of Egypt's markets.

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B2 Project

A survey should be made of selected emerging and mature national markets where regulations mandate or encourage the use of independent credit ratings for certain financial activities. The survey should provide a comparative basis for formulating policy guidelines for recognizing local rating agencies and for the use of credit ratings in prudential regulations related to debt issuance, investment, and other financing activities. The survey should examine the following areas for each of the countries selected:

- 1 Types of financing and investment activities requiring ratings
 - rating requirements for issuance of specific types of financial instruments, including bonds (publicly listed and private placements), commercial paper, certificates of deposits, mutual funds, etc
 - rating-related investment guidelines for institutional investors (e.g., pension funds and insurance companies) and commercial banks (e.g., reserve and capital requirements)
 - rating requirements for select financial institutions (e.g., commercial banks and insurance companies)
- 2 Types of fiscal and other incentives that encourage the use of ratings
 - tax-exemptions or reduced tax rates for income from rated financial instruments
 - exemption from certain filing requirements when issuing debt
- 3 Standards, if any, for licensing or approving local rating agencies
 - minimum capital requirements
 - guidelines pertaining to ownership structure and conflicts of interest
 - professional qualifications of staff
 - training, assistance and support from international rating agencies
- 4 Regulations, if any, governing the activities of rating agencies
 - rating scales and symbols
 - conflicts of interest for management and staff
 - operating procedures and criteria

- 5 The impact of the above regulations, incentives, and standards on the local use of credit ratings and the development of the local rating industry
- structure and dynamics of the rating industry, including the number of rating firms, trends over time, and the role of international rating organizations
 - level and trends in the proportion of rated financial instruments relative to the total market
 - performance of local ratings during periods of financial stress

In addition, the report should include an overview of expert views on the regulation of ratings and rating agencies

B3 Resource Requirements

Completing the project will require approximately 40 person days, involving a mix of senior- and intermediate-level staff. No travel expenses are required; the information can be gathered through the files of a major credit-rating firm and contacts with regulators. The project will require 2-3 months to complete.

C Feasibility Study for Establishing a Local Credit-Rating Agency

C1 Background

The Egyptian Government has implemented regulations requiring the use of independent credit ratings for certain types of bond issues. To date, one local credit-rating agency has been officially recognized by the CMA. However, many challenges face the development of high-quality, independent credit-rating agencies in Egypt. These challenges will need to be considered when licensing rating agencies and developing the use of credit ratings. First, the capability of properly financing a high-quality, local rating agency depends on adequate demand for credit-rating services and a sufficient capital base for the rating agency. However, the current number and value of domestic bond issues is quite modest, prospects for bond issuance are uncertain, short-term debt markets (e.g., commercial paper) are undeveloped, and the understanding and potential use of credit ratings outside of the bond market is unclear. Second, the feasibility of providing high-quality rating opinions hinges upon adequate information and disclosure. Market participants express some concerns about certain aspects of local accounting standards, auditing practices, and other aspects of public reporting on business and financial developments. Third, the ownership structure and operating procedures of a local rating venture are critical determinants of the actual and perceived independence and integrity of any rating venture. With the introduction of regulatory requirements for ratings, many organizations and individuals with other interests and activities in local financial markets may seek to set up rating ventures in Egypt.

C2 Project

A study of the local demand for rating services, the availability of financial information for producing high-quality credit-rating opinions, and an overview of key ownership and operating considerations in establishing a local rating agency should be undertaken. The study should provide background and insights for regulators in establishing internal procedures for licensing local rating agencies and developing new policies and regulations pertaining to the use of credit ratings in new types of financing and investment activities. The report should include the following three components:

1 Market survey

- *Overview of Egyptian capital markets* The study should begin with a review of Egyptian capital and other financial markets to establish the likely universe of ratable instruments and potential users of ratings, including borrowers, counterparties, investors, and intermediaries. This analysis will establish the growth, size, diversity, and transparency of financial markets, and the nature of current and prospective debt issuance. Information should also be sought to profile the market by number and type of borrowers, intermediaries, and investors. Trends and prospects for various types of debt instruments should also be reviewed.
- *Regulatory environment* An evaluation of the Egyptian regulatory environment for issuance and investment in capital and money markets should be made so as to establish its impact on the operating efficiency and transparency of the domestic debt markets and the practical use of ratings. Comparisons should be made with relevant regulations in other emerging markets. Analysis should also be offered on possible regulatory enhancements and their implications for the use of credit ratings.
- *Investor/issuer needs* The needs of investors, intermediaries, and borrowers for credit-risk analysis and opinions should be identified and assessed. The analysis should evaluate the major motivations each of these various market constituents could have for wanting a rating and the various advantages that could arise from having a system of national credit ratings.

2 Review of disclosure standards and legal practices

- *Information and disclosure* Accounting and auditing practices and the level of publicly disclosed information should be analyzed to provide a general impression as to the data quality upon which an Egyptian rating agency could be expected to base its analyses. To the extent that any significant shortcomings are identified, they should be highlighted.
- *Legal environment* The subcontractor should undertake an overview of the Egyptian legal environment, especially related to creditor and debtor rights and the liability exposure of local rating agencies. In addition, it should review the level to which existing legal provisions impede the development of an efficient capital market and the introduction of new financial instruments.

3 Business plan

- *Ownership structure* A review should be undertaken of potential shareholding structures and the impact they may have on the independent operation and basic credibility of the rating agency. In particular, it is important that any shareholding structure avoids actual or perceived conflicts of interest.
- *Product mix* From its review of the business environment, the current and projected operations of the local financial markets, and assessment of the likely demand for credit ratings, the subcontractor should suggest guidelines for developing a structure and mix of credit risk and other financial-information services that may be appropriate for a newly-established rating agency.
- *Marketing strategy, tactics* Based on the outline of product options, suggestions should be offered on marketing strategies to promote business and stimulate demand for credit-rating services. This should include considerations as to pricing and fee structures, as well as suggestions regarding possible promotional initiatives and assistance with relevant marketing publications, brochures, and general information dissemination.
- *Management and personnel* Potential staffing levels and skill requirements of a new rating agency should be assessed and suggestions offered concerning the organizational structure of the agency, including the role of the board and the agency's executives. The subcontractor should also make suggestions regarding the way the rating agency's management might be organized based on the type and volume of business it can be expected to encounter.
- *Training of management and analytical staff* The subcontractor should suggest procedures for training employees of the new agency, in the fields of both credit analysis and rating-agency management.
- *Financial projections and sensitivities* A variety of scenarios should be constructed to reflect the agency's prospective financial performance. The scenarios should form the basis for evaluating projected business volumes, fee levels, payroll costs, and other key financial parameters. Various balance-sheet projections will also produce suggested guidelines regarding initial capitalization and financial policies.

C3 Resource Requirements

Seventy person days involving a mix of senior- and intermediate-level staff will be required. For further market and related research, the project will entail travel expenses for two separate trips to Cairo, for a total of up to three weeks, by a three-person team. Meetings will entail discussions with a broad cross-section of current and prospective debt issuers, major financial intermediaries and institutional investors, a range of local accounting and legal firms, and relevant government authorities. The project will take four to five months to complete.

D Market Education and Training on Credit Risk Analysis and Ratings

D1 Background

While the Egyptian authorities have introduced rating requirements for certain types of debt financing, local market participants appear to have a limited understanding of the role of independent credit ratings. In general, local investors, intermediaries, investors, and government organizations appear to possess an insufficient knowledge of the procedures and methodologies employed by credit-rating agencies. Moreover, the potential range of applications for independent credit ratings is not well appreciated among market participants. As a result, the imminent introduction of credit ratings to the Egyptian capital markets may prove disruptive, as there is significant potential for ratings to be misunderstood and misused.

D2 Project

To facilitate the introduction of credit ratings to the Egyptian market, ensure the proper use of ratings, and stimulate the wider use of sophisticated credit-risk techniques, the subcontractor should offer a mix of a public seminar and customized credit-risk training classes in Cairo or, in the case of the training classes, at a convenient location outside Egypt (e.g., London). The major components of this training should be:

1. A one-day, general seminar in Cairo on credit-rating methodology and procedures for major market participants, offering an overview of international rating practices and criteria, and applications of this methodology in Egypt and other emerging markets. The length and detail of this seminar could be expanded to two days, if project 4 has been completed.
2. Two, three-day training classes for local market participants in either Cairo or a convenient international financial center (e.g., London) should be conducted. One training course should address the analysis of financial institutions, including an overview of internationally accepted methodology and case studies. The second training course should address industrial companies, again including an overview of internationally accepted methodology and case studies. The appropriate level of sophistication of the training courses will need to be determined based on further research, and both courses could be better customized for Egypt after project 4 is completed. Without the benchmarking study, the training programs could be offered using off-the-shelf courses currently offered by international experts in the credit-rating field, with no specific orientation or applications pertaining to Egypt.

D3 Resource Requirements

The one-day seminar will require approximately 25 person days involving a mix of senior- and intermediate-level analysts, and travel to Cairo by four to five persons. If the training programs are held in Cairo and customized to the Egyptian market, the two training programs will require 60-80 person days, including two separate trips to Cairo of one week each by four persons. The resource requirements and content of the seminar and training courses will vary depending on whether project 4 is completed. A customized seminar and training programs will require 4 to 6 months to complete, again depending on the status of project 4. Personnel requirements and travel expenses could be reduced if the seminar and training courses were coordinated over a single two-week period. Off-the-shelf training programs in London can be provided with considerably less advance preparation and cost.

E Benchmarking an Egyptian National Rating Scale

E1 Background

The Egyptian government, regulators, and market participants have expressed concerns about the potentially disruptive impact of introducing independent credit ratings to a domestic market that has little understanding or experience with such ratings. In particular, if the use and public dissemination of local credit ratings is limited to new public bond issues and the pace of such issuance remains slow, the market will have little comparative context for interpreting the meaning of the initial credit ratings published during the next year or two. In the absence of an adequate comparative context, only top-rated issuers may gain access to the bond market, thus hindering rather than enhancing the development of the local capital market. Moreover, if the bond market is slow to develop, under-resourced local rating agencies may lack the ability to analyze a representative sample of prospective bond issuers, thus creating the potential for setting inappropriately high or low benchmarks during the introduction of a rating scale tailored to the Egyptian markets.

E2 Project

The CMD project should undertake credit analyses of a representative sample of 25 current and prospective Egyptian bond issuers and publish the rating opinions and supporting analytical reports based on available public information. The analysis will yield credit-rating benchmarks for local market participants, thus providing an essential comparative context for more effective interpretation and use of the initial credit ratings assigned to specific bond issues over the next few years.

The representative sample should include a mix of bank and non-bank financial institutions and various industrial enterprises spanning three or four major sectors of the Egyptian economy. The sample should be selected based on achieving a good mix of companies of varied size, market position, and financial strength, as well as on the availability of adequate public information (in English) and the willingness of company management to cooperate with the exercise.

Each credit analysis can be prepared by a two-person team of credit-rating analysts based on available public information and supplemented by a half day of meetings with the management of each company evaluated. Each analysis should contain an overview of the company's major business and financial risk attributes, and follow generally accepted international rating methodology.

The written credit analyses should be presented to a rating committee drawn from an internationally-known firm specializing in credit ratings, which will assign 'public information' credit ratings to each company, based on a national rating scale devised by that firm to meet the unique needs of the Egyptian market. The Egyptian national rating scale should provide a current opinion of the relative creditstanding of Egyptian obligors (i.e., debt issuers, guarantors, or counterparties) relative to their local peers, and should differentiate Egyptian obligors into one of six to eight rating classifications. The scale will need to strike a balance between offering a sufficient number of categories to provide adequate differentiation of credit risk among local issuers and not attempting to be overly precise given the limited sample and reliance on public information. The rating classifications should use rating symbols and definitions tailored to the Egyptian market, and emphasize relative credit risk in an Egyptian context. Each rating symbol should be accompanied by a 'pi' subscript to indicate that the opinion is based on public information.

Prior publication of the national scale, public information ratings, each preliminary rating opinion, and the accompanying report should be shared with the companies managements to ensure the accuracy of factual information and to allow them to comment on the report's conclusions. All of the rating opinions and written analyses should initially be published in a single report and circulated to major borrowers, intermediaries, institutional investors, and government organizations in Egypt.

E3 Resource Requirements

An estimated 170 person days, involving a mix of senior- and intermediate-level staff will be required. The analysis will entail travel expenses related to four or five separate one- to two-week trips by two-person teams of credit-rating analysts, including half day meetings with each of the sample companies and background meetings with local accounting firms, financial institutions, local economic and financial research groups, and relevant government authorities. The project will require approximately four to five months to complete.