Problems Faced By the Dual Rating System in the Chinese Market and How to Improve It

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Abstract: Credit rating is an important component of the modern financial market economy and has a great impact on the financial market, but China's current credit rating system is facing the problem of inflated ratings, according to Wind data statistics, in the first quarter of 2021 the bond market has 52 credit debt defaults, involving a stock size of 58.351 billion yuan of bonds, the default theme rating pivot significantly increased, the first quarter default theme AAA ratings accounted for the year-on-year increase. The data shows the inflated ratings, and the real market mismatch, for investors information - asymmetry problems increased, for the market economy - the market investment costs rise, investment risk increased, is not conducive to market economic development. In order to reduce the problem of inflated ratings, we have borrowed from the dual rating system and improved it to suit the Chinese market. Although the dual rating system has been around for a while, it has not been implemented because it is not adapted to the Chinese market and Chinese market culture. In this regard, we hope to use market competition to promote competition between rating agencies and to conceptualise the rating of rating agencies, to show the market recognition of rating agencies, to increase market supervision of rating agencies, and ultimately to form a virtuous market cycle. thus breaking the current situation of inflated credit ratings.

Keywords: Inflated Credit Ratings; Dual Rating System; Market Acceptance of Rating Agencies

1. Introduction

1.1 Background and significance of the chosen topic

1.1.1 Background to the selection of the topic

According to Wind data statistics, China's current credit rating faces a major problem - the credit rating is falsely high, the credit rating of enterprises in the market and its default rate does not match, and there are even incidents of successive defaults of highly rated enterprises, Wind data shows that in 2021, a total of 148 bonds defaulted, with a total default of 159.593 billion yuan, about 20% downward in scale from 2020. Among them, the issuers such as Sunshine City Group Co., Tianjin Real Estate Group Co., Ltd. and Beijing Ziguang Communication Technology Group Co., Ltd. were all rated AA and above in the main body before the default, and some of them were rated AAA. demonstrating the aggravation of the market information asymmetry problem, in such a false high environment, the rapid economic development of the market is hindered, and for investors, inaccurate information .

1.1.2 Theoretical implications of the study

(a) The theoretical implications of studying the reduction of inflated credit ratings include at least two points.

First, Reducing the inflated credit rating is conducive to resolving the information asymmetry between investors and companies, thus enabling more accurate investment information to be presented in the market, reducing investors' investment risks, facilitating the development of the market economy and suppressing unrealistic rating practices.

Second,Form a healthy competition environment between rating agencies, use market competition to eliminate rating agencies that do not meet the market requirements, competition between rating agencies is conducive to promote the production of more high-quality rating methods, so as to break the current situation of inflated ratings. The competition between rating agencies will help to produce better quality rating methods, thus breaking the current situation of inflated ratings. Enterprises focus on the real enterprise development situation, rather than looking for rating agencies that give themselves inflated ratings. The result is an environment where ratings match the market, a good rating system and thus a reduction in the overall cost of market development. Narrowing the rating gap with foreign countries and expanding China's international market share.

1.2 Points of emphasis and innovations

1.2.1 Key points

How to maintain the objectivity and independence of the rating agencies. In order to grow, companies need to look for rating agencies for their ratings, and companies as customers prefer rating agencies with high ratings for themselves. In this trend, rating agencies that give normal ratings will lose customers and thus face problems of survival, and eventually, under this pressure, they also give inflated ratings in order to survive.

How to increase the level of competition between rating agencies, which may suffer a degree of loss when rating agencies that want to give accurate ratings are resisted by the forces in the market that do not want to change when they first give a rating that is not inflated. 3.Who should bear the cost of a second rating for an enterprise? Under the dual rating system, the cost of another rating is increased. For enterprises, the dual rating system itself is to reduce the inflated rating of some enterprises, which is not conducive to some enterprises to attract investors, and in this case requiring enterprises to pay for a second rating is bound to be more reluctant.

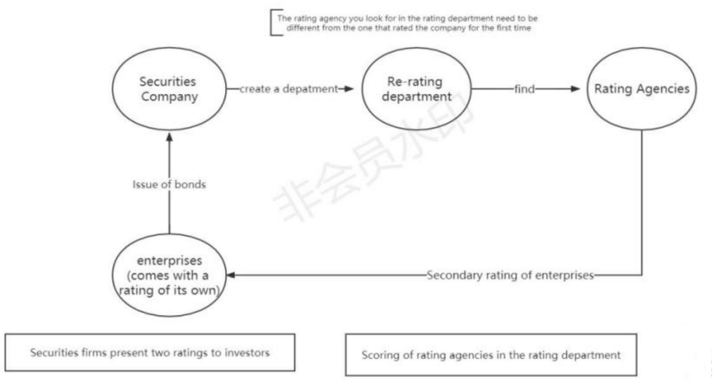
1.2.2 What's innovative

First, The dual rating system has been improved to make the system suitable for the Chinese market and to promote a virtuous circle in the market, strengthening the regulation of the market and promoting the development of credit ratings.

Second, A new rating agency has been added for rating agencies. While the conventional wisdom lies in government regulation of rating agencies, the addition of a new agency to rate rating agencies shows the level of government recognition of the financial institution.

2.1 An improved dual rating system

2.1.1 Improved dual rating system model



Firstly, the model assumes that the securities firm has a "re-rating department". This department has a certain degree of independence and plays a role in the issuance of debt by the firm.

(i) There is a degree of independence in this process between the "re-rating department" and the department that negotiates the issuance of debt between the securities company and the company.

(ii) For the second rating the cost should be shared by the enterprise and the investors (or by the government and the enterprise if there is government support, or by the investors, the government and the enterprise). The portion to be borne by the investor may be reflected in the price of the bond or as an information service fee. Reflecting the fee in each bond can amount to a sum of money that is borne in full by the company at the outset, but partially recovered at a later date when the bond is sold. If there is a significant difference between the two ratings, resulting in lower than expected bond sales, the firm will accept a loss for not recovering the rating fee; when the fee is reflected in the service fee, the cost of the sub-sector is first paid by the brokerage firm and collected from the investor each time the securities are sold.

(iii) In the process, the "re-rating department" will also rate the rating agency, and the re-rating department can rate the rating agency based on the two rating results of the transaction process and the rating agency's rating history data, after a period of time, the re-rating department has all the rating agency's rating result data, and then compare it with the actual difference, using big data analysis to come up with a score. The rating can be enhanced by adding a "+" to the letter, and the letter division can be adjusted. The specific score can be adjusted to the reality, but no specific score is given.

2.1.2 How the model is implemented in the market

In order for companies to raise funds for further growth, the issuance of bond shares must be done through a bond company. Each of the individuals involved has their own intentions and contributes to the model being able to operate.

Information asymmetry is a major problem in the current market, and credit ratings can effectively alleviate the problem of information asymmetry, in the process investors can obtain more credible information and reduce the risk of investment.

The current inflated credit rating will cause an increase in bond defaults, leading to a shock to the bond market credit system and affecting the healthy development of the bond market. It is also evident through relevant government policies that the government is also thinking about how to solve this problem.

The issuance of bonds or shares is the most common way for companies to raise capital. In a dual rating presentation, a company with both results equal can demonstrate its spirit of truthfulness and development, thus gaining the approval of investors, which in turn makes its bonds popular. Companies that seek to raise capital with an inflated rating will be discarded by the market if there is a significant difference between the two ratings. This means that the former group of companies will have a competitive advantage in the market.

Securities firms that use this model will provide a higher quality of service to investors and will inevitably be more popular with investors. In turn, more popular securities firms will inevitably attract firms to raise capital.

For the second rating, the cost is no longer borne only by the company or the investor, but by the method in the model a certain percentage of the cost is borne separately, which can be acceptable to all parties involved.

In the case of the "re-rating department", this department is different from the department of the securities company responsible for pre-listing commercial communication with the company, and there is a degree of independence between the two departments, which prevents companies and securities companies from colluding behind the scenes to select companies for a second rating, so that they still give a high rating, thus preventing investors from receiving true information. This will transform the direct business relationship between the second rating agency and the company, allowing the second rating agency to maintain a certain level of objective independence from the company. The current market is also characterised by a direct commercial relationship between the rating agency and the company, which makes the rating agency less objective and independent.

The impact of a dual rating system on companies: with two ratings on display, the reduction of inflated ratings prevents companies from attracting financing by purchasing inflated ratings and can only shift their focus from seeking inflated ratings to working to improve their competitiveness. This provides a positive boost to business development.

In a rating mechanism where rating agencies are scored by a "re-rating department", the rating of a rating agency is equivalent to the market's recognition of the rating agency's competence. This will make it possible to distinguish and eliminate non-credit rating agencies, reduce the number of rating agencies and alleviate the problem of an overabundance of rating agencies. Under this scenario, a healthy competitive atmosphere will develop among the rating agencies and the rating agencies will focus on ways to improve the accuracy of their ratings, rather than on how to give inflated ratings to attract companies.

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