THE REGULATORY USE OF CREDIT RATING: A TWO-EDGED SWORD

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ABSTRACT

This paper discusses the uses of crediting rating for regulatory purpose. It focuses on the Basel Accords and the use of credit ratings in the Accords to increase the safety and soundness of internationally active banks. The paper focuses mainly on the Basel Accords and rating of developing countries such as Thailand. In developing countries, the Basel Accords have an impact on the way financial institutions manage their reserve requirements for risky assets. Split rating and Rating shopping are also discussed as foreseen problems of credit rating.

INTRODUCTION

After the world financial crisis of the 1970s, the Bank of International Settlements (BIS) was established by major developed countries to stabilize the international banking system. The Basel Committee is composed of central bank supervisors from the major developed countries (G-10) who are required to meet every three months at the Bank for International Settlements (BIS) in Basel, Switzerland. The Basel Accords, which was issued in 1988, require banks that have international activities in G-10 countries to hold part of their capital in at least 8 percent of a risk-weight-adjusted portfolio of assets (Dale and Thomas, 2000).

The main objectives of the Accord were to establish an adequate level of capital in the international banking system and to create a fair competitiveness between internationally active banks. Banks could no longer increase their business volume without adequate capital back up. Within 10 years, more than 100 countries applied this benchmark in their banking systems. However, the standard of 8% created incentive for banks to remove high quality assets from the balance sheet especially by asset-backed securitization, thus decreasing the average quality of bank loan portfolios. Furthermore, the 1998 Accord did not take into account credit risk reduction methods (Dale and Thomas, 2000).

Because of the drawback of the 1988 Accord, the committee proposed a more suitable risk-sensitive framework in June 1999. The 1999 Accord contained three improvements. First, two additional 'Pillars' dealing with supervisory review and market discipline to support the existing quantitative standard. Secondly, allowing banks with sophisticated risk management capabilities to use their own systems for assessing credit risk (CreditRisk+ and CreditMetric™ from J.P. Morgan). Finally, banks were permitted to use ratings of approved external credit assessment institutions to classify their claims (Dale and Thomas, 2000).

The committee published the Second Consultative Package on the New Accord in January 2001. The Basel Committee proposed to conclude the Final version of the New Accord by the end of 2001 and implement the New Accord in 2004.

The New Accord is intended to improve the soundness and safety of the financial system by aligning regulatory capital requirement to the underlying risk in the banking business and to encourage better risk management by banks and enhanced market discipline (Dale and Thomas, 2000).

The Uses of Credit Ratings in the New Basel Proposals

Credit rating is not only being used to interpret the default probability of the issuers of debt, it is also used for regulatory purpose. The Basel Accord provides an example of the importance of credit rating for regulatory purpose.

The 1988 Accord of maintaining the capital against risky assets at 8% is unfair for financial institutions as this is the 'use-together' rule for both high risk financial institutions and low risk financial institutions (European Central Bank 2001). Therefore, in June 1999, the Basel Committee proposed to adjust a new Basel Accord and concluded on January 2001 that the new Accord shall be used instead of the old Basel Accord of 1988.

The new Accord focuses on three important areas: (1) proportion of minimum capital requirement for financial institutions – the new Accord requires that a financial institution retain it's capital according to the risk level of the holding assets instead of a general fixed ratio. Therefore, financial institutions will retain capital of more or less than 8% depending on the risk level of assets and the quality of the institutions' risk management styles. (2) The control of capital adequacy – the new Accord specifies that the institutional managers need to be confident that their institutions have an internal risk control system. This is to support their risk taking activities. Also managers should monitor and interfere anytime when there is a signal that the financial institutions have capital inadequacy. (3) Market monitoring – the new Accord requires financial institutions to show to the market the information about the structure of the capital, capital ratio, management of capital, risk level, risk management activities and the asset allocation. This would help the financial institutions to work with caution and retain their capital strength in the future. The new Accord was to be used in year 2004 (TRIS 2001, BOT 2001).

The use of credit ratings in international banking regulation is broadly formalized in the number (1) area mentioned in the new Capital Adequacy Framework of the Basel Committee in June 1999. The committee is incorporating credit rating agencies in determining the risk weights to be applied to exposures to sovereigns, banks, securities firms and corporations. The risk weighting scheme of the committee extensively relied on external ratings, which are provided by private agencies. Therefore, the committee defined the standards for institutions to be recognized as an external credit assessment institution.

The role of credit rating agencies became more crucial in the Basel Capital Accord of January 2001 when the committee provided additional guidelines for incorporating credit ratings in banking regulation. In terms of mapping credit ratings into the standardized risk-weighting framework, national supervisors will assume such responsibility. Banks are required to reveal to the credit rating agencies that they use risk weighting of their assets.

Split Ratings and Rating Shopping in the Market

As the new Basel Accord applies to international financial institutions, there are two foreseeable problems in the market namely split ratings and rating shopping.

Split Ratings

When there is more than one credit rating agency in the market, split ratings can be created. Split Ratings can be defined as different opinions of ratings agencies about the same assets or borrowers. It is a disagreement in the rating assigned to an asset or issuer by different rating agencies. Cantor, Packer and Cole (1994) suggested that split rating is normal and unavoidable and it creates transparency to the market.

Cantor, Packer and Cole's (1994) suggestions to deal with split ratings could be applied to the regulatory purpose: (1) The rating agency with the higher rating is assumed to produce better information about the particular issue if the asset is priced in accordance with the higher rating. Banks should use the higher rating. (2) If the asset is priced according to the lower rating, then the market accepts the lower rating. The pessimistic agency is assumed to have superior information about the bank. (3) If the market does not respect either the pessimistic or optimistic view of rating agencies, then averaging is the suitable way of solving the problem of split rating.

Rating Shopping

The increase in the number of rating agencies raises the probability that more assets can meet minimum ratings required due to either 'likely deviation' in opinions of rating agencies or lower standards for rating scales of some agencies allowing more assets or borrowers to meet regulatory standards and requirements. There are a lot of benefits which accrue from being rated high, therefore many banks/issuers look for different rating agencies in order to get the best or better ratings, this is known as rating shopping. To prevent this happening, Dale and Thomas (2000) suggested that the market encourage the use of rating average (Jewell and Livingston, 1999; Ronapat, 2002).

In practice, financial institutions prefer to be rated by additional rating agencies. Reasons behind this are; (1) institutions think that the rating agencies misinterpret some relevant information and thus misjudge some issues. Therefore, additional ratings convey useful information to the market, thus affecting the assets' prices and the reputation of the institutions. (2) Institutions may seek second or third ratings because of the favorable ratings of the additional agencies (Jewell and Livingston, 1999; Ronapat, 2002).

The Effect of the Basel Proposals in Developing Countries

Although the Basel Accord has been widely applied to many banks in developed countries, the implementation of the risk weighted capital approach will be difficult and complex in developing countries because of two factors. First, the rating industry has no experience in developing countries. Secondly, the rating agencies' financial strength indicators of the modern world such as financial ratios, would not be effective indicators in assessing the true risk of banks in developing markets. Currently, there are only three recognized international rating agencies, they are Standard and Poor's (S&P), Moody's Investor Services and Fitch (Cantor and Packer, 1994).

Credit rating agencies have limited experience with private sector ratings in developing countries. Most agencies started their coverage of emerging markets only in the 1990s. Furthermore, a country's downgrading or upgrading has little or no impact at all for capital adequacy requirements of banks in developed countries, but it brings large fluctuations for capital adequacy requirements for banks in developing countries (Ferri, Liu and Majnani, 2001). Therefore, the new Basel Proposal would intensify the volatility of bank capital adequacy requirements in emerging markets. The framework could noticeably worsen the availability and cost of credit to these countries' private sector by triggering corporate bankruptcies and decreasing production capacities.

Most of the time, rating agencies use five key variables as indicators of a bank's strength. These variables are capital adequacy, asset quality, management, earning and liquidity or the so-called CAMEL ratio. None of these conditions work in emerging markets. It is argued that rather than a CAMEL ratio, a different set of indicators would have worked better in Latin American and East Asia Banking crisis as an early warning system (Rojas-Suarez 2001; Ferri, Liu and Majnani, 2001).

Even Moody's accepted that the financial statistics and ratios are less valuable as a way of measuring bank strength, value, risk and of comparing banks with each other, instead the economy and environment in which the banks operate are much more important drivers of financial strength and credit rating (Rojas-Suarez 2001; Ferri, Liu and Majnani, 2001).

The Future of Basel Proposals in Thailand

After the Asian Economic Crisis in 1997, many Thai financial institutions had to continuously increase their capital to support the higher Non-Performing Loans (NPLs), which were created from the economic crisis. Any financial institution that is not able to find adequate capital would normally open the opportunity for the foreign investors to become shareholders or ask for government's help (BOT 1998, 2000).

Currently, the Bank of Thailand (BOT) has set the ratio of capital that must be maintained against the risky assets of financial institutions to the amount of 8.5% in the case of commercial banks and not less than 8% for other financial institutions which is equal to the BIS regulation (TRIS 2001; BOT, 2000).

In the near future, the Bank of Thailand should consider implementing the new Basel Accord of 2001 which would raise the importance of the only credit rating agency of Thailand known as TRIS (Thai Rating and Information Services) (Ronapat, 2002).

It is true to believe that there will be more demand for credit rating in the near future, thus bringing up the issue of having two or more Thai rating agencies. With more demand for credit ratings, for Basel purpose or securities rating, TRIS would be either too small or provide too narrow a range of services which are inadequate. TRIS should start offering more lines of services and develop itself as an active and professional body in the rating market internationally.

CONCLUSION

The Basel Committee Proposal is a classic example of the role of credit ratings for regulatory purposes. The ratings from the three big rating agencies have been compared and set as the benchmark for measuring the credit risk of assets of internationally active banks, such a rating is useful to assure the safety and soundness of financial institutions. As a developing country, Thailand cannot avoid applying this New Basel Accord. Thus, it is essential that financial institutions in Thailand are ready for this development and this needs to be done promptly. The government should also take this opportunity to create a credit culture by stimulating Thais to increase their awareness of risk levels in their choices of depositing/borrowing money. This sets the foundation for an effectively managed risk system and creates a guiding principle for the nation's institutions and private sector to conduct transactions in a well managed and transparent manner.

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