

Speech by:

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**Reducing mechanistic reliance on Credit Rating Agencies (CRAs) – sharing
of country experiences and the plans ahead.**

Your Excellencies, Ladies & Gentlemen - good afternoon

I am pleased to be able to speak to you today on the subject ‘reducing mechanistic reliance on Credit Rating Agencies (CRAs)’ and to present the Central Bank of Kuwait’s viewpoint on this matter, both in terms of how reliance on such ratings may have affected the financial system in Kuwait in the past, and how we envisage matters developing in the future whilst incorporating the observations the FSB.

Perhaps we should remind ourselves that at the 2013 G20 Summit Meeting in St. Petersburg the G20 called on national authorities to accelerate progress in implementing FSB Principles in accordance with a roadmap agreed in 2012, and first proposed back in 2010. According to a statement “The Roadmap sets out milestones for work to reduce mechanistic reliance on CRA ratings in standards, laws and regulations, and to promote and, where needed, require that financial institutions strengthen and disclose information on their own credit assessment approaches.”

Background

Before discussing in outline the FSB’s principles, as contained in the roadmap, I would like to touch briefly on how the CRAs and the use of their ratings rose to such prominence before the onset of the recent global financial crisis.

Until the 1980's global demand for ratings agencies' services was not high, except possibly in the U.S. Until then the financial market remain simple¹, however, post-cold war the financial systems became more deregulated companies started borrowing, as well as investing in, the globalized debt capital markets and the opinion of ratings agencies became more relevant.

It is generally agreed that CRAs contributed to the current financial crisis, which began in the United States in summer 2007 with problems in the subprime mortgage market and which subsequently took on global dimensions. The agencies underestimated the credit risk associated with structured credit products. CRAs were accused of both methodological errors and unresolved conflicts of interests, with the result that market participants' confidence in the reliability of ratings was seriously shaken. It is unsurprising, against this backdrop, that a heated debate emerged about the rating process, rating agencies, competition, and liability rules, prompting calls by politicians for greater regulation of CRAs.

However, the growth of the international financial markets over the last twenty years would have been unthinkable without CRAs. The CRAs worked for decades on designing a simple and readily understandable system that would allow any investor to invest in international securities with which they were not directly familiar. Markets for structured products could not, on the other hand, have developed without the quality assurance provided by CRAs to investors about inherently complex financial products. In this regard CRAs operated as trusted gatekeepers. However, the ratings for structured credit turned out to be much less robust predictors of future developments than were the ratings for traditional, single name securities.

In identifying the shortcomings of CRAs and how they may have exacerbated the global financial crisis I refer to a report issued in 2009 by the committee set up by the European Commission to give advice on the European future of financial regulation and supervision which stated:-

- CRAs lowered the perception of credit risk by giving AAA ratings to the senior tranches of structured finance products like collateralized debt obligations (CDOs), the same rating they gave to government and corporate bonds yielding systematically lower returns.

¹ Post-cold war huge movement of talent pools – mathematicians and nuclear physicists in finance field led to huge uncontrolled innovations in financial services industry

Flaws in rating methodologies were the major reason for underestimating the credit default risks of instruments collateralized by subprime mortgages. Therefore, the global financial crisis, whilst being blamed on a great number of factors, illustrated how credit ratings, while continuing to play a role in financial markets, can contribute to and exacerbate the implications of a financial crisis. Indeed, developments during the crisis suggested that the automatic use of CRA ratings within elements of prudential regulation was wrongly interpreted by some investors as providing ratings with tacit official approval. In turn, this interpretation may have reduced incentives for banks, investment companies and investors to develop their own capacity for credit risk assessment and due diligence.

It is, however, my contention that rather than reducing the need and the scope of work provided by CRAs in future we, should instead focus on how we can effectively create an independent institution to regulate them to overcome their shortcomings and to incentivise the use of CRA ratings by regional financial institutions as a supplement, rather than an alternative, to in-depth local market knowledge and customer information. In the context of creating effective regulations – I would like to stress on creating independent institutions to regulate CRA through revisiting ECAI's recognitions principles.

Mechanistic reliance

What then is mechanistic reliance, and how could the use of ratings provided by CRAs have been so relied upon and possibly misinterpreted by regulators, investors and financial institutions alike?

Principles outlined in the roadmap prepared by the FSB do not suggest that reliance on the rating provided by CRAs should be discarded altogether, but rather that adequate means exist to perform an independent and corollary assessment of risks to which there may be exposure.

The Kuwait experience

Bearing in mind the State of Kuwait's stage of development in terms of its financial markets it is the Central Bank's view that for the majority of domestic operations involving an assessment of risk, local knowledge is possibly a more reliable indicator than that provided by an international CRA. On the other hand, the majority of local banks, and a number of larger companies have already obtained ratings from CRAs primarily so that offshore lenders or investors have the requisite knowledge and resources to assess the risk characteristics of local borrowers.

At one stage, even on a sovereign level, the State of Kuwait had cause to seek a rating to support its entry into the international capital markets in the aftermath of the Gulf War in 1992. In this regard ratings currently provided to the State of Kuwait by the major CRAs² continue to serve as the basis for the provision of information to all interested parties regarding the country's economy and financial system.

However, it is true to say that the majority of Kuwaiti companies listed on the Kuwait Stock Exchange (KSE) are not, at present, rated by CRAs. From the Central Bank's perspective we encourage the rating of KSE-listed companies – as at a later date such information will be useful for developing internal rating models.

CRA ratings have not, therefore, in the past played a major role in Kuwait – neither in terms of its laws, the financial system, nor in terms of its financial markets. As a consequence there has not been strong mechanistic reliance on such ratings.

The main use of CRA ratings in Kuwait has been, and continues to be, within bank prudential regulation - which is based on the internationally agreed Basel framework. The most important reference to CRA rating in Central Bank of Kuwait regulations is in terms of establishing the capital adequacy ratio (CAR) and in this respect all banks in Kuwait currently use the BCBS standardised approach as outlined in Basel III³. Even in this context, however, the CBK has a robust independent regulatory framework for ensuring that banks adequately manage their exposure to credit risk.

As a general rule the Central Bank's supervisory approach towards assessing the adequacy of bank's own credit assessment is embedded in the on-site and off-site supervision of bank's credit risk management. In performing a supervisory role the Central Bank may also use ratings provided by CRAs in conjunction with its own evaluation through an internal supervisory tool⁴ for local banks – such use is not, however, mechanistic and used primarily as a means of substantiating the Central Bank's own findings

² Moody's Long-term **Aa2** / Short-term **P-1**, Standard & Poor's Long-term **AA** / Short-term **A-1+**, Fitch Long-term **AA** / Short-term **F1+**

³ Currently Kuwaiti Banks are only reporting CAR based on Basel III standardized approach

⁴ Entitled as CAMEL BCOM – a model based on CAMEL framework

Therefore, although banks in Kuwait do not use an Internal Ratings Based (IRB) approach to assess credit risk they are required to form their own views on creditworthiness/risks - based on adequate due diligence, quantitative and qualitative analysis and even in cases where there are CRA ratings, banks are nevertheless required to supplement such ratings while determining the credit risks and the pricing to which they are exposed.

Central Bank operations

The Central Bank of Kuwait uses CRA ratings to manage its foreign exchange reserves, although this is largely confined to setting counterparty limits. The use, however, is not mechanistic and some time ago the Central Bank developed an internal risk evaluation procedure which focusses more on the intrinsic strength, trade relationship and quality of an individual counterparty, rather than on the long-term or short-term credit ratings provided by CRAs.

The way ahead.

As part of the Central Bank of Kuwait's existing rigorous prudential regulatory framework it will continue to examine the use of CRA ratings and ensure sound risk assessments are undertaken in the financial system.

Compared to some of the more mature international markets the banking system and dynamics of financial markets in Kuwait are at an emerging stage of development - but nevertheless remain well controlled. Middle East markets in general may be at the lower end of the complexity in terms of financial market lifecycles and lack some of the more complex and complicated innovative financial products - but we anticipate a similar growth pattern in the financial market lifecycle as in developed financial markets. In which case, along with other regional regulators, it is important to take note of, and where necessary jointly work together to incorporate adequate regulations into our existing regulatory oversight.

It has been demonstrated that ratings and the emergence of ratings agencies are an important complementary backdrop to growth of financial markets. It is also, therefore, more than likely that the number of ratings agencies catering to the unique requirements of the local markets will grow in number to provide specialist information on both the Islamic and conventional financial market sectors.

At this stage, however, we anticipate that international CRAs will continue to serve a useful reference for the issue of securities and ratings of individual companies and banks – but in keeping with previous Central Bank practices such use will not be mechanistic with such information being used only to support independent assessment of financial, managerial, and market risk.

In the context of effective regulations we should adhere to the principles of External Credit Assessment Institutions (ECAIs) as recognised by respective national regulators and in this respect we should ensure that the following aspects are applied to the operations and business activities of CRAs within our respective jurisdictions:

- an overview of CRAs (*enhancement of statement of compliance and code of conduct through independent regulator*)
- objectivity
- independence - thereby introducing new regulations for conflicts of interest
- international transparency
- disclosures
- adequate resources
- credibility
- adequacy of credit mapping

The CBK will also closely monitor FSB's guidelines for Reducing Reliance on CRA Ratings. Whilst the G20 nations make arrangements to implement FSB's recommendations on reducing mechanistic reliance on CRAs we will ourselves evaluate market reforms for, amongst things: i) managing conflict of interest; ii) accountability of CRA's; iii) governance controls, and iv) enhanced transparency to improve quality of CRA ratings.

Therefore, to avoid the possibility of mechanistic reliance on CRA ratings by local financial institutions at some stage in the future we will consider following aspects: -

- while establishing an independent regulator, apply sound principles and regulations ~~for~~ as outlined by ECAI's, and ~~to~~ encourage the development of regional ratings agencies, - i.e., locally focused, and useful as a means of obtaining information on smaller entities and small and medium-sized enterprises
- guidelines on the use of internal assessments in parallel with CRA rating benchmarks – thereby promoting the use of CRA ratings alongside the IRB approach.

- guidelines to avoid the automatic use of rating thresholds (i.e. minimum rating criteria for certain eligibility such as margins and collateral calls, etc.).
- engage in dialogue with regional as well as local market participants on methods by which internal credit assessment can be strengthened.

In conclusion, and to return to my original point, it is my contention that the collapse of financial markets cannot be blamed entirely on the sharp downgrade in ratings given by CRAs - but in many cases the regulators themselves allowed a *laissez-faire* attitude to develop concerning the application of ratings rather than imposing upon financial institutions the need to undertake independent and thorough examination of risk beforehand, supported by a concise framework of both macro and micro prudential regulation.

I thank you for your attention, and look forward to a continuing constructive discussion on how the FSB and we, as regulators, support and strengthen the base from which institutions in the region emerge from the global financial crisis as solid, secure and profitable organs of financial intermediation.

1st October 2014