

CCMF/Caricom/CARTAC Workshop on Regional Financial Stability

A Caribbean Architecture



Importance of Credit Ratings to Financial Stability

Arjoon Harripaul

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Structure of Presentation

- Background & Introduction
- Imperatives for Efficient Capital Markets
 - Some Regulatory Issues
- Role of Credit Ratings in the Financial Sector
- Recent Experiences - Lessons for the Caribbean

Background & Introduction

- Recent Financial Crisis
 - a search for answers
 - exposed fundamental flaws in regulation?
 - spotlight on regulators
 - more sweeping changes in regulation
- Banks to be most affected by the changing landscape
 - return to traditional funding sources
 - shy away from reliance on structured finance
 - reduced leverage but lower, more stable returns

Background & Introduction

- Credit Ratings are critical to any discussion on Financial Stability
 - complimentary to activities of financial system supervisors
 - play an important role in investment & risk management frameworks
- Important element in the quest for Financial Stability
 - development of a well-functioning capital market
 - as important as the need for financial system supervision
 - increases the prospects for L-T financial stability

Imperatives for Efficient Capital Markets

1. Transparency and high disclosure standards

- the real backbone of financial market stability
- markets are prone to the risks arising out of information asymmetry
- credit ratings reduces the problem of information asymmetry
- however, inadequate penetration of ratings in Caribbean bond markets

Imperatives for Efficient Capital Markets

2. Corporate Governance for listed companies

- lessons to be learnt from experiences in North America and Europe
- adopting best global practices are critical for improving investor confidence and developing capital markets
- application of corporate governance ratings can promote further development of healthy and vibrant capital markets

Imperatives for Efficient Capital Markets

3. Reducing Dependence on bank-based lending

- disclosure-shy businesses favour bank-based lending
- over reliance on bank funding could lead to inefficient allocation of capital
- bond markets provide the necessary diversification
 - crucial factor in the Asian crisis in the late 1990s
 - the Jamaican experience vs the Dom Rep

Imperatives for Efficient Capital Markets

4. Systemic Development of S-T debt market

- money markets: an important element in capital market development
 - provides liquidity
 - important tool for transmitting monetary policy decisions
 - offers firms an alternative to bank finance
 - reduces the cost of borrowing for top-tiered corporates
 - CP market is underdeveloped or non-existent in the Region

Direct Usage of Credit Ratings

BIS survey found that credit ratings have five key uses in the financial sector:

(i) Determining Capital Requirement

- quite possibly the broadest application
- widely used for calculation of capital charges for credit risk
- Basel II framework – standardized approach
 - used to enhance risk sensitivity
 - used to risk-weight securitization exposures

Direct Usage of Credit Ratings

BIS survey found that credit ratings have five key uses in the financial sector:

(i) Determining Capital Requirement

- widely used in the insurance sector to determine whether an asset is eligible to cover technical provisions
- Canada: a significant portion of an insurer's capital requirement is determined using asset default factors (linked to credit ratings)
- the new insurance regulation in T&T is proposing this.

Direct Usage of Credit Ratings

(ii) Identifying or Classifying Assets

- used in the designation of permissible investments for mutual funds, etc
- used in the establishment of asset concentrations limits for certain assets
- in some jurisdictions (e.g. India) bank exposures above an agreed size must be rated

Direct Usage of Credit Ratings

(iii) Evaluation of credit risk associated with assets for securitization

- In many countries securitization transactions must be rated
- UK: the counterparty must have an appropriate credit rating
- US & Canada: asset-backed instruments reference ratings
- The new Securities Act in T&T is proposing this.

Direct Usage of Credit Ratings

(iv) Determining Disclosure Requirements

- Used in some countries' legislation regulating disclosure
- Rated entities are required to disclose their ratings & disclose when such ratings were changed
- Some countries' legislation contain provision excluding the disclosure of certain documents

Direct Usage of Credit Ratings

(v) Determining Prospectus Eligibility

- Key role in legislation governing prospectuses for securities offerings
- E.g. short form prospectuses include an investment grade rating as a criteria for eligibility
- UK: the prospectus for debt instruments must disclose the credit ratings of the issue or issuer
- US & Canada: widely used
- Jamaica: investment grade securities need not be registered with the FSC

Recent Experiences – Lessons for Region

- Credit Rating Agencies fingered in the recent sub-prime crisis
- Strong pressure on policy makers to regulate credit rating industry
 - relied on self-regulation for a century
 - focus mainly on micro-prudential issues
 - aim at reducing conflicts of interest
 - increasing transparency and competition

Recent Experiences – Lessons for Region

- What does this mean for regional credit ratings?
- CariCRIS surpassed the global best practices since inception
 - Robust governance structure
 - Multi-layered and influence-limiting
 - Independent external rating committee
 - Transparency in key operations' policies and processes
 - Transparent fee structure
 - Salaries of rating staff not linked to business targets
 - Chinese wall separation between rating analytics and business development.

Conclusion

- Credit ratings are critical to any discussion on financial stability
- Development of integrated vibrant Caribbean capital markets is a key imperative for financial stability
- As central as the need for careful monitoring of the health of financial institutions
- The need to act and do whatever is required to achieve this goal has never been more pressing
- What is needed is a determined effort by regulators & market players to resolve the issues through productive dialogue.

THANK YOU

The logo for CariCRIS features the text "CariCRIS" in a white, serif font, set against a blue rectangular background. A thin green horizontal line is positioned below the blue background.

CariCRIS

**Caribbean Information &
Credit Rating Services Limited**

aharripaul@caricris.com

www.caricris.com

