

3-1-2012

Ratings game : a review

Phebian N. Omanukwe

Follow this and additional works at: <https://dc.cbn.gov.ng/efr>



Part of the [Economics Commons](#)

Recommended Citation

Omanukwue, P.N. (2012): Rating Game: a review, CBN Economic and Financial Review, 50(1), 115-119.

This Article Review is brought to you for free and open access by CBN Institutional Repository. It has been accepted for inclusion in Economic and Financial Review by an authorized editor of CBN Institutional Repository. For more information, please contact dc@cbn.gov.ng.

Ratings Game¹ - A Review

Phebian N. Omanukwue*

I. Introduction

Post-2008 global financial crisis placed the search light on the activities of global rating agencies, especially in the United States and Europe. The article discussed the regulatory role played by private credit rating agencies and their impact on the financial system. The author attempts to draw attention to the conflict of interests between the objectives of private credit agencies and the regulatory role they play. A synopsis of the article is presented in section II below, while comments and lessons for Nigeria are discussed in section III.

II. Overview of Article

The article noted that credit rating agencies have become an integral element of the financial system in which they operate. The role of these agencies center on the provision of information on the credit-worthiness of a potential borrower and risk of default associated with a financial instrument. Put simply, they perform credit-risk assessment. The substantial reliance by individuals, firms, governments and regulatory authorities on the ratings by these agencies in making key credit, regulatory and investment decisions was pointed out by the author. According to the author, use of the ratings of these agencies has meant {i} less reliance on "static and fixed percentages" to more "dynamic scores" in credit risk assessment {ii} Private credit rating agencies are now seen to perform a regulatory role. Both of these outcomes introduce complexity in the financial system. First, the use of more dynamic percentages could lead to misleading risk assessments. Second, the fact that these private credit rating agencies seem to have been provided with license to regulate the financial sector, a role often seen as a public function introduces, *ab initio*, a conflict of interest problem.

The author traced the increased role of credit rating agencies to the introduction of the Basle II Accord which stipulated risk and capital adequacy requirements for financial institutions to enable them mitigate potential risk. He further added that increased borrowing opportunities and the difficulty of ascertaining full

¹ Published in the IMF Journal of Finance and Development, March 2012 by Panayotis Gavras

* Phebian Omanukwu is a staff of the Research Department, Central Bank of Nigeria. The usual disclaimer applies. The author thanks anonymous reviewers and colleagues for their comments and suggestions.

information on potential borrowers associated with an expanding financial market had also expanded the activities of the rating agencies. Some positive benefits of the activities of credit rating agencies, as highlighted by the author, were: (i) economies of scale derived in the provision of borrower's information; (ii) it narrows the information asymmetry between a borrower and a lender; (iii) improves the access of credit-worthy borrowers to low-cost financing and improves liquidity as information asymmetry is narrowed. The author was however of the opinion that the "institutionalized" role of private credit rating agencies in banking sector regulation meant that they most often influence assets values, capital requirements, eligibility of collateral in central bank operations as well as investment decisions of publicly controlled funds such as pension funds. Thus, in the author's words, the participation of credit rating agencies in banking regulation has replaced the need for due (regulatory) diligence, amounts to privatization of the regulatory process and has meant government's abdication of its key regulatory role, while retaining responsibility for the overall outcome.

The continued reliance on such ratings, according to the author, may not be a feasible alternative to due regulatory diligence, in the long-run mainly due to (i) divergent motives between a private organization and a public institution- while a private agency's major objective is profit maximization, the regulatory body is charged with providing information for the public interest. (ii) Ratings, often times, depend on judgment and most rating agencies (perhaps in a bid to disassociate themselves from any negative outcome) provide a disclaimer on any public consideration of their ratings as an investment advice. (iii) Licensing and regulation of credit rating agencies are often based on market recognition, rather than a standardized system of utilizing regulatory requirements. (iv) Possibility of the credibility of the rating and regulatory process being undermined since a private rating agency is confronted with conflict of interest between the provision of accurate information and its "institutionalized" public regulatory role.

In an attempt to provide elements of a post-crisis regulatory reform aimed at achieving less conflict of interest and improved accuracy of ratings, the author postulated:

- (i) Modification of existing regulatory rules, which could require rating agencies to be more transparent about how they operate.
- (ii) A possible regulation of fees of rating agencies to help resolve conflicts of interest.
- (iii) Establishment of investor boards to delineate rating agencies from their clients.
- (iv) To establish and evaluate the rating methodologies adopted by the rating agencies

- (v) The regulation of private credit rating agencies to the point that they become public utilities.
- (vi) A possible exclusion of private agencies from performing the regulatory role or replaced by a new public rating agency
- (vii) A return to the use of predetermined capital rules. This could improve transparency, eliminate errors in judgment, and reduce conflict of interest
- (viii) Eliminate the reliance on credit ratings: this can be done through a market-pricing process whereby the market, rather than rating agencies determine the quantum of capital that a financial institution must hold to back an asset.

Nevertheless, the author was quick to raise potential questions that arise from some his recommendations. For instance, establishing a new public rating agency raises the important question of who rates the Sovereign? Thus, conceding that not all aspects of the public-private conflict of interest would be resolved. In addition, the use of simpler and predetermined percentages may not capture or differentiate the inherent risks and could lead financial institutions to engage in riskier lending and could even curtail lending.

III. Comments and Lessons for Nigeria

The author introduced an often overlooked dimension in the discourse of credit rating agencies into the literature by drawing readers' attention to the divergence of interest between the profit maximization objective of a credit rating agency and the regulatory function, which they subtly perform without trying to minimize the challenge of conflict of interest that arises between credit agencies and the companies that hire them.

The rating industry is relatively new and evolving in Nigeria when compared to its widespread patronage in advanced economies. At end-March 2011, the number of domestic credit rating agencies, (CRA's) registered by the Securities and Exchange Commission stood at five (5). As part of the efforts to reduce the menace of non-performing credits, reduce overexposure to debtors and boost the credit culture in Nigeria, the Central Bank of Nigeria introduced the Credit Risk Management System which acts as a public credit database, introduced the know-your-customer (KYC) initiative for deposit money banks and further issued operational and regulatory guidelines as well as licenses for credit bureaus {a.k.a, credit reference companies (CRC's)} to, among other functions, provide credit information services. With these infrastructures, the rating emphasis seems to be on "scoring" borrowers with emphasis on ascertaining their creditworthiness for loan creation purposes and not on rating financial debt instruments or their issuers per se, which is the prerogative of the private credit rating agencies.

Lessons gleaned from the events of the post-2007 global financial crisis have indicated that a slight perception of misleading or inaccurate rating can lead to a loss of confidence in the market and is costly to restore investors' confidence. The demand for rating services seems to be driven by international obligations and regulatory bodies, which often permit and mandatorily require debt issuers, including sovereigns to obtain these ratings and credit report from licensed private agencies. It has also been argued that as the financial system develops in breadth and depth, the demand for rating services is bound to increase. This, in itself, enhances the need to strengthen regulatory, supervisory and oversight parameters of the CRAs and CRCs. Global discourse has shown that there are no easy solutions to reduce the reliance on the privately issued credit ratings. It would, however, seem that since 2010, investors have relied less on ratings and attached more weights on political pronouncements, which seem to affect developments in the markets. Whether this is the new norm or a transitory development remains to be ascertained.

The business of credit rating of borrowers or financial instruments thrives on availability, accuracy and accessibility of sometimes privileged information. Building a credit profile is often times based on historical and current credit standing. In Nigeria, the ability of a creditor to obtain full information about potential debtors, is not necessarily constrained by a growing financial market or increased borrowing opportunities as in developed economies, but rather by the lack of unique identifier on clients that is commonly accepted, apathy to full disclosure of information by clients, outdated client data/information, and low use of ICT in requesting for client information due to, amongst other challenges, the perceived mistrust of the authenticity of the sender. The lack of a unique national identifier that is commonly accepted by all service providers in the economy is very critical to the survival of the credit bureaux, especially within a system where it costs next to nothing to assume multiple identities which are hardly verifiable. These invariably lead to an abuse of the system by potential borrowers since credit is not linked to a national identity number. Consequently, intervention measures should aim at addressing the issues above. One of such measure is the Know-Your-Customer (KYC) initiative by the Central Bank of Nigeria. Anecdotal evidence, however, indicated that the implementation of this initiative was fraught with some challenges including the inability of bank customers' to provide personal information to branches of their banks' as clients were being referred to visit their bank branches where their account was domiciled to update their details, misunderstanding of the KYC initiative by some staff of financial institutions, man-hour lost due to required physical presence to provide these information and in some cases, clients' concerns about data protection as well as potential loss of confidentiality.

Post-implementation challenges of government initiatives such as the KYC, national identity card scheme should be reviewed periodically. In gauging the performance and acceptability of the CRCs and CRAs, accuracy of ratings of existing CRAs as well as access to the credit database registry in terms of number of visitors (online and offline) should be assessed. In addition, consistency, quality of services provided and integrity of ratings are factors that could determine the future development of the industry.

The overriding objective of a lending institution such as a bank or finance company is to make profits which calls to question the assurances that a lending institution will issue credit to a potential debtor who always pays outstanding debts in record time with little or no prospect of the bank earning an interest income? Therefore, certain concerns that need to be addressed revolve around ensuring that the credit scoring systems gives more weight to the inherent risk rather than profit. For instance, some deposit money banks conduct “name check” and have developed cautious approach towards issuing debt to politically exposed persons. Potential lenders should also move beyond ascertaining how desirable it may be to lend money to a borrower and examine the legitimacy of the application for credit. In some jurisdictions, a broad review of the CAMELS ratings system has been proposed in order to generate ratings that reflect risks in all components. Consumer education on the role of credit bureau and rating agencies is further recommended to aid consumer understanding of their products and further develop the industry. Value-added services would need to be introduced as the industry expands. The need to reverse the upward trend of “trust deficit” in the system cannot be over-emphasized in order to assure consumers that their data is protected. Furthermore, the current approach by lending financial institutions to mandatorily require that a periodically funded account must be domiciled and maintained in their bank before a client can be considered for a loan facility needs to be revisited. This situation begets questions such as (i) what is the purpose of establishing a credit bureau (ii) what is the essence of giving one's bankers a standing instruction to credit a designated account in the lending institution without having to move accounts. Finally, there should be continuous research and update of rating practices, harmonization of methodologies (while accounting for industry specifics), and regular update of rating models and CRAs code of conduct to reflect current and evolving realities.

Reference

Gayras, P. (2012), “Ratings Game”, *IMF Journal of Finance and Development*; March