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