Ratings: **Strengthening Credit Market Regulation**

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Excellence in the Regulation of Credit Markets stimulates their development, and is critical to the long term stability of the financial system. While Caribbean regulators have made significant strides, especially in the commercial banking arena, the author calls for further attention to regulation of the investments and securities market, with a focus on individual exposure quality, concentration risk and liquidity risk. Regulators should move quickly: "The easiest way," suggests the Author, "would be to appropriately borrow from tried and tested best practices in other emerging economies."

Regulation plays an extremely critical role in developing financial markets, and further, in taking them to a level of sophistication. A financial market regulator's role, at the core, is to lay down rules of engagement and monitor conformance to the same, to ensure a level playing environment for all participants and create the confidence for all stakeholders that fair practices are followed.

In addition, good regulation should promote good corporate governance practices, as it should seek to set the expectations and demands of all stakeholders, by setting inviolable standards of conduct for the entities regulated- in terms of accounting, disclosure, reporting, governance structures, management practices and stakeholder relations.

Regulatory Models: Regulation is a tough job, especially in free market economies, and calls for careful balancing of various issues. It is also important for regulation in emerging markets to be dynamic, in that it needs to evolve over time, and shape itself according to the priorities of the market, the needs of the economy, and the maturity of market participants. Regulation also should guard against becoming counter-productive - the cost to participants of conformance to regulation in terms of both money and effort should not outweigh the benefits and discourage the growth of the market itself. Several models of regulation can be observed around the world; but on balance, most market practitioners favour a "light-handed" system, which has comprehensive and exhaustive laws combined with minimal controls and intervention, over a "heavy-handed" system, which has minimal laws, but leaves much to interpretation and consequently frequent and drastic interventions.

Regulation of Credit Markets: Credit markets invariably account for the bulk of the financial system in any economy and as a consequence, regulation of credit markets, i.e., lending and investments by financial institutions, insurance companies, pension funds, trust funds etc, is critical for determining the long term stability of the financial system. Moreover, credit and counterparty risk is the most critical risk in a financial system, with the maximum potential for causing system-wide distress or losses. Accordingly the regulations which determine the credit quality and concentration risk of credit or investments become a key issue.

The Caribbean Context: In relatively small economies like in the Caribbean, this issue assumes greater significance, as the concentration of ownership of businesses increases the potential for concentrated exposures and connected lending. Moreover, shared ownership interests in merchant banks, commercial banks and asset management companies, a common feature in the Caribbean, may not provide sufficient scope for arm's length transactions in investment decisions and does not present a credible degree of independence to an external observer. A scrutiny of regulations surrounding financial institutions in some Caribbean countries shows that regulation of portfolio credit risk deserves far more attention.

For instance, with the application of International Financial Reporting Standards, IFRS, valuation of unlisted investments is largely assumption driven (rate of return, perceived risk, profitability expectations and the value of underlying assets). Under conditions where few debt securities listed and there is virtually no secondary market in debt across the Caribbean, valuation can at best be a good guess, particularly with respect to non-sovereign debt. In such a situation, auditors, as a professional group would greatly benefit from the presence of credit ratings for debt securities that could be used to construct a yield curve across risk categories and across tenors.

Another area calling for attention is that of liquidity risk management in banks and financial institutions. For instance, some financial institutions in the OECS adopt a maturity bucketing of (a) less than 1 year (b) 1 to 5 years and (c) beyond 5 years, while disclosing their asset-liability mismatches. In CariCRIS opinion, the second maturity bucket of 1 to 5 years is too broad and might potentially mask liquidity issues that might start surfacing just at the end of the 1 year period.

Ratings & Regulation of Credit Markets: In the banking sector, Basel-I earlier and now Basel-II guidelines set the standard for indirectly regulating the quality of loans or investment exposures of banks. Even though the Basel guidelines relate to capital adequacy, by linking capital requirements to credit ratings, there is an in-built incentive for banks to achieve a reasonably high credit quality in order to optimise the level of capital they hold. In the Caribbean, most economies are a good distance away from having a game plan for implementing Basel-II, although Barbados and Bahamas are reputed to be moving in that direction decisively.

For investment institutions, in many countries around the world, both developed and emerging, regulators seek to control credit quality by stipulating credit rating thresholds for investments made by insurance companies, pension funds and trust funds. A sample list of usage of ratings in regulation of investments is provided in the attached tables. A guideline which can be commonly observed in these regulations is the requirement of minimum investment grade rating (Rating of BBB- or equivalent). Another feature included by regulators in many countries, though not detailed in the tables here, is to stipulate that not more than a certain portion of the total investment portfolio can be invested in unrated debt. Similarly, either by way of formal regulations or by market practice, mutual funds (particularly gilt funds and money market funds) often use external credit ratings to determine the profile and characteristic of various investment

schemes, and it is common to find schemes marketed as “AAA” Funds or “AA” Funds, which presents a clear picture to the investor about the credit risk associated with the investment choices.

Table 1: Use of Ratings in Regulation in Select Countries- Developed Markets

Industrial Countries	Rating Linked Investment Regulations
Australia	The provinces of New South Wales and Victoria restrict fiduciaries to invest only in securities that have a stipulated rating (AA or higher in the first province, varying depending on the rating agency in Victoria)
Canada	More simple filing procedures apply when issuing nonconvertible debt or preferred stock in the case of companies that already have investment-grade outstanding debt.
Japan	The Ministry of Finance stipulates that any listed company can issue commercial paper provided it has an investment-grade rating from two recognized agencies.
United Kingdom	The European CAD directive was adopted in 1996. Banks and securities firms are permitted lower capital provisions for investment grade rated securities.
United States of America	The office of the Comptroller of the Currency (OCC) and the Federal Reserve Board (FRB) have, since 1936, restricted banks to investing in investment-grade debt securities.
	The National Association of Insurance Commissioners (NAIC) established in 1951 capital requirements for insurance companies that give the lowest requirement ratio to investment-grade debt securities.
	Since 1989, the Department of Labour has permitted pension funds to invest in asset-backed pass-through certificates if, among other conditions, these certificates are rated in one of the three highest categories by one of the four largest rating agencies.
	Under the Financial Institutions Recovery and Reform Act of 1989, savings and loans are prohibited from investing in non-investment-grade securities.

Table 2: Use of Ratings in Regulation in Select Countries- Emerging Markets

Emerging Markets	Rating Linked Investment Regulations
Asia	
India	The Reserve Bank of India requires that loan and investment companies have a minimum investment grade rating in order to accept public deposits.
	Ratings are compulsory on all public issues of debentures with maturity exceeding 18 months.
	Pension funds can only invest in securities that have two ratings.
	Insurance companies have a stipulation on the proportion non-government bonds in the portfolio that are unrated
	In the rated category, insurance companies have a minimum investment grade stipulation
Indonesia	There is a minimum rating requirement on commercial paper issues (A4, the local minimum investment-grade rating) and a rating requirement on non-government bond issues.
Korea	There is a requirement of two ratings for the issuance of non-government bonds and commercial paper but under discussion is the possibility to remove this requirement.
Malaysia	There is a minimum rating requirement (BBB, which is the local equivalent of investment grade) on non-government bonds and commercial paper.
Philippines	There is a rating requirement for non-government bond issues, and the security and exchange commission there has the direction to mandate a rating for commercial paper issues.
Latin America	
Argentina	Banks must be rated by two separate agencies and have to disclose these ratings to counterparties in a transaction upon demand.
	Banks cannot purchase bonds issued by (or extend credit to) related clients if these bonds are rated below BB.
Mexico	Private pension funds can only invest in securities rated at least AA.
	Firms must have an investment-grade standing when they issue debt.

Local Rating Agencies: In the described instances, regulators have the ability of using rating linked investment guidelines, since in many countries local rating agencies provide national scale ratings, apart from ratings available from international agencies such as Standard & Poor's. However it must also be borne in mind that it was such initiative with regard to rating linked regulations that led to the establishment of local rating agencies in many countries. Malaysia is a case in point where rating linked regulation preceded the establishment of the local rating agency. While lack of sufficient number of ratings by international rating agencies could have been a problem in the Caribbean in the past, the establishment of the Caribbean regional rating agency, CariCRIS by several Central Banks and financial institutions from across the region, makes the situation quite different now, as access to ratings for issuers is now locally available. Regulators need to now take advantage of this development and take a leaf from best practices in other emerging markets.

In applying ratings, regulators would need to consider the availability of rated securities, particularly when evolving from a scenario where no such regulation exists. The ideal or recommended way of resolving this problem, is to provide a graded transition. For instance the investment institution could be required to meet, say over a three year period a desired limit of having, say 60% of all investments in investment grade rated securities, (by stipulating 20% in first year , 40% in the second year etc.).

Conclusion: Financial Sector regulators in the Caribbean have taken significant strides during the past decade and a half, to strengthen their respective financial systems, particularly in the wake of system failures observed in the region in the past. This is especially the case with the commercial banking sector. . While a few regulators such as the Financial Services Commission, Jamaica have taken some initiatives, across the board, there is substantial scope for strengthening regulations which drive the investments and securities market, particularly those which determine investment by pension funds, debt (mutual) funds, trust funds and insurance companies, being institutions that have serious fiduciary responsibility in terms of handling public funds. Specific areas needing attention include individual exposure quality, concentration risk and liquidity risk. The Caribbean region, as has been proved time and again, is susceptible to external shocks and the risk is heightened by the high indebtedness at the sovereign level in many countries. In this context, it behoves financial system regulators to quickly move, and the easiest way would be to appropriately borrow from tried and tested best practices in other emerging economies, rather than re-invent the wheel. While this would require some serious adjustments on part of the regulated institutions, there is no doubt that such measures would ultimately serve to make our financial systems more robust and resistant to potential systemic crises.

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