



FSB regional consultative group MENA

Reducing mechanistic reliance on CRAs : Kuwait Experience and Suggested Measures

October 01, 2014

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Introduction

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- Credit rating agencies (CRA's) impact on Financial markets:
 - CRAs played a major role in the growth of global financial markets
 - Bridging the gap: Information asymmetry between issuer and investors
 - The recent financial crises demonstrated cliff effects of CRA rating and caused world-wide systematic disruptions



Financial Stability Board (FSB) recent initiatives

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- FSB initiatives to address cliff effect CRA rating:
 - ▣ The mechanistic reliance on CRA ratings has been identified as source of concern to global financial stability
 - ▣ FSB with G20 Leaders and central bank governors have come up with a roadmap and finalized stock taking
 - ▣ G20 has come up with stock-taking and implementation plan



FSB Roadmap

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- Relevant national authorities should:
 - aim to reduce mechanistic reliance on CRA ratings through standards, laws and regulations
 - work to promote and, where needed, require that financial institutions strengthen and disclose information on their own credit risk assessment approaches



However, still the question remain .. “Who is to blame for the crisis ?”

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- Is it only CRAs ?
 - ▣ Financial institutions
 - ▣ Public policy
 - ▣ Monetary policy
 - ▣ Too-big-to-fail assumptions
 - ▣ Accounting/Auditing firms
 - ▣ Rating agencies
 - ▣ Market players
 - ▣ Supervisors
 - ▣ Standard setters
 - ▣ Human greed



Then what's ... “Mechanistic reliance ?”

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- Mechanistic reliance - a definition (*):
 - “It is considered that there is sole or mechanistic reliance on credit ratings (or credit rating outlooks) when an action or omission is the consequence of any type of rule based on credit ratings (or credit rating outlooks) without any discretion”

(*). Definition adopted by the European System of Financial Supervisors in reports issued February 2014



The Critical Questions

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- The critical questions:
 - ▣ How could the use of ratings provided by the CRAs been so relied upon ?
 - ▣ How were the CRAs ratings so misinterpreted to create world-wide systematic disruptions ?
 - ▣ What's the solution ?



The real-world solution ... need not be unique

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- Broad level solution features for avoiding CRAs mechanistic reliance:
 - CRAs to consistently provide high quality, independent and objective credit ratings
 - Independent CRA regulator
 - Apply sound principles of ECAI's recognitions
 - Develop adequate means to perform an independent assessment of CRAs rating
 - Where applicable directly apply FSB's roadmap
 - Regional/country specific solutions



Kuwait experience (1)

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- Impact of recent financial crisis:
 - ▣ The direct cliff-effect of CRAs rating in the domestic market : Not significant
 - ▣ However economic impact through financial market connectivity
- Kuwait market 'Rating dynamics':
 - ▣ Kuwait financial market maturity issues vs. developed market
 - ▣ Major banks and large cross-border organizations are rated by known CRAs
 - ▣ Aftermath of Gulf-war (in 1992) the State of Kuwait has cause to seek rating to support its entry into international capital market
 - ▣ Major challenges of rating for family organizations including KSE listed entities



Kuwait experience (2)

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- CBK operations and Stock-taking:
 - Reliance on CRAs ratings as mentioned across BCBS standardized approach capital and liquidity guidelines
 - While CBK uses CRAs rating as an input for setting counterparty limits – this is not, however, considered mechanistic
 - CRAs ratings are an input in the supervisory frame-work – this is not, however, considered mechanistic



The way ahead ...

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- My contention:
 - Effectively create an independent institution to regulate CRAs
 - Case for Kuwait – market dynamics and need of CRAs
 - Develop adequate means to perform an independent assessment of CRAs rating
 - Joint stock taking in related economic activities.
 - Adequate Prudential regulations to avoid possible mechanistic reliance

Conclusion

- Given the development phase of financial market ... Kuwait requires CRAs rating ... the suggested measures are:
 - Continue stock taking activity
 - Apply sound principles of ECAIs recognition for the market
 - Independent institutions for regulating CRAs
 - Encourage development of regional CRAs
 - Guidelines to use internal assessment in parallel with CRAs rating
 - Guidelines to avoid automatic use of CRAs rating threshold
 - Engage in dialogue with regional as well as local market participants

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Q&A ?



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Thank You !





References

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- ▣ Bank of England
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