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Interview with RMI Director, Prof. Duan Jin-Chuan

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Dec 13 2011 Patricia Lee in Singapore **recommended**

Professor Duan Jin-Chuan, director of Risk Management Institute (RMI) at the National University of Singapore (NUS), is a strong advocate of not-for-profit credit rating agencies.

Here he tells Thomson Reuters why public credit rating agencies will provide some much-needed and healthy competition to private rating agencies, and that the process to start a publicly-funded alternative must begin now. He also shares his views on why the regulatory reform that has been contemplated for rating agencies may be doomed to failure.

In addition to his directorship at the RMI, Duan concurrently holds the Cycle & Carriage professorship in finance at the NUS Business School. He is also an Academician of Academia Sinica. Prior to joining NUS, Duan held the Manulife chair professorship at the Rotman School of Management, University of Toronto, and has also taught at the Hong Kong University of Science and Technology and McGill University.

Duan obtained his PhD in finance from the University of Wisconsin-Madison. He specialises in financial engineering and risk management, and is known for his work on the GARCH option pricing model. He has authored numerous scholarly publications on derivative securities and risk management, and has written a book and occasional media commentaries on current financial/economic events.

Duan was a speaker at the 2nd Pan-Asian Regulatory Summit hosted by Thomson Reuters in Singapore in September.

For a long time, the concept of public rating agencies never really existed. Why was there no effort made by the global financial services sector to promote the use of public rating agencies? How can industry players and potential issuers be convinced that they can rely on the services of public rating agencies?

This has more to do with "the way things are". It happened not as a result of some grand design but because of the way in which the business of ratings naturally evolved. Credit ratings started as a buy-side activity, meaning that investors used ratings to make bond purchase decisions. With the advent of photocopying technology in the 1970s, major rating agencies gradually evolved into sell-side rating houses to avoid free-riders.

There are a few issues to consider however, if public rating agencies were to be set up. These include: What would be the incentive to create a public-funded rating agency? Where would one get the financial support for a seemingly unnecessary undertaking that could cost a serious sum? How could it be possible to establish the credibility of such an operation without going through serious growing pains? How could an initiative of sort survive the lobbying efforts by the industry?

Assuming that the quality of ratings issued by a publicly-funded operation are scientifically superior, most industry players and users will still adopt a wait-and-see attitude because the rating business has never been about quality anyway; it has always been more about business conventions and regulatory requirements. Indeed, it may well seem easier to stick to an existing but failed system than to embrace a new, but as-yet proven, one. I am optimistic that, if it can be demonstrated scientifically that a publicly-funded system can generate quality ratings that are also easy to use, it will win users over and develop a new business convention that includes the public alternative. Although this will take time, the process must begin now.

You have advocated the need for both public and private rating agencies in the financial marketplace to overcome the problems which, had long existed but only came to the fore during the recent financial crisis. These problems included the mis-ratings of structured products by rating agencies and the conflicting role of rating agencies which are paid by their clients to do the rating. How will having public rating agencies in the market help to overcome these problems?

The first thing is to separate the rating business into buy-side and sell-side. The buy-side credit analysis is proprietary in nature and its aim is to gain an edge over competitors to increase investment returns. The buy-side rating activities are naturally funded by users, and we need not worry about these. The sell-side ratings are paid for by issuers, and the ratings can determine to a large degree the cost of funds for the issuers. Naturally, there is potentially an inherent moral hazard in such an issuer-pay arrangement. I have no problem at all with commercial rating agencies, be they for the buy-side or sell-side.

Although the quality of ratings issued by the for-profit rating agencies may vary, their objectives are the same: to maximise the value for their owners-shareholders, the way that they are supposed to do. If we did not understand this, we would inevitably bark up a wrong tree. My problem lies with the fact that the core of the debt market infrastructure somehow exclusively relies on a distorted business model and is left entirely to a handful of for-profit credit rating agencies. If we view credit ratings as a public good, we will certainly not leave the credit-rating market as it is. A not-for-profit credit rating competitor will provide some much-needed and healthy competition.

Could you tell us about the initiative that the RMI embarked on in 2009 by taking on the role of a public credit-rating agency? What were the main motivations for taking on this role? What will be the business model of the RMI of Singapore as a public rating agency? Do you charge a fee for your services?

It occurred to me in March 2009 that the world has gone about credit rating reform in a wrong way, and it was due to our failure to recognise the public-good nature of credit ratings. Thus, it seemed to me that the regulatory reforms of credit rating agencies which were being contemplated were doomed to fail. I thought I could demonstrate to the world that the public-good concept could be an operational reality. I was privileged to head up the RMI of the National University of Singapore, which happened to have resources and support from the university to try something innovative, and that is what has made this ambitious undertaking possible. Being an academic institution, the RMI is naturally non-profit and supported by public funds. We will not charge users because the credit rating system created under this initiative is meant to be a public infrastructure that belongs to the world. We do not need a business model, but we still need to justify our value to society. It is my belief that the public will see the initiative in a positive light and support its continued operation. They may even support this initiative with direct donations.

What challenges has the RMI faced in building its credibility? Has it been actively promoting itself in the global financial marketplace? How has the response been so far? What has the institute done to convince international market players to rely on the services of public rating agencies?

Credibility can only be earned, and that is what we intend to do. Fortunately, the concept is naturally appealing, and all that needs to be done is to explain to people the idea and our action plan. I have been speaking to people around the world, and have won over many supporters. The system has about 1,000 users now, and we have also received proposals to collaborate. We will not be content if the RMI system is just a public system freely available to any users. We have set out to create a system through a Wikipedia-style development effort so that it becomes the best system in the public domain, and is also able to evolve organically over time.

From my conversations with many industry professionals, I have learned of several ways in which the system can be used. For example, some use the RMI system to benchmark or examine their own rating models, some contemplate using it for counterparty credit risk management, and some think of using it to identify trading opportunities presented by the gap between the commercially available ratings and the one by RMI. In addition, RMI is currently working with a central bank to develop a stress-testing system using the RMI model. I believe that many more industry professionals and regulators will begin to see the RMI credit research initiative as an essential part of the world financial infrastructure, and will be able to enjoy direct or indirect benefits from it.

In your presentation at the 2nd Pan Asian Regulatory Summit hosted recently by Thomson Reuters, you pointed out the need to separate ratings for the buy- and sell-side, to understand where problems with credit rating might lie. You also noted that the problem lay largely with sell-side credit ratings. How do you think these problems can be best resolved?

Sell-side activities are a critical element of any financial market; they are as natural as having TV commercials for consumer products. The solution is not to get rid of them, rather it is to establish some kind of balance. RMI in the credit rating sphere is like a consumer protection bureau that runs regular and independent checks on products, but its operation is not tainted by conflicts of interest. Financial regulations are more like setting food and safety standards, and there is a limit to how effective they can be.

You have said that sell-side activities have a public angle and that sell-side credit ratings are based on rules. You also pointed out that the global financial crisis showed that sell-side credit ratings lacked an infrastructure. What exactly is the infrastructure that is lacking and in what form should the infrastructure take?

Sell-side ratings are important not because of the credit information they carry. The rules and conventions in the financial world have evolved into a state where they typically reference the sell-side ratings, hence their prominence. For example, pension funds can only buy investment-grade bonds, with the investment grade being defined by the sell-side credit rating agencies. It is also a common business practice to refer to sell-side credit ratings in collateral agreements; for example, the debt instrument serving as the collateral for a CDO (collateral debt obligation) must be rated AA or higher. My view is that the provision of sell-side ratings should be treated as an infrastructure matter for a society, and should therefore not be left entirely in private hands, much as we do not let a few private operators control the entire roadway system.

You talked about the case of China where rating shopping is still very prevalent, where rating agencies are still largely for profit, and where the basic business model has not changed, and that they are still subject to the same fault. Could you elaborate a bit more on these points? How can Asia learn from China's experience?

With the exception of one new agency, all credit rating agencies in China are for-profit, much like S&P and Moody's. In fact, S&P and Moody's have significant stakes in some of the Chinese credit rating agencies. It should not really be a surprise, therefore, to see rating shopping taking place in China. The lesson is quite obvious: China is rapidly developing a credit rating system that is destined to crash unless something is done about it, and quickly.

I mentioned a new credit rating agency in China that is not-for-profit. In September 2009, China Credit Rating Co was established on the user-pay principle by the National Association of Financial Market Institutional Investors (NAFMII). The ratings to be issued by this credit rating agency will be paid for by securities dealers instead of issuers. I am not entirely convinced how independent this arrangement will be, but I applaud the effort and hope that it will help to reduce the kind of unhealthy competition which has manifested in the form of rating shopping.

You have pointed out the need to move beyond the current thinking and to confront many of the issues which surround credit rating agencies, rather than hiding behind it. What, in your view, should constitute a new way of thinking regarding the operation and business model of credit rating agencies? Do you think that industry players' vested interests have resulted in the industry not confronting the real issues?

Taking a public-good approach to credit ratings is one example, and the establishment of the China Credit Rating Co is another. The focus should be on finding ways to improve the information content of ratings, and in my opinion the best way to do this will be through healthy competition. Some segments of the industry have obviously benefited from the current business model, and they have a vested interest in maintaining the status quo. The inherent incentive problem with the current business model for credit rating will not, therefore, go away unless we confront it head-on. By the way, I am completely pessimistic about relying on a regulatory route to get this market in order.

RMI credit rating initiative's can be found on http://www.rmi.nus.edu.sg/cri/