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Singapore university seeks to break hold of credit-rating goliaths

Commented by RMI Director Professor Duan Jin-Chuan

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* Banks sign up to use system

* Does away with alphabetic ratings

* Run on not-for-profit basis

By Rachel Armstrong

SINGAPORE, Oct 14 (Reuters) - In a small lab, tucked away in the depths of a Singapore university campus, a team of researchers and their computers calculate the credit ratings of about 50,000 companies.

Relying just on public data and stock price movements for their analysis, the project's founder, professor Jin-Chuan Duan, is confident their system can provide a more reliable guide to a company's credit risks than the commercial rating agencies.

A confident claim, but a growing number of the system's 800 users are banks and fund managers, utilizing it to help guide their own internal credit risk systems.

"It offers a very transparent and objective approach to estimating the credit rating of companies," said Benjamin Wong, a senior risk analyst at a UK bank.

"I'm not sure a single bank could do what they've done in terms of collecting the data, assembling the research capabilities, and having the technology to do the calculations on such a large volume of companies."

BORN OUT OF FRUSTRATION

The idea was born in March 2009, out of frustration at the debate surrounding credit rating agencies in the wake of the financial crisis.

"It occurred to me that just criticizing the rating industry and going about the conventional way of regulatory reform is never going to go anywhere, so I was asking myself is there something more constructive I could do?," said Duan, the director of the National University of Singapore's Risk Management Institute.

An evangelist for revolutionising the way credit rating agencies operate, Duan believes the private sector model, where agencies are paid by the issuers to rate their products, is flawed.

"Credit ratings should be viewed as a public good and part of infrastructure," he said.

"The natural way to achieve this is for a knowledge enterprise to do it."

So that's what Duan did, allocating S$7 million ($5.5 million), part of a grant provided to his institute by Singapore's central bank, to fund a free-to-use credit rating service for four years.

He and his team of around 30 researchers built the system using data from Reuters and Bloomberg terminals on companies listed across Asia, Europe and America.

They designed models to calculate the probability of a company reneging on its debts, shaped by analysis of previous corporate defaults.

NO MORE AAAs

Rather than issuing the well known alphabetic ratings like AAA, the system produces a numerical probability instead. For example it estimates that the recently rescued Franco-Belgian lender Dexia SA has a 3.4 percent probability of defaulting in the next two years -- low but still five times the European financial sector's average probability of 0.7 percent.

The big-three credit rating agencies -- Moody's , Standard & Poor's and Fitch Ratings -- have defended their lettering system as a useful shorthand understood across the finance industry.

But Duan is among the many critics who believe debt should be assigned a more precise credit rating.

"In the political polling sphere during election time we tell people the points and margin of error in a poll and TV viewers don't have a problem understanding, so it should be possible in the financial sphere," he said.

COMPETITION

It's not the first time someone has tried to give the big three agencies and several local players a run for their money. Following the financial crisis, Wall Street analyst Meredith Whitney, entrepreneur Jules Kroll and research firm Morningstar Inc are among those who have ventured into the ratings space.

What distinguishes the university's offering is it's not out to make money and welcomes outside contributions that will improve its model.

"As we are not for profit, we are happy to invite people to participate with us in a Wikipedia-type spirit of development," said Duan, adding that they don't register intellectual property rights for the project, nor do they take corporate donations.

It's this approach that is one of the big winners with the industry. With banks under more pressure than ever from the regulators to provide a thorough explanation of their approach to risk management, they need a credit rating system with a public methodology they can test for themselves.

"They (the institute) are transparent in their methodology and in disclosing the performance of their ratings," said Wong at the UK bank.

"For the credit rating agencies, a rating decision is made based on a committee approach, so it can be quite subjective."

That's not to say the system's not got its limitations -- it can only rate publicly listed companies and lacks the access to issuers that the big rating agencies have.

But Duan believes their system, based as it is on quantitative analysis of previous defaults, will provide a scientific benchmark for banks and regulators to test other credit rating systems against.

Asked what the commercial players have made of their offering, he says they have initially been rather defensive but come round once they realise they are not facing financial competitors.

"Once we've made it clear we're here to create scientific competition, we're not here to create business competition they start to feel a bit more comfortable with it," said Duan. ($1 = 1.276 Singapore Dollars) (Editing by Muralikumar Anantharaman)