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Caribbean Information & Credit Rating Services Limited

Credit Ratings Critical to Capital Market Development

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The Central Bank of Trinidad and Tobago (CBTT) and the Trinidad & Tobago Stock Exchange (TTSE) must be congratulated for their successful implementation of a platform to facilitate the electronic trading of bonds and fixed income securities. This is the latest in a number of critical initiatives undertaken by the CBTT to develop the domestic capital market, the others being the introduction of an electronic auction system for government securities in the primary market and an electronic clearing and settlement system linked to the trading platform. The electronic trading platform should facilitate in the first instance an increase in trading activity of government bonds. However, to reap the full benefit of the CBTT's initiatives, we must also encourage the trading of corporate bonds as well. The use of credit ratings and more specifically regional credit ratings is critical to the development of our region's corporate bond market and indeed the wider capital markets.

Role of domestic capital market in the local economy

By way of background, investment – both private and public – is the means by which an economy grows. The money to finance this investment comes from savings – either domestic savings or foreign savings. While globalization of capital markets is making it ever easier to access foreign savings, reliance on external financing may come with the risks of system-wide liquidity or solvency crisis that can be precipitated by a sudden stop in external finance. This is why most policy makers agree on the critical role that domestic capital markets play in both growing the domestic economy and in insulating it from global financial crises.

Indeed, 2004 was a stark reminder of how a government's access to domestic savings could make or break a country's fiscal position. Dominican Republic, whose external public debt to GDP was 22% (total debt to GDP was 50% which is considered moderate), was forced to default due to its lack of access to a vibrant domestic capital market. On the other hand, Jamaica, whose external debt was in fact much higher at 75% (total debt to GDP was 136%) was able to avoid a default due to a vibrant domestic capital market, from which the government raised monies to meet maturing debt obligations, both local currency and foreign currency. It is precisely this flexibility that a healthy domestic bond market gives to a government, that serves to improve its sovereign foreign currency credit rating.

Matching of risk tolerance with return objectives

Savings have to be placed somewhere – either deposited into the banking system or invested in various tradable financial instruments in capital markets. Credit ratings, in estimating a probability of default, help savers (i.e. investors) to assess their options and rationally match their risk tolerance with their savings objectives. This use of credit ratings to pool risks results in a more efficient use of funds.

Development of the corporate bond market

In the absence of analytical information about a company's financial position and corporate strategy, many would-be investors in corporate credit markets stay within the confines of the relative comfort (and lower returns) of the banking system or the government securities markets. By virtue of enabling investors to easily compare credit risk across companies, industries and countries, credit ratings deepen the capital market by attracting more investors into the corporate bond market.

Reduction in cost of capital

From the perspective of those trying to raise funds, credit ratings enable them to access funds from a wider range of instruments (and not only bank loans) as well as reduce information risk, both of which should result in more efficient pricing. This reduces the cost of capital and allows a larger number of projects to be economically viable, thus increasing the rate at which the overall economy can grow. On account of a greater number of projects being funded, credit ratings also improve the liquidity of a bond market. Inefficiencies typically inherent in any banking system such as high operating costs, the management of non-performing loans and the cost of maintaining high reserve requirements at the central bank are usually less prevalent in capital markets.

Greater transparency in the market

Credit ratings reduce informational asymmetry, not only via the information contained in the credit rating symbols assigned to various instrument, but also by supporting greater financial disclosure, better corporate governance and improved access to publicly available expert analysis.

Greater information disclosure and improved liquidity also deepen the market by attracting money that would otherwise have been placed off-shore or in real assets, which are not as productive to the economy as investments in real sector (manufacturing / services). Greater participation overall in the financial markets enables a government to have more flexible and arguably more effective monetary policies. This is because it is more effective for governments to manage short-term interest rates by open market operations using government securities than by making direct loans or changing the repo rate.

More scientific pricing of risk

Regular issuance of government paper in different amounts and of varying tenors is necessary for the construction of a base yield curve which is fundamental to the development of a healthy domestic bond market. It is impossible to construct any yield curve other than the government one in the absence of credit ratings. This is because credit ratings give the independent measure by which to allocate various instruments into risk buckets (AAA, AA, A, etc.) for which a credit curve can be constructed. By enabling such construction, credit ratings lead to a more scientific and clearer pricing of credit risk and cause inefficiencies in the bond markets to be glaringly obvious, thereby allowing for their correction.

Global vs. Regional Credit Ratings

Of direct relevance is the fact that there are very few debt issues that have been rated in the English-speaking Caribbean, by global rating agencies. Therefore, global credit ratings obviously cannot provide all the benefits that are supposed to accrue to our capital markets because such credit ratings are not very relevant to domestic and regional investors. While they are necessary for those institutions who wish to raise funds in the international capital markets, global credit ratings do not help local investors in differentiating the credit quality of alternative investment options within the region.

The global scale credit ratings assigned to companies and other non-sovereign entities are typically capped by sovereign ratings. On their part, the sovereign ratings in this region tend to remain low in the global rating scale (BBB or below), reflecting the small size of the regional economies, moderate stage of development and relative lack of income diversity. This in turn leads to bunching of all credit ratings assigned in the lower end of the global scale. While this is not of material importance to a global investor who is deciding whether to place their funds in Eastern Europe or the Caribbean, it is of vital importance to the local or regional investor.

Regional Ratings more relevant

A regional credit rating agency being based in the Caribbean will provide an estimate of the relative probability of default in the universe of debt issued in the Caribbean. Because they will provide far more relevant information to investors and enable useful differentiation of credit risk within the region, the regional agency's rating penetration will be far higher than that of the global rating agencies.

These two factors viz. a better differentiation of credit risk within the region and a greater penetration of credit ratings will go a long way in the development of our regional bond markets.

Conclusion

While several of the necessary infrastructure are now in place to support the growth and development of the domestic bond market, full development will be stymied and indeed impossible without greater utilization of credit ratings as part of the investment decision making process. Further, as we works towards the next step up in developing the region's capital markets - a common regional electronic platform for the trading of all stocks and bonds in the region - having a regional rating scale as currently provided by CariCRIS, that compares credits both corporate and sovereign across the region, and ranks their relative creditworthiness in a consistent, transparent and easily identifiable manner, becomes even more critical.

CariCRIS is the Caribbean's Regional Credit Rating Agency. For more info E-mail: wdass@caricris.com or call 868-625-3007.