DIRECTED RISK RESEARCH PROPOSAL

Risk Theme	Credit Risk

Client Info: *(only applicable if proposal is in response to a client problem statement)*

Problem Title	Suitability of external agency ratings for rating in-country bank borrowers in emerging markets				
Client Name	Simon Greenberg			**Client Org.**	BAG
Designation	Head: independent Validation Unit (Model Risk)				
E-mail	Simon.Greenberg@absa.co.za	**Tel (w)**	011 846 2393	**Mobile**	082 441 9010

Research Team:

Team Leader	Tanja Verster	**Designation**	Associate Professor: BMI		
E-mail	Tanja.Verster@nwu.ac.za	**Tel (w)**	018 299 2566	**Mobile**	082 922 0065
Team member	Riaan de Jongh	**Designation**	Director: Centre for BMI		
E-mail	Riaan.deJongh@nwu.ac.za	**Tel (w)**	018 299 2575		

University	NWU	**Classification**	
Problem Nr.	PS17003	**Type**	Technology-Pull
Proposal Nr.	RP17004	**Date**	July 2017

PROJECT TITLE: Suitability of external agency ratings for rating in-country bank borrowers in emerging markets

PROJECT GOAL:

Given the considerations employed by the rating agencies in producing their ratings (data, methodology, overlays, adjustments, floors, seniority, etc…), we will investigate whether the bank's lending to the rated borrowers should use the ratings and PDs published by the agencies, or should the agencies' ratings/PDs be adjusted due to the fact that the bank faces different level of risk compared to the intended consumers of rating agencies' ratings by virtue of the comparative domicile/seniority/contract/legal environment? We will investigate whether these ratings should be adjusted and it so, we will investigate how this should be adjusted. The answer will likely differ on the type of the borrower (sovereign, bank, non-bank financial institution, large corporate), the industry of the borrower and local versus in-country business.

PROJECT SCOPE

External rating agencies (e.g. S&P and Moody's) rate South African entities by taking a generic lender view, i.e. the ratings are not conditional on the lender type/position and take into account the borrower and transaction characteristics only. The rating also depends on the sovereign rating through a full or partial use of sovereign floors. However, when a South African bank lends to a local entity, the bank's perception of the PD may be different (in our experience, lower) that that implied by the external rating agencies. As an example, a systemically important SA bank and a small Canadian bank would assign the same PD to a South African Bond Issuance through the use of external agency ratings. However, it is not clear-cut whether the risk of sovereign default to the two banks is the same, by virtue of the importance of a systemically important local bank to the SA economy and not being exposed to transfer risk through its locale.

The AIRB banks are not compelled to use external agency ratings/PDs. However, they are widely used, either directly or as a benchmarking tool for internal models. It is, therefore, important in the interest of consistency across the industry to develop guidelines for use and adjustment of external agency ratings in the South African (and emerging markets) context, taking into account both the borrower and lender characteristics

PROJECT OBJECTIVES

Overall our objective will be to provide a scientific analysis of the rating/PD assignment methodologies followed by external rating agencies for sovereigns, banks, non-bank financial institutions and corporates. To assess, on the basis of the analysis, what are the characteristics of the intended consumers of these ratings and whether they are consistent with those of South African banks. Consequently, to determine the suitability of external rating agencies' ratings/PDs in a South African context.

Specific questions that need to be addressed are:

- How are the ratings calibrated to be converted to PDs? (not necessarily the rank-ordering ability)
- Is it and in which situations it is applicable to apply the sovereign floors to PDs?
- Whether and how the external ratings should be adjusted based on lender and borrower characteristics?
- To articulate which lender/borrower characteristics (e.g. domicile, legal environment, borrower type, lender type, industry, loan characteristics, etc…).
- Should the in-country banks lending to corporates take into account sovereign risk?

RESEARCH OUTPUTS / DELIVERABLES

PUBLICATIONS:	**Name(s) / Title(s)**
Article	1
STUDENTS:	**Name(s) of Student(s)**
OTHER:	

APPROACH TO BE FOLLOWED

In order to achieve the objectives of this project, the following approach is suggested:

1. Literature search to find relevant papers
2. Report the main findings of the literature study
3. South African case study on local ratings (to confirm the main findings of the literature study)
4. Recommend guidelines to incorporate the methodologies and data of the external agencies into internal rating models
5. Documentation.

STRATEGIC VALUE TO DIRECTED RISK RESEARCH

This research will increase insight into how to use both internal and external ratings in determining corporations credit ratings.