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Andre is Group Chief Risk Officer at United Bank for Africa PLC, where he oversees the group's total risk management and compliance framework. Prior to joining UBA in January 2008, he was Executive: Group Risk at Absa, a member of the Barclays Group. He holds BSc. Hons, BCom.Hons and MBA degrees from various South African universities and is a Chartered Financial Analyst and member of the Association of Investment Management Research.

Andre has extensive experience in the application of advanced risk management practices. At Absa, he was leading the group's Basel II and IFRS risk implementation as well many other frameworks – stress testing, risk appetite, economic capital, credit rating systems, market risk VaR measurement, risk-reward pricing

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Basel II and Credit Ratings

INTRODUCTION

Credit risk is by far the most significant risk of a bank. Judging by the global credit crisis, it is also the most complex and least understood risk. Credit creation is the most important function of a banking system in the economy. Credit risk assessment frameworks are receiving renewed attention as crucial elements of the banking system to be strengthened to ensure sustainable economic growth and to prevent a repeat of the crisis.

The China Banking Association, together with related institutions, held a forum in Beijing earlier this year to summarize the experiences and lessons learned from the global financial crisis. Their conclusion was that an in-depth understanding of development rules in a credit economy and the speeding up of the establishment of credit rating systems in China are key factors that will safeguard the healthy development of that country's financial industry. This is true for many developing economies.

CONCEPT OF A CREDIT RATING SYSTEM

Recently, several ATM card customers have received emails purportedly from Interswitch (the switching company in Nigeria) and the Central Bank of Nigeria, stating that there has been an upgrade of service, and in some instances that the company has improved its security features and hence the need for the customer to immediately click on a link provided to ensure that his/her card is usable.

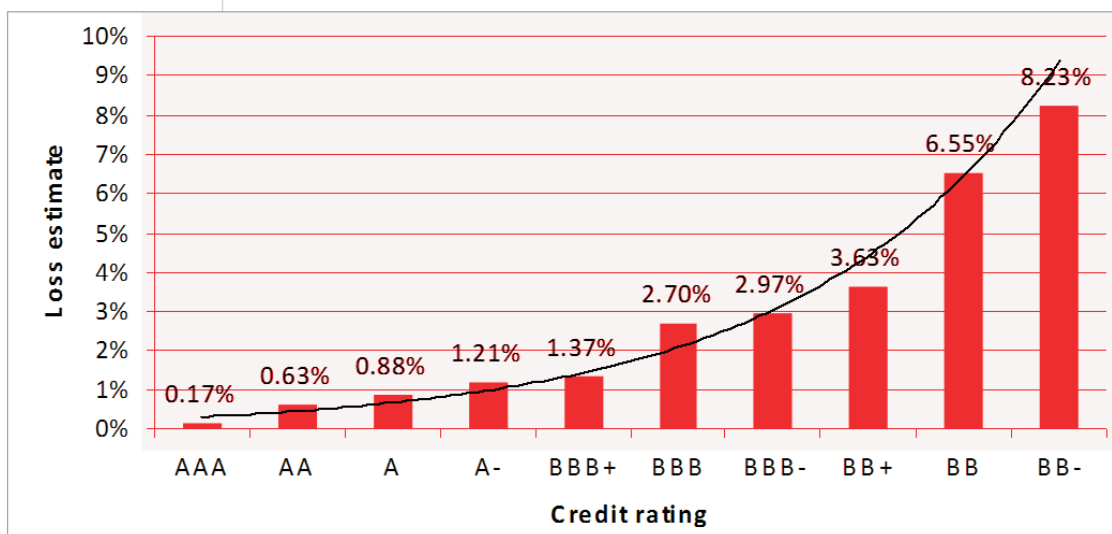
The link leads to a website which appears very authentic and details requested on the website include card number, name of card holder, PIN number and other details that fraudsters require to make a 'copy' of the card. Once this data is received by the fraudster on this bogus website, the details are fed into a card encoding machine and encoded onto the magnetic stripe of any plastic card. This card becomes a 'clone' of the individual's ATM card and is thereafter used by the fraudsters to withdraw funds from any ATM across the country.

These fraudulent emails are also called 'Phishing' emails. Years ago, they were in bad, broken English and emanated mostly from Central and Eastern parts of Europe and the erstwhile Soviet Bloc countries using a 'Yahoo' or 'Hotmail' email

tools, etc. He was also a member of the Barclays Group Risk Technical committee, the oversight body in the Barclays group for all technical risk management frameworks implementation. During the 4 years of Basel II implementation in South Africa he served as the chairman of the credit risk task

identities. More recently, the fraudsters have become more sophisticated in creating authentic looking email IDs of the Central Bank of Nigeria and Interswitch. They have also created websites that appear genuine to the ordinary consumer.

Consumers must be aware that, BANKS AND CARD COMPANIES WOULD NEVER ASK FOR A CARDHOLDER'S PIN NUMBER and are therefore urged to call their bank on the BANK'S customer service line (not on the number provided on the fraudulent email!) and confirm the authenticity of the request. Consumers are advised to immediately delete such emails and advise friends to do the same.



group of the accord implementation structure, lead by the SA central bank. Andre has been a regular presenter at conferences and international risk industry events. The World Bank invited him on two occasions to share his experience of Basel II implementation in South Africa with the central banks of other emerging markets at Basel II implementation planning events in Colombia and Turkey.

ASSET CLASSES

BII recognises the fact that the characteristics driving credit risk differs by segment. Rating system requirements are therefore differentiated by the following asset classes: corporate exposures, specialised lending (project finance, etc.), sovereign exposure, public sector entities, bank exposures, other financial institutions, retail exposures, revolving exposures, purchased receivables, securitized assets, SME's, etc. Where risk behaviour differs within an asset class – e.g. salaried v self employed retail customers, further differentiation of the rating system is required so that the unique credit risk characteristics of each homogenous risk pool is adequately captured.

Risk grading, default estimation and loss estimation models and methods must be implemented for each asset class/ homogenous risk pool. With the South African implementation of BII, banks typically had to implement 40-50 rating models to meet the requirements for accurate risk differentiation by rating systems.

To execute its BII adoption, UBA has commenced with the design of a comprehensive rating systems architecture that will provide the key building blocks for ratings based decisions. This will enable scientific measurement and management of credit risk in all the group's local and international customer segments.

USE OF RATING SYSTEMS

To meet the stringent requirements of the BII internal ratings based approach, banks must be able to demonstrate the use of credit ratings in key business decisions such as credit approvals, loan pricing, market segmentation, credit portfolio monitoring, provisioning, debt collections, capital allocation and performance management. Merely using ratings as a credit assessment tool is not sufficient.

Maintaining the integrity of rating system outputs is crucial given the many uses and key decisions which depends on credit risk. The BII framework recognises this fact and sets elaborate process requirements for ensuring the ongoing quality of rating systems outputs. These include:

- Independent credit control unit responsible for the design and maintenance of credit rating systems;
- Data history requirements to ensure rating models are taking a wide range of historical risk events into account;
- Rating model validation requirements, using back testing and other techniques to ensure model accuracy;
- Regular internal audit review of all aspects of rating systems;
- Ongoing training of the board and senior management on the internal workings of the bank's rating systems;
- Designated board committee tasked with approval, oversight and monitoring of rating systems effectiveness
- Disclosure of rating system results in published financial reporting, regulatory reporting, etc.

Designing and implementing a credit rating system is a highly complex activity. Key challenges that banks have to overcome are:

- Lack of sufficient historical data
- Limited expertise and knowledge of rating methodologies
- Integrating ratings with bank IT systems
- Awareness, understanding and interpretation of credit ratings
- Timeously adapting rating systems to ever changing customer profiles, credit risk environment, business strategy changes, etc.

Credit ratings development is therefore a journey. International banks have spent many years in developing and enhancing their credit rating systems and are still continuing to do so.

CURRENT STATE OF CREDIT RATING SYSTEMS IN NIGERIA

Credit rating systems application in Nigeria is currently at an early stage of development. Consumer credit behaviour data is being pooled by credit bureau's that can be used in the design of retail credit rating models. External credit ratings assigned by credit rating agents for bank and multinational corporate names are available and are being used in the credit decision process by some banks. Few Nigerian banks have, however, attempted to develop loss and default estimates for their ratings as required by BII. Wider using of ratings outputs in business decisions is limited. Rating systems knowledge is very scarce.

The CBN should take a lead role in credit ratings system implementation in the Nigerian banking system. These actions should include:

- setting requirements for mandatory default and loss data collection by banks
- setting standards for rating integrity assurance
- setting ratings information disclosure requirements
- setting requirements for the use of credit ratings in banks business decisions, etc

Early adoption of BII implementation by the CBN will institutionalise these issues.

CONCLUSION

Every credit decision is a bet with shareholder's money. In the Nigerian environment, the odds of making a good bet is not very high, given the many uncertainties impacting the outcome of a credit decision and resulting credit losses. This will limit the development of credit growth in the economy. The BII internal ratings based approach provides a rigorous framework for high quality credit rating systems which can provide a solid foundation for the development of a credit economy in Nigeria. The CBN should play a lead role and accelerate BII implementation to institutionalise the application of credit rating systems in the banking system.