A “Public Good” Approach to Credit Rating Reform

By Prof Duan Jin-Chuan, Director of Risk Management Institute, NUS

Synopsis

Credit rating agencies’ failure to uphold their gatekeeper role figured prominently in the 2008-09 financial crisis. In the aftermath, tighter regulation and oversight of credit rating agencies have been proposed and implemented in some jurisdictions. The US Dodd-Frank Act went as far as requiring the removal of regulatory references to credit ratings when appropriate. As an alternative and complementary route to credit rating reform, the Risk Management Institute (RMI) of National University of Singapore embarked on a “public good” approach to credit ratings in March 2009. Being a not-for-profit undertaking, the RMI credit rating initiative was designed to tap into the global talent pool and to function in a Wiki-style by offering alternative credit information based on an organically evolving and cutting-edge rating methodology. A fully functioning RMI default prediction system was launched in July 2010 with an initial coverage of over 17,000 listed corporates in 12 Asian economies. The system was further expanded to include North America and Europe with a total coverage standing at over 28,000 listed firms in 30 economies.

The RMI default prediction system employs a quantitative model to be presented in Part II. The default predictions are updated daily for all firms over time horizons ranging from one month to two years. RMI welcomes challenges and suggestions to its default prediction model. Challenges and suggestions are viewed as an integral part of its Wiki-style undertaking. Professor Duan will provide the background to and discuss the conceptual foundation of the RMI credit rating initiative. He will describe the research team and the credit research infrastructure being built up at RMI, and how researchers from around the world can take part in this collective effort. A brief demonstration of the default prediction system will follow.

A forward intensity approach for the prediction of corporate defaults over different future periods is proposed. Maximum likelihood analysis based on this new approach is then conducted on a large sample of US industrial and financial firms spanning the period 1991-2009 on a monthly basis. Several frequently used factors and firm-specific attributes are shown to be useful for prediction at both short and long horizons. The prediction is very accurate for shorter horizons. The accuracy deteriorates somewhat when the horizon is increased to two or three years, but its performance still remains reasonable. The forward intensity model is also amenable to aggregation, which allows analysts to assess default behaviour at the portfolio and/or economy level.

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Speaker’s Biography

Duan is the Director of Risk Management Institute at the National University of Singapore (NUS) and concurrently holds the Cycle & Carriage Professorship in Finance at the NUS Business School. He is also an Academician of Academia Sinica. Duan completed his undergraduate education at the National Taiwan University, an MBA from the State University of New York at Albany and a PhD in Finance from the University of Wisconsin-Madison. He specializes 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 written a book and occasional media commentaries on current financial/economic events. Before joining the NUS, Duan held the Manulife Chair Professorship at the Rotman School of Management, University of Toronto, and also once taught at the Hong Kong University Science and Technology and McGill University. Duan is spearheading a non-profit credit rating initiative launched in 2009, which pioneers a “public good” approach to credit rating reform via a Wiki-style model development undertaking. The initiative currently provides daily updated default forecasts for over 28,000 listed firms in 30 economies in Asia, North America and Europe (http://www.rmi.nus.edu.sg/cris/).
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