

Role of Credit Rating Agencies in the Ethiopian Capital Market

1. Introduction

The establishment of a centralized capital market system under Proclamation No. 1248/2013 has brought about a significant change in the financial landscape of our country. Among the various service providers licensed and regulated by the Ethiopian Capital Market Authority (ECMA) under this legal framework, Credit Rating Agencies (CRAs) play a crucial role in enhancing investor confidence, enhancing market transparency, and facilitating efficient capital allocation.

One of the instruments of the capital market is debt instruments (bonds), and before companies can issue and sell debt instruments to the public, they must be assessed by licensed agencies. This article examines the role, regulatory framework, operational framework, and

expected impact of CRAs, primarily based on the Capital Market Service Providers Licensing and Supervision Directive No. 980/2016, the Capital Market Proclamation, and international experiences.

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2. Establishment of a Centralized Capital Market in Ethiopia

The Ethiopian economy has been operating on a decentralized capital market and unregulated basis for many years. The enactment of Capital Market Proclamation No. 1248/2013 has laid the legal foundation for a modern, regulated centralized financial market. The main objectives of the Proclamation include

protecting investors, creating a fair, efficient and transparent securities trading, and as well as reduction of risk. To achieve these objectives, it is necessary to establish a strong regulatory and operational framework for authorized capital market service providers. In this regard, the aforementioned Directive sets out detailed licensing, governance, and operational requirements for fifteen categories of service providers, including CRAs.

CRAs are entities licensed to assess the creditworthiness of corporate entities, sovereigns, and certain debt securities. These credit rating agencies assign a rating (e.g. AAA, BB, C) to an issuer based on a set of criteria. The Public Offering and Trading of Securities Directive stipulate that issuers may issue debt or debt securities to the public with this rating.

The ratings and independent assessments provided by CRAs play a crucial role in protecting investors by reducing the risks associated with debt securities. In emerging markets such as Ethiopia, the introduction of

credible CRAs is a matter of fulfilling the fundamental institutions for market depth and integrity.

3. Regulatory Framework: The Proclamation and the Directive

The Capital Market Proclamation, Article 55 is the basis for the establishment of CRAs in the Ethiopian capital market ecosystem. In addition, CRAs operate by obtaining a license in accordance with the Licensing and Supervision Directive. This Directive, in particular Section Thirteen (Articles 94-100), sets out a detailed regulatory framework for CRAs.

3.1 Fit and Proper Requirements for CRAs (Articles 94-95 of the Directive)

The Regulation provides for two ways to license CRAs, which include domestic and reputable international agencies.

Domestic CRAs: Organizations that can obtain a license from the Authority to provide credit rating services, such as joint share companies or private limited liability companies with a valid business registration. Subject to the strict

licensing process, which requires the licensee to provide detailed rating methods, sample client contracts, and, if affiliated with a foreign credit rating agency, detailed documentation, including evidence from the capital market regulator in the country where the foreign rating agency is located, and audited financial documents.

Foreign CRAs: Recognizing their potential, applicants for foreign-based service providers may be granted a license if they have obtained an Ethiopian investment license and can demonstrate that they have strong regulatory frameworks in place in the country where they are established or operate, consistent with the principles of the International Organization of Securities Commissions (IOSCO). This provision allows Ethiopian issuers to be rated internationally by incorporating international knowledge and experience.

There are international rating agencies such as Standard & Poor's (S&P), Moody's, and Fitch that rate the creditworthiness of countries and

large corporations. It is known that there are similar capital market service provider agencies in Africa.

The licensing requirements stipulated in the capital market legal framework require the Authority to license firms demonstrate proven technical capacity, operational integrity, and a strong reputation for both domestic and international standards.

3.2 Permitted Activities and Restrictions of CRAs (Articles 96-97 of the Directive)

The primary function of licensed CRAs is to provide credit rating services to organizations or companies that issue securities and to establish rating systems and categories. This involves a structured analytical process to assess the ability and willingness of a company to meet its financial obligations. The Directive requires rating service providers to maintain impartiality and to fully disclose any conflicts of interest in order to ensure the objectivity of this process.

These rating agencies are strictly prohibited from rating companies that issue the following securities:

- The Directors and Shareholders of its own company,
- Debtors of the Directors and Shareholders of its own company,
- Affiliates or Subsidiaries Directors and Shareholders of its own company,

This prohibition is essential to protect the ratings from undue influence or other relationships and to ensure that ratings reflect independent analysis rather than commercial or relationship pressures.

4. Operational Framework for Credit Rating Service Providers

In addition to licensing, the Directive includes a comprehensive system of ongoing obligations designed to ensure the quality, transparency and accountability of credit rating service providers.

4.1 Credit Rating Service Providers' Rating Procedures and Contracts (Article 98 of the Directive)

Credit rating service providers must develop and disclose clear, rigorous and consistent rating methodologies. Each rating process must be governed by a written contract that sets out the purpose, the duration of the rating, the rights and obligations of the rating provider and the rating issuing company, and the fees. This not only makes the relationship contractual but also provides a clear basis for accountability.

4.2 Credit Rating Service Provider Transparency and Ongoing Monitoring (Articles 99-100 of the Directive)

Transparency of credit rating service providers' procedures is a non-negotiable pillar. Therefore, credit rating agencies must perform the following:

- Publicly disclose the rationale and criteria for each rating;
- Provide clear reminders that ratings are opinions and not buy/sell/hold recommendations;

- Continuously monitor rated entities and review ratings when there are new fundamental changes;
- Publicly disclose any rating changes within five business days;

In addition, CRAs are prohibited from using misleading statements or testimonials to advertise their past rating achievements in the media. This is done to prevent market-driven advertising from distorting the integrity of the rating process.

4.3 Code of Conduct for Credit Rating Service Providers (Article 178 of the Directive)

Part 20 of the Directive sets out a detailed code of conduct applicable to all capital market service providers. The Directive requires credit rating service providers to comply with the Code of Conduct issued by the International Organization of Securities Commissions (IOSCO). In line with international best practices, the Directive requires Ethiopian credit rating service providers to conduct their

activities in accordance with the following principles:

- Ensure the quality and integrity of the rating or rating process,
- Maintain impartiality and avoid conflicts of interest,
- Act responsibly towards the investing public and issuers.
- Implement strong internal governance, including ongoing review of rating or rating methodologies,
- Ensure transparency by disclosing all matters that require disclosure,

This will elevate the standards of our country's credit rating service providers beyond regulatory compliance to internationally accepted levels and, ethical and professional standards.

5. Conclusion

The Capital Market Service Providers Licensing and Supervision Directive provide a framework for credit rating service providers in Ethiopia to operate their businesses in a principled legal

and regulatory framework. This Directive sets out the requirements for obtaining a license to provide credit rating services, fit and proper criteria, educational background, experience and certification requirements for the appointed representatives of a rating agency, rating methodology, impartiality, transparency and compliance with international ethical standards, thereby laying the foundation for rating service providers to play their vital role as indicators of credit risk.

Ethiopian Capital Markets Administrative Court is vested with the mandate to hear and determine appeals relating with license request submitted to the Authority, disciplinary measures imposed on them in the course of their operations after the issuance of a license, and other disputes with their clients arising from the qualification assessment and rating.