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An Overview of Credit Rating Agencies

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ABSTRACT

Increasing varieties of instruments and the growth of financial market created not only the opportunities for the investors but also complexities in the market, the reputation of the issuer company became no longer a guarantee to the quality of financial instrument which the company issued. Credit rating agencies play an important catalytic role in demystifying the complexity of financial instruments, fostering the growth, stability and efficiency of capital markets. This paper is a modest attempt to highlight various facets related to credit rating agencies such as birth of credit rating agencies, role played by them in financial markets, regulatory framework, Rating methodology and process.

KEYWORDS Credit rating agencies, Catalytic role, Financial Instruments, Regulatory framework

1. INTRODUCTION

The opening up of the financial markets enabled investments to cross the boundaries and collaboration at international level became common. To cater to the needs of diverse categories of investors, various tailor made financial instruments were introduced. Increasing varieties of instruments and the growth of financial market created not only the opportunities for the investors but also complexities in the market, the reputation of the issuer company became no longer a guarantee to the quality of financial instrument which the company issued. Credit rating agencies play an important catalytic role in demystifying the complexity of financial instruments, fostering the growth, stability and efficiency of capital markets. A comprehensive analysis of a credit instrument offers numerous benefits to all parties in concern. The need for credit rating agencies owing to regulatory purposes is growing rapidly. These rating agencies are now playing a stupendous role in assessing the quality of financial instruments and they are regarded as super powers in the world.

According to Roman Kraussl, Professor of Economics at University of Crete, "The historical logic underlying the existence of credit rating agencies has clearly resided within the basic problems of financial markets: Asymmetric Information. Further, the following developments in the financial markets also contributed for the need of credit rating agencies such as expansion of financial markets and its increased role after liberalization, privatization and globalization; introduction of innovative financial instruments to cater to the diverse needs of investors; increased securitization of borrowing and lending; amplified number of cases of bankruptcy and defaults in payment of interest and principal; fraudulent practices of companies (window dressing of balance sheets). Credit rating agencies supply market participants with a system of relative creditworthiness of all bond issues by incorporating all the components of default risk into a single code: "The Credit Rating". It is in this background the research paper attempts to study the importance of credit rating and the role played by Credit Rating Agencies (CRAs) in the financial markets. It also emphasizes on understanding the regulatory framework of CRAs.

2. OBJECTIVES

- To throw some light on the concept of credit rating and its importance
- To study the genesis and growth of credit rating agencies
- To understand the regulatory framework of credit rating agencies
- To emphasize the importance and the role played by Credit Rating Agencies in the International Financial system.
- To know the determinants of credit ratings and the rating process

3. GENESIS AND GROWTH OF CREDIT RATING AGENCIES

The history of credit rating is a century old. Corporate bond ratings were developed prior to 1st world war (1914 – 1918) in response to a commercially viable need for independent and reliable judgment about the quality of corporate bonds (Pogue and Soldofsky, 1969). However, in the background of the great financial crisis in USA (1837), the need was felt in United States of America to predict the ability of merchants and traders to pay their financial obligations. Hence, it is considered that US has been the birth place of Credit rating agencies.

Louis Tappan, one of the pioneer professional thinkers established the first mercantile bank credit rating agency in New York in 1841, which rated the debt paying ability of the merchants. John Bradstreet, a financial analyst, started a similar rating agency in 1849, and the analytical work done by the rating agency was published in its rating book in 1857. Louis Tappan's mercantile credit rating agency was acquired by Robert Dun and its first rating guide was published in 1859. In 1900, John Moody founded Moody's investors' services in US and began rating the rail road bonds in 1909 and published a manual of rail road securities with comments on 200 major rail road companies. Further, in 1914, Moody's rated utility and industrial bonds, followed by rating the bonds issued by US cities and other municipalities in early 1920's. Moody's also assigned sovereign ratings to debt of various nations like Britain, Italy, Japan, China etc. Moody's also started rating the debt of international issues in 1950. The Poor's company entered the bond rating business by publishing its first ratings in 1916. Standard Statistics Company – A new entrant in information and rating business also started its operations in 1922, followed by Fitch publishing company in 1924. In 1933, Robert Dun's agency and John Bradstreet's agency merged together to form Dun and Bradstreet. Similarly, the Poor's publishing company and Standard Statistics Company merged to form Standard and Poor's (S & P) in 1941. In 1962, Dun and Bradstreet acquired Moody's investor's service and in 1966 controlling interest in Standard and poor was taken over by Mc Graw Hill the publishing giant. The credit rating agencies expanded from 1970's through 1990's, much as they did from 1909, when John moody introduced the concept in 1930's (Jutur, 2005). In 1972, Canadian bond rating service was established followed by Thomson bank watch in 1974. In 1975, Japanese bond rating institute was incorporated by Japan economic journal. The other rating agencies in Japan such as Japan bond research institute, Japan Credit rating agency and Nippon investor's services were established soon. In the same year (1975), Mc Carthy Crisanti and Maffei agency were established in US. Dominion bond rating service was established in 1977 in Canada and IBCA limited in 1978 in London (UK). In 1980, Duff and Phelps credit rating company was formed, and it acquired Mc Carthy Crisanti and Maffei agency in 1991. With increasing internationalization of financial markets and the development of the capital markets the world over, the concept of credit rating is become a universal phenomenon (Sarkar, 1994). Now, there are credit rating agencies operating in all parts of the world such as India, Singapore, Malaysia, Bangladesh, China, Pakistan, Thailand, Indonesia, Australia, Israel, Korea etc. But the big-three CRAs viz., Moody's, S&P and Fitch kept expanding their operations overseas with offices at the most important financial centers such as Tokyo, London, etc.

In the light of the successful experiences drawn from credit rating agencies in US, a few Indian and Foreign financial institutions and banks established credit rating agencies in India. It started with the setting up of the Credit Rating Information Services of India (now CRISIL Limited) in 1987. CRISIL was promoted by premier financial institutions like ICICI, HDFC, UTI, SBI, LIC and Asian Development Bank. Now CRISIL is an S&P company with a majority shareholding. Apart from CRISIL four more rating agencies have been registered by SEBI in India. These are ICRA, promoted by IFCI and now controlled by Moody's, CARE promoted by IDBI, Fitch India a 100% subsidiary of Fitch, and a new born Brickworks. In India, CRAs that rate capital market instruments are governed by Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999. SME Rating Agency of India Limited (SMERA) is the 6th rating agency registered by SEBI on March 03 2011 under SEBI (Credit Rating Agencies) Regulations, 1999 and is a joint initiative by SIDBI, Dun & Bradstreet Information Services India Private Limited (D&B) and several leading banks of the country. ONICRA is the seventh credit rating agency functioning in India, but not registered by SEBI. The regulatory bodies - Securities exchange board of India (SEBI) and Reserve bank of India (RBI) has made credit rating mandatory for a variety of instruments and schemes. In some cases, some institutional investors have stipulated a minimum credit rating as criteria for investments. Credit rating is used as an additional input for decision making. The role of credit rating in Indian market is rising rapidly.

Table 1: Summary of CRAs established

Year	Country	Credit Rating Agency
1841	USA	Mercantile credit agency
1849	USA	John Bradstreet agency
1859	USA	Robert Dun agency (formed by the acquisition of Mercantile agency)
1900	USA	Moody's Investors service
1916	USA	Poor publishing company
1922	USA	Standard Statistics company
1924	USA	Fitch publishing company
1933	USA	Dun and Bradstreet agency (formed by the merger of Robert Dun and John Bradstreet agency)
1941	USA	Standard and Poor (formed by the merger of Poor publishing company and Standard Statistics company)
1972	Canada	Canadian bond rating service
1974	Canada	Thomson bank watch
1975	Japan	Japanese bond rating institute
1975	USA	Mc Carthy Crisanti and Maffei
1977	Canada	Dominion bond rating service
1978	UK	IBCA Limited
1980	USA	Duff and Phelps (formed by the acquisition of Mc Carthy Crisanti & Maffei) Maffei)
1987	India	CRISIL Limited
1991	India	ICRA Limited
1993	India	CARE Limited
1995	India	INDIA RATINGS AND RESEARCH (IND-RA)
1993	India	ONICRA
2005	India	SMERA
2007	India	BRICKWORKS

Source: Compiled from various sources and websites

4. REGULATORY FRAMEWORK OF CREDIT RATING AGENCIES ABROAD

Corporate governance is the framework (systems, processes, relationships and rules) through which companies are controlled. The principles of corporate governance are developed by OECD which functions as an international benchmark for policy makers, investors, corporations and other stakeholders. SEC is the US governing body which is primarily responsible for overseeing the regulation of securities industry and is an important stakeholder in the corporate governance system (Nofsinger, 2004). Federal securities laws questioned the appropriate role of ratings and highlighted the need to establish formal procedures for designating and monitoring the CRAs. It was then Securities Exchange Commission (SEC) proposes to define the term NRSRO (Nationally recognized statistical rating organization) in 1997. For the credit rating agencies to be designated as NRSRO, the CRAs should possess Adequate staffing, financial resources and organizational structure, Be recognized through out, Use of systematic rating procedures that are designed to ensure credible and accurate ratings, Internal control procedures to prevent misuse of information and compliance of such procedures, CRAs should disclose their procedures and methodologies for assigning ratings, Disclose public specific performance measurement statistics including historical downgrades and default rates.

NRSRO issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities; is generally accepted in the financial markets as an issuer of credible and reliable ratings and NRSRO uses systematic procedures designed to ensure accurate ratings, manage potential conflicts of interest and prevent misuse of information. In this background NRSRO were created. While, issuers purchase credit ratings through broker-dealers who adhere to SEC requirements, which implies that SEC does not regulate NRSRO themselves and indicated that SEC has uncertain authority to conduct further oversight of NRSROs. In light of SECs perceived lack of statutory authority, "CRA reform act was enacted – CRA reform act 2006".

Despite the CRA reform act 2006, CRAs found themselves in controversy again in 2008, because of residential mortgage backed securities (RMBS) when they began to default. Confidence fell in the entire asset backed market as NRSROs issued extensive downgrades even on newly rated securities. In response to the market crisis, The Presidents working group commission issued a series of proposed rules and recommendations to NRSROs and credit ratings such as

- Required all NRSRO to distinguish ratings by using different symbols for different types of products or disclosing the differences between the ratings.
- Sought to educate investors on the limits and purposes of credit ratings
- All NRSRO require submitting an annual report to SEC detailing the number of credit rating actions for each class of security taken in the fiscal year.

- Finally, SEC added three new prohibited conflicts to prevent NRSROs from rating products or having individuals participate in the rating of products where conflict of interest exist, which includes
- Prohibiting an NRSRO from issuing a rating with respect to an obligor or security where the NRSRO made recommendations to the issuer about its corporate or legal structure, assets, liabilities or activities.
- Prohibiting a person within an NRSRO who participates in determining credit ratings or developing methodologies from also participating in fee discussions and perhaps obviously,
- Prohibiting NRSRO credit analysts from receiving gifts valued at an excess of twenty five dollars from the issuer of the product being rated.
- Improving the integrity and transparency of CRAs processes and practices, taking steps to ensure that the world's financial institutions manage risk more effectively.
- Disclose the nature of qualitative reviews they perform on originators, require the underwriters of asset backed securities to disclose the due diligence performed on underlying assets.
- To manage conflict of interest
- To assist investors in understanding credit ratings by displaying the information regarding the rating methodologies.
- To employ different models for rating structured products from corporate and municipal securities
- Make rating performance statistics available; monitor and update ratings effectively.

Regulatory Framework In India
The securities and Exchange Board of India (SEBI) credit rating agencies (CRAs) regulation, 1999 empowers SEBI to have CRAs under its regulatory ambit in exercise of powers conferred on it by section 30 read with section 11 of the SEBI act 1992. The act now requires all the CRAs to be registered / recognized with SEBI.

Any applicant/ body corporate should satisfy the below conditions set forth by SEBI as eligibility criteria to get recognized as CRA.

- The applicant must have a company set up and should be registered as a company under the companies act, 1956.
- The company in its memorandum of association (MOA) should have specified that rating activity is one of its main objectives.
- The applicant must have a minimum net worth of rupees five crores. (If the CRA already existed at the commencement of these regulations and had a net worth less than five crore shall be deemed to increase net worth to the said amount within a period of three years).
- The applicant should have adequate infrastructure to support the organization in provide rating services in accordance with the provisions of the act and regulations.
- The applicant and its promoters must have professional competence, reputation of fairness and integrity in all business transactions and must be financially sound.
- The applicant or its promoters should not be involved in any kind of legal proceedings connected with the securities market.
- Neither, the applicant nor its promoters/director be convicted of any offence involving moral turpitude or any economic offence in the past.
- The employees of the rating agency must possess adequate professional and other relevant experience.
- Any body connected with the applicant (directly or indirectly) must not, in the past been refused to grant a certificate by the board.
- The applicant , in all other respects must be fit and proper for the grant of the certificate to operate the company as CRA
- The grant of certificate by SEBI is in the interest of investors and the securities market.

The applicant should be promoted by either a public financial institution, as defined in section 4 A of the companies act, 1956; A scheduled commercial bank included for the time being in the second schedule to the Reserve bank of India (RBI) Act, 1934; A foreign bank operating in India with the approval of RBI; A foreign credit rating agency having a minimum of five years of rating experience and is recognized by the country of its incorporation. SEBI has given a detailed regulations pertaining to the functioning of CRAs.

5. ROLE OF CRAs
The role and importance attached to credit rating agencies has increased since 1990's with liberalization, globalization and privatization. CRAs hold a central role in the international system of capital allocation owing to disintermediation and globalization (Kerwer, 1999). They are the only actors in the modern international financial system to have access to assess the creditworthiness of substantial number of entities and instruments. CRAs have particular importance because their ratings are embedded or hardwired into investment mandates, global banking regulations and securities rules and regulations. Technological improvements, Burgeoning money supply and the removal of regulatory restrictions have liberalized the international money market and enabled the providers of foreign capital to transfer investments and credit between states and trans-national corporations quickly and cheaply (Sinclair, 1999).

The role of CRA as providers of opinion about the creditworthiness of companies, instruments and countries is mounting high due to growth in capital markets, credit derivative markets, financial globalization and has received an additional boost from Basel II which incorporates the ratings of CRAs into the rules for setting weights for credit risk. Credit rating agencies use both qualitative and quantitative data in analyzing and evaluating the creditworthiness of borrowers. Investors in the financial markets do not have timely access to the same set of information, and credit ratings represent one potential solution to the issue of asymmetric information (Ramakrishnan and Thakor, 1984). Borrowers or issuers with lower credit rating require to pay higher interest rate to commensurate with the risk the instrument bears, which in other words increases the cost of debt capital for issuers with lower credit rating. On the other hand, issuers with higher credit rating pay moderate or market interest rates. Similarly the sovereign ratings of the country helps decide the capital flows to country and help in cross border relations. CRAs have also secured an integral role in steering credit and FDI through helping the providers of that capital navigate an increasingly complex global investment environment (Michael D. Priebe, 2012). Investors do not have a thorough understanding and knowledge of a company; they rely on the ratings assigned by rating agencies for their investment decisions. Credit rating also helps the issuers who are first time public goers (for IPOs) in right price fixation. Rating helps in enhancing access to private capital markets and lower debt issuance and interest costs. There are other indirect benefits from ratings for low income countries such as to foster FDI; and to promote more vibrant local capital markets greater public sector financial transparency"(S&P). As a result, even some sovereigns that do not intend to issue cross-border debt in the immediate future are also seeking credit ratings from CRAs.

6. DETERMINANTS OF CREDIT RATINGS
CRAs evaluate issuers or instruments based on certain criteria. Sinclair's analysis demonstrates that the rating agencies are not applying an objective set of criteria onto each issuer or instrument they rate. Rather, CRAs apply a set of judgments to help them assess the willingness and ability of a receiver of credit to pay that credit back. Credit rating agencies use both qualitative and quantitative data to analyze an instrument or firm. The factors used are summarized below in table 1.

Table 2: Table showing the determinants of credit ratings

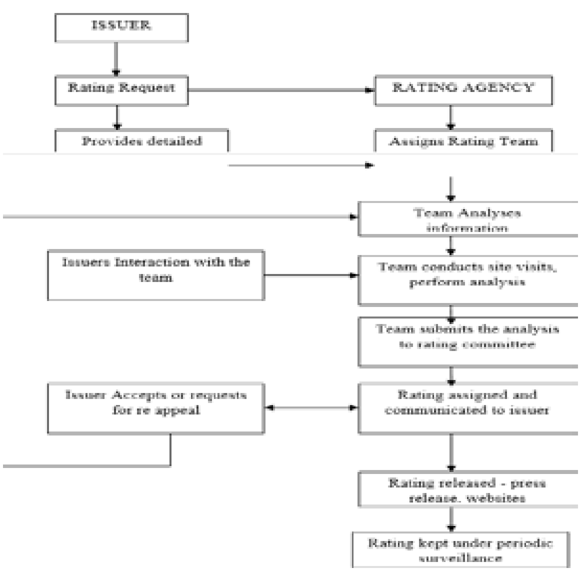
Industry Risk	Business Risk	Financial Risk	Management Risk
Demand Supply Scenario	Market Position	Accounting Quality	Management Experience and Track record
Price Trends	Operating Efficiency	Accounting Policies	Management Strategy
Change in technology	Research and Development	Financial Ratios: Growth, Liquidity, Leverage and Coverage, Turnover, Profitability, cash flow ratios	Risk appetite of management
Intensity of Competition	Diversification	Financial Flexibility	Integrity and honesty of management
Overall prospects and government support for the industry	Human Resource Policies		Competence of Management
Regulatory Risks	Seasonality and Cyclicality		Corporate Governance
	Diversification		Performance of group concerns

Source: Compiled by author from various rating agencies websites

7. RATING PROCESS OF CRAs

The rating process begins with a request for a credit rating from the issuer, the rating agency accepts the request and the issuer signs the detailed rating agreement and provides detailed information and rating fees. The rating agency forms a committee or a rating team. The team studies the information given by the client and does cross validation from both the public and private sources. The team also interacts with the issuer or the client and discusses the management views on their competitive strategy, marketing plans, financial projections; both short term & long term outlook, corporate governance policy as well as hedging policies, etc. Based on the information gathered, the rating team assigns the rating and communicates the same to the issuer. The issuer accepts or may re appeal for the rating. If the rating is accepted, it is published in various sources and communicated to investors. In the case of re appeal of rating by issuer, the rating agency verifies the information again the process repeats.

Chart 1: Chart showing the rating process of credit rating agencies



Source: Compiled by author from various source

8.CONCLUSION

The credit rating agencies play a pivotal role in helping issuers and investors take informed decisions. SEBI regulations are one of the best regulations in the world. CRAs do not roam the globe unchallenged, despite the important role played by CRAs they are criticized for being ignorant and reactive many a times seen in cases like Lehman brothers, Enron abroad and in cases like Satyam in India. CRAs should overcome certain issues like conflict of interest, issue of transparency, agency problems.

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