

# Role of Credit Rating Agencies in Finance

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**Abstract – Before we delve into the role of credit rating agencies, we need to understand what is ‘credit’. And why it is required to access the credit worthiness of a company. Let us look at a small example to illustrate this. Assume you are running a shop where you get some raw material for making soaps and create a soap and then sell it in the market, now you need some time to have some sales (generate some revenue) in order to pay back your suppliers. So based on the trust which they have in you, they might extend a credit line to you, eg. 1 lakh rupees and offer a period say 30/60/90 days to make the payment. The more is the trust, you may have better terms to make the payment. Your past behavior with the supplier will mostly shape the credit terms. Now this scenario can exist when there is a 1:1 engagement between the supplier and the company. But what will happen if a security or borrower is looking to raise funds for their business from a bank or a merchant? How can a merchant bank like UBS, SBI etc. identify the credit worthiness of a company so that they can identify if they can lend money to a company/business and at what terms.**

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## INTRODUCTION

When a company is looking to raise funds or a credit line, typically the banker looks for these things:

- Is responsible in its payment procedures;
- Has the assets to repay debts or provide collateral if necessary;
- Has the character and background to stand behind its business transactions.

A good credit rating provides a company with the ability to obtain the necessary funding for expanding or purchasing new equipment. It can also help in matters of liquidity, ensuring that the business has the necessary cash on hand for day-to-day operations. Now, along with a view on the above, there needs to be a common scale to rate the specific debt securities and the borrowing entities, so that the scores/ratings are comparable across and makes it easier for the lenders to evaluate an entity. The credit rating industry is dominated by three big agencies, which control 95% of the rating business. The top firms include Moody's Investor Services, Standard and Poor (S&P), and Fitch Group. Moody's and S&P are located in the United States, and they dominate 80% of the international market. Fitch is located in the United States and London and controls approximately 15% of the global market.

Morningstar Inc.'s been expanding its market share in recent times and is expected to feature in the "top four rating agencies." The U.S. Securities and

Exchange Commission (SEC) identified the big three agencies as the Nationally Recognized Statistical Rating Organizations (NRSRO) in 1975.

## What is a Rating Agency?

As per the definition provided by Chartered Finance Institute (CFI) I, "A rating agency is a company that assesses the financial strength of companies and government entities, especially their ability to meet principal and interest payments on their debts. The rating assigned to a given debt shows an agency's level of confidence that the borrower will honor its debt obligations as agreed. Each agency uses unique letter-based scores to indicate if a debt has a low or high default risk and the financial stability of its issuer. The debt issuers may be sovereign nations, local and state governments, special purpose institutions, companies, or non-profit organizations."

The image below show the rating grades/scales as per Moody's, S&P and Fitch. Usually specific debt securities and the borrowing entities with a rating of A, AA and AAA are considered as safe for investments. The ones lower in the category are Junk grade securities.

	Moody's	S&P	Fitch	Meaning
Investment Grade	Aaa	AAA	AAA	Prime
	Aa1	AA+	AA+	High Grade
	Aa2	AA	AA	
	Aa3	AA-	AA-	
	A1	A+	A+	Upper Medium Grade
	A2	A	A	
	A3	A-	A-	
	Baa1	BBB+	BBB+	Lower Medium Grade
	Baa2	BBB	BBB	
Baa3	BBB-	BBB-		
Junk	Ba1	BB+	BB+	Non Investment Grade Speculative
	Ba2	BB	BB	Highly Speculative
	Ba3	BB-	BB-	
	B1	B+	B+	
	B2	B	B	
	B3	B-	B-	
	Caa1	CCC+	CCC+	Substantial Risks
	Caa2	CCC	CCC	Extremely Speculative
	Caa3	CCC-	CCC-	In Default w/ Little Prospect for Recovery
	Ca	CC	CC+	
		C	CC	In Default
		CC-		
D	D	DDD		

Another way to look at these categories is:

- **Investment grade:** Low risk, low return, low fees
- **Junk:** High risk, high return, high fees

**Functions performed by credit rating agencies:**

1. **Collecting information:** Valuable information relating to credit quality of an issuer of a debt security is collected by the Credit Rating Agencies.
2. **Supply of information:** The information about the credit quality of the issuer is provided to the public and potential investors.
3. **Providing basis for measuring risk and return:** The information enables investors to decide whether to invest in the debt security or not.
4. **Facilitate corporate discipline:** Investors prefer appropriate credit rating as good credit enhances corporate image and visibility of the firms.

The rating companies charge a fees to determine the rating of a given entity and the fee varies as per the size and turnover of the entity. The ratings are usually valid for an year and can be obtained again after a fresh assessment. In India there are different bodies which provide credit ratings for SME's. The ratings range from a scale of 1-8, where 1 is the highest and 8 being the lowest. The bodies which provide these ratings to SME's in India are: SMERA, Care SME Rating and ICRA SME Rating. This is just another way to look into the rating, the global bodies provide the rating for bonds and securities and the Indian bodies provide the same to SME's as well.

To summarize these are the key benefits of a rating:

- **Better business opportunities:** The independent risk evaluation of SMEs by an unbiased 3rd party lends credibility to them

and opens doors for them while dealing with MNC's and lender bodies. They can also submit credit ratings for tenders and make themselves more credible for bigger orders. Better ratings have helped SME's retain customers and suppliers, and negotiate better terms with them. The govt. also favours rated SME's, restricting certain contracts for such firms. It also operates a performance and credit rating scheme through various credit rating agencies via the National Small Industries Corporation.

- **Tools for self-improvement:** Another advantage of rating is that highlighting of strengths and weaknesses act as a trigger for self-correction. A regular renewal of ratings not only helps improve a firm's performance but also builds confidence within the lender fraternity and trading channel. It is like a report card for SME's. The analysis helps them to continuously evolve based on the changing regulation, business requirements and changing scenario.
- **Increased visibility:** Rating increases visibility and credibility of the SME. Since rating is an independent 3rd party opinion on credit worthiness to the lenders and various stakeholders. With higher credibility the SMEs are able to acquire funds from various avenues which otherwise would not be that keen on lending.

**RELIABILITY OF CREDIT RATINGS**

As they say, history is a great teacher. US subprime crisis is still a fresh in our minds, the agencies were criticized for giving high credit rating to debts that later turned out to be high-risk investments. They failed to identify risks that would have warned investors against investing in certain types of debts such as mortgage backed securities.

Rating agencies were also criticized for possible conflict of interest between them and issuers of securities. Issuers of securities pay the rating agencies for providing rating services, and therefore, the agencies may be reluctant to give very low ratings to securities issued by the people who pay their salaries.

The following can lead to a lack in reliability in the ratings:

1. **Biased rating and misrepresentations:** It is very important that credit rating agencies function independently and are objective in their assessment of company's financial

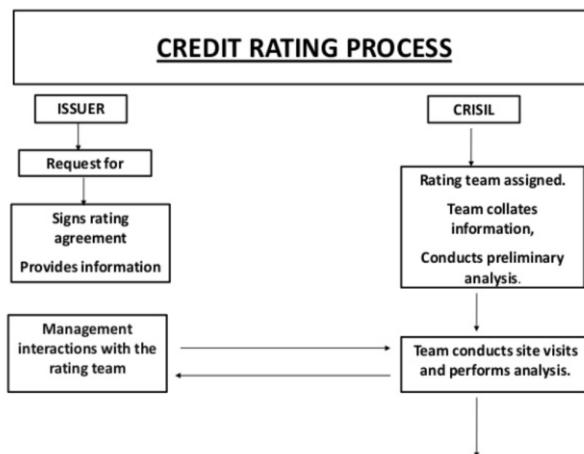
position and its ability to meet its obligations on time.

2. **Static study:** Rating is done on the basis of present and past historical data of the company and this is only a static study. There can be other macroeconomic factors which can affect the health of a company.
3. **Concealment of material information:** The issuer company might conceal vital information from the investigating team of the credit rating agency. So this might induce further bias.
4. **Human Bias:** Human bias may adversely affect the credit rating.
5. **Difference in rating of two agencies:** Rating done by two different credit rating for the same instrument of the same issuer company in many cases can be different.
6. **Downgrading/Upgrading the score of a company:** Credit rating agencies can very well upgrade or downgrade the rating of company which can potentially improve or degrade the image of a company. This much upside and downside can sometimes lead to manipulative practices in the rating process.

Let us now look at how the Rating agencies come up the credit rating for a given issuer. The flowchart below shows how CRISIL does ratings evaluation. CRISIL is a rating agency based out of India, it's an S&P owned company. It stands for Credit Rating Information Services of India Limited. A CRISIL rating reflects CRISIL's current opinion on the relative likelihood of timely payment of interest and principal on the rated obligation. The debt obligations rated by CRISIL include:

- Non-convertible debentures/bonds/preference shares
- Commercial papers/certificates of deposits/short-term debt
- Fixed deposits
- Loans
- Structured debt

**CRISIL credit rating process:**



**CREDIT RATING**

Also it needs to be noted that a credit rating is not an assurance of the rated instrument. Rather, it is an opinion on the relative degree of risk associated with such repayment. The opinion represents an estimate of the likelihood of credit worthiness and default. A credit rating is one of the inputs which can be used by investors to make an investment decision.

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