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Understanding Rating Agencies

June 2023 | Theme 378

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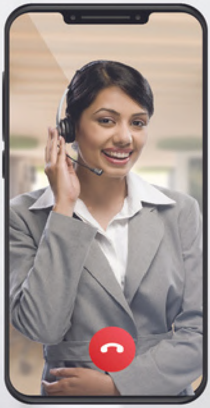

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Understanding Rating Agencies

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"Credit rating agencies are the glue that holds the financial industry together, yet they are also the weak link."

Bethany McLean

The 'SIB Students' Economic Forum' is designed to kindle interest in the minds of the younger generation. We highlight one theme in every monthly publication. Topics of discussion for this month is 'Understanding Rating Agencies'.

A rating agency, also known as a credit rating agency, is a company that assesses the creditworthiness of individuals, corporations, or even governments. Their primary function is to provide credit ratings, which are opinions about the financial stability and ability of an entity to meet its financial obligations, such as repaying debt.

Credit ratings are expressed through letter grades or symbols that indicate the risk level associated with lending money to a particular entity. These ratings help investors, lenders, and other stakeholders make informed decisions about lending money, investing, or doing business with the rated entity.

The major credit rating agencies include Standard & Poor's (S&P), Moody's Investors Service, and Fitch Ratings. These agencies conduct thorough analyses of an entity's financial health, including its revenue, expenses, debt levels, and market conditions. Based on this analysis, they assign credit ratings that range from high credit quality (low risk of default) to lower credit quality (higher risk of default).

Investors often rely on these ratings to determine the potential risk and return associated with various investments. Entities with higher credit ratings are considered more financially stable and are more likely to meet their financial obligations, while entities with lower credit ratings may have a higher likelihood of defaulting on their debts.

It's important to note that credit ratings are not infallible, and there have been instances where they failed to predict financial crises or defaults accurately. However, they remain a significant tool in assessing the relative risk of investing in various entities or financial instruments.

I. Credit Rating Process

- Initial Request: The process begins when an issuer, such as a corporation or government, or a client, such as an investor or lender, requests a credit rating from a credit rating agency.
- Information Gathering: The issuer or client provides extensive financial and non-financial information to the rating agency. This information includes financial statements, business plans, market conditions, legal documents, and any other relevant data.
- Analysis of Financials: The credit rating agency's analysts scrutinize the financial statements and data provided by the issuer. They assess the entity's revenue, expenses, cash flow, debt levels, and other financial metrics. They also consider economic and industry-specific factors that might affect the issuer's financial stability.
- Industry and Market Analysis: The agency conducts research on the industry and market in which the issuer operates. This analysis helps in understanding the competitive landscape, regulatory environment, and trends that could impact the issuer's financial health.
- Management Interviews: Credit rating analysts may interview the issuer's management team to gain insights into their strategic plans, risk management practices, and overall business strategy.

- Credit Committee Review: A credit committee within the rating agency reviews the analysis and recommendations made by the analysts. This committee consists of experienced professionals who make the final rating decisions.
- Assigning a Credit Rating: Based on the analysis and committee's review, the rating agency assigns a credit rating to the issuer or the specific financial instrument (e.g., bonds or securities) being rated. Credit ratings typically range from "AAA" or "Aaa" (indicating the highest credit quality) to lower ratings such as "BB" or "B" (indicating lower credit quality).
- Monitoring and Updates: Credit ratings are not static. The rating agency continues to monitor the issuer's financial performance and may update the credit rating if significant changes occur. This ongoing monitoring helps investors and lenders stay informed about any emerging risks.
- Publication: The credit rating agency publishes the assigned credit rating along with a detailed report explaining the rationale behind the rating. This information is made available to the public and financial markets.
- Issuer's Use: The issuer can use the credit rating to attract investors and lenders. A higher credit rating may lead to lower borrowing costs for the issuer.
- Investor and Lender Decision: Investors and lenders use the credit rating as a tool to assess the risk associated with investing in or lending to the rated entity. It helps them make informed decisions about allocating their capital.
- Feedback and Challenges: Issuers have the opportunity to provide feedback or challenge the assigned credit rating if they believe it is inaccurate or unfair. Credit rating agencies have mechanisms in place to address disputes and potentially adjust ratings if necessary.

It's important to note that the process of credit rating is conducted by independent rating agencies to provide an objective assessment of credit risk. However, the accuracy of credit ratings can vary, and investors and lenders should consider multiple factors when making financial decisions.

II. Main Credit Rating Agencies:

Worldwide:

- Standard & Poor's (S&P): S&P is one of the largest and most well-known credit rating agencies globally. It provides credit ratings for governments, corporations, and financial instruments worldwide.
- Moody's Investors Service: Moody's is another prominent global credit rating agency. It assesses the creditworthiness of various entities and financial instruments, including bonds and securities.
- Fitch Ratings: Fitch is a major global credit rating agency that offers credit ratings and research on a wide range of entities, including governments and corporations.
- DBRS Morningstar: DBRS Morningstar is a global credit rating agency known for its expertise in rating structured finance products and asset-backed securities.
- Japan Credit Rating Agency (JCR): JCR is a Japanese credit rating agency that provides ratings for both domestic and international entities.

In India:

- Credit Rating Information Services of India Limited (CRISIL): CRISIL is one of the leading credit rating agencies in India and is known for its ratings on Indian corporations, financial institutions, and government securities.
- ICRA Limited: ICRA is a credit rating agency based in India and provides ratings and research on a wide range of entities, including corporations, financial institutions, and infrastructure projects.

- India Ratings and Research (Ind-Ra): Ind-Ra is a credit rating agency in India and is a subsidiary of Fitch Ratings. It offers credit ratings for Indian entities and financial instruments.
- CARE Ratings: CARE is an Indian credit rating agency that provides ratings for various Indian entities, including corporations, financial institutions, and government entities.
- Brickwork Ratings: Brickwork Ratings is a credit rating agency in India that offers ratings for various sectors, including manufacturing, infrastructure, and services.

These credit rating agencies play a crucial role in assessing the creditworthiness of entities in their respective regions and help investors, lenders, and businesses make informed financial decisions. It's important to note that the regulatory environment for credit rating agencies can vary from country to country, and different regions may have their own set of agencies that are recognized by local regulators.

III. Credit Rating Agencies and the Global Financial Crisis

Credit rating agencies played a significant role in the financial crisis of 2007-2009, often referred to as the "Global Financial Crisis" or the "Great Recession." Their actions and practices contributed to the severity and scope of the crisis in several ways:

- Flawed Ratings for Mortgage-Backed Securities (MBS) and Collateralized Debt Obligations (CDOs): Credit rating agencies assigned high credit ratings to complex financial products, such as mortgage-backed securities (MBS) and collateralized debt obligations (CDOs), which were backed by subprime mortgages. These high ratings gave investors a false sense of security, leading them to invest heavily in these products, believing they were low-risk.
- Conflicts of Interest: Credit rating agencies were paid by the very institutions whose securities they were rating. This created a conflict of interest because agencies had an incentive to provide favorable ratings to maintain their business relationships with the issuers. This conflict compromised the objectivity and independence of their ratings.
- Lack of Transparency: The models and methodologies used by credit rating agencies to assess the creditworthiness of financial products were often opaque and not fully disclosed to investors. This lack of transparency made it difficult for investors to evaluate the quality of the ratings.
- Failure to Account for Market Dynamics: Credit rating agencies did not adequately account for the changing dynamics in the housing market, particularly the significant increase in subprime mortgage defaults. As a result, they underestimated the risks associated with mortgage-backed securities and related financial instruments.
- Pro-Cyclical Behavior: Credit rating agencies tended to be pro-cyclical, meaning that they downgraded securities precisely when the market was under stress, exacerbating market declines. This behavior amplified panic and market volatility.
- Ratings Downgrades: When credit rating agencies eventually downgraded the ratings of MBS and CDOs, it triggered a wave of panic selling by investors, leading to massive losses and liquidity problems for financial institutions holding these securities. This, in turn, had a cascading effect throughout the financial system.
- Impact on Financial Institutions: The downgrades reduced confidence in financial institutions, making it difficult for them to secure funding in the credit markets.

In the aftermath of the financial crisis, there were regulatory efforts to address some of these issues, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act in the United States. These regulations aimed to improve transparency, reduce conflicts of interest, and enhance the oversight of credit rating agencies.

The financial crisis underscored the need for reforms in the credit rating industry to prevent similar problems in the future and to restore trust in the accuracy and independence of credit ratings. However, it also served as a stark reminder of the limitations of relying solely on credit ratings for assessing the risks associated with complex financial instruments.

Conclusion:

In conclusion, credit rating agencies play a crucial role in the global financial system by providing assessments of creditworthiness for entities and financial instruments.

However, their actions and practices have been a subject of scrutiny and criticism, particularly in the context of the 2007-2009 financial crisis. During that crisis, these agencies assigned high ratings to complex securities backed by subprime mortgages, contributing to a false sense of security among investors and exacerbating market turmoil when those ratings proved inaccurate.

Conflicts of interest, a lack of transparency, and pro-cyclical behavior further undermined the credibility of credit rating agencies. The crisis highlighted the need for regulatory reforms to improve their independence, transparency, and accountability.

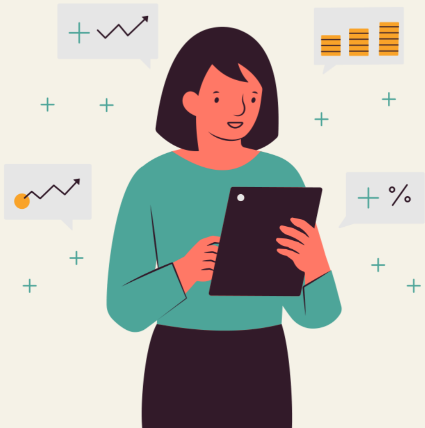
Despite these challenges and controversies, credit rating agencies continue to be integral to financial markets, aiding investors and lenders in making informed decisions.

In the Indian context, credit rating agencies hold a pivotal role in the country's financial ecosystem. India has several domestic credit rating agencies, with CRISIL, ICRA, and India Ratings being among the most prominent.

These agencies provide essential credit assessments for Indian corporations, financial institutions, and government securities, aiding investors and lenders in evaluating risks.

References:

- Research articles and reports from institutions like the Reserve Bank of India (RBI) or the Securities and Exchange Board of India (SEBI) often provide insights into the functioning of credit rating agencies in India.
- "SEBI (Credit Rating Agencies) Regulations, 1999"
- "The Financial Crisis Inquiry Report" - This U.S. government report discusses the role of credit rating agencies in the 2008 financial crisis.
- "The Role of Credit Rating Agencies in the Financial System" - A report by the International Organization of Securities Commissions (IOSCO) that discusses the global impact of credit rating agencies during the crisis.
- "Credit Rating Agencies: In Need of Reform" - An article in the Journal of Economic Perspectives that discusses conflicts of interest in the credit rating industry.
- "Rating Agency Compensation and Conflicts of Interest" - A report by the U.S. Government Accountability Office (GAO) on conflicts of interest in credit rating agencies.



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