A Study on Rating Worthiness of Credit Rating Agencies

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Abstract

Credit rating agencies play very important role in financial market. Many investors’ decisions are based on their ratings. Many crises have witness that there is some serious issue with these rating agencies. If all the rating agencies are performing the same task, then why firm purchase multiple credit ratings. Lack of accountability, Lack of regulation, multiple regulation bodies and conflict of interest are the main problem with these agencies.

This paper is an attempt to high light some of the problem with these agencies and some relevant cases also.

Keywords: Credit rating, Rating downgrade, Conflict of interest, regulation, accountability.

Introduction

Credit ratings are relatively new concept and have been widely accepted by the investors. Credit rating is very useful rating that is used by creditors to determine the trust and credit worthiness of borrowers (whether individual, country or corporation).

Credit rating is an independent company that evaluates the financial condition of issuers of debt instruments and then assigns a rating that reflects its assessment of the issuer's ability to make the debt payments. Potential investors, customers, employees and business partners rely upon the data and objective analysis of credit rating agencies in determining the overall strength and stability of a company.

Credit assessment and evaluation for companies and governments is generally done by a credit rating agency such as Standard & Poor’s, Moody’s, CRISIL etc.

Most of the developed markets did not have effective regulations for rating agencies till 2008 or so, but SEBI has had a strong set of norms to govern the functioning of credit rating agencies.

Borrowers always strive for highest credit rating as it will affect the interest rate of the credit and amount of loan also. A high credit rating indicates that the borrower has a low probability of defaulting on the debt; conversely, a low credit rating suggests a high probability of default.

Different rating symbols are used by different agencies for given ratings to the clients. For example S&P gives rating like AAA, AA, C or D etc. A debt instrument with a rating below BBB- is considered to be speculative grade or a junk bond.

Credit rating is derived by using financial data of the borrower’s history. Over the period of time, investor’s knowledge about credit rating improved significantly. Investors are also aware about the credit rating agency and give importance to this aspect also.

Investors give importance to good scores and give them weight age while maintaining their portfolio. Credit ratings affect the decisions of investors like in Aug, 2011 when credit of USA is downgraded by S&P then the equity market was not performed well in that particular week.

Different rating agencies use different system for evaluation the credit score of the borrowers. The main factors which are used to give credit score to an individual is the credit payment history, time period taken, type of credit, current debts and what is the frequency of application of new credit.
Different weightage is given by different agencies. It might be possible that different rating agencies give different score to an individual which is based on same credit report information.

Since there are future events and developments that cannot be foreseen, the assignment of credit ratings is not an exact science. Ratings opinions are not intended as guarantees of credit quality or as exact measures of the probability that a particular issuer or particular debt issue will default.

Instead, ratings express relative opinions about the creditworthiness of an issuer or credit quality of an individual debt issue, from strongest to weakest, within a universe of credit risk. The likelihood of default is the single most important factor in our assessment of creditworthiness.

This paper examines the worth of rating given by rating agencies. For this some case studies have been studied and problems and conclusion have been drawn.

**Literature Review**

Many studies have been conducted on credit rating agencies. Some of them are discussed in this paper also.

Lilliana Rojas –Suarez in “Rating banks in emerging markets: What credit rating agencies should learn from financial indicators.” Examined the commonly used indicator of banking problems in industry countries. The poor performance of banking problem indicated the problems in Latin America and East Asia. He explained the reasons for the same. It is because of (a) severe deficiencies in the accounting and regulatory framework and (b) lack of liquid markets for bank shares, subordinated debt and other bank liabilities and assets needed to validate the “real” worth of a bank as opposed to its accounting value. In spite of these problems, an appropriate set of indicators for banking problems in emerging markets can be constructed. But such a system should be based not on the quality of banks loans or on levels of capitalization, but on the general principle that good indicators of banking problems are those that reveal the “true” riskiness of individual banks because they are based on markets that work rather than just relying on accounting figures. He also explained all the difficulties that rating agencies may encounter in considering the suggested approach in this paper is that the methodology implies that the appropriate indicators of banks’ performance evolve over time as markets develop and that, given large differences among emerging markets, a single set of indicators will not “fit all.

Calabria Mark and Ekins Mcclintock Emily (2012) in “Regulation, Market Structure, and Role of the Credit Rating Agencies” explained that during the financial crisis of 2008, the financial markets would have been better served if the credit rating agency industry had been more competitive. They presented evidence that suggests the Securities and Exchange Commission’s designation of Nationally Recognized Statistical Rating Organizations (NRSROs) inadvertently created a de facto oligopoly, which primarily propped up three firms: Moody’s, S&P, and Fitch. They also explain the rationale behind the NRSRO designation given to credit rating agencies (CRAs) and demonstrate that it was not intended to be an oligopolistic mechanism or to reduce investor due diligence, but rather was intended to protect consumers. They gave importance to the capital infrastructure and the power of credit rating agencies in financial markets, and despite the good intentions of the uses of the NRSRO designation, it is not worth the cost and should be abolished. Regulators should work to eliminate regulatory reliance on credit ratings for financial safety and soundness. These regulatory reforms will, in turn, reduce CRA oligopolistic power and the artificial demand for their ratings.

Bansal Rohit and Bansal Ansu (2012) in “Do high credit rating IPOs influence the determinate of underpricing? - A Logit Analysis” examined unique accreditation mechanism for IPOs introduced by SEBI in 2007. As per this regulation, all IPOs have to undergo mandatory quality grading by independent rating agencies. They employed sample of 142 Indian IPOs. They also experiment ex-ante uncertainty with the efficacy of IPO grading mechanism. They showed that grading decreases IPO underpricing and positively influence the demand of retail investors issue size, earnings before interest and dividend, long-term debt-equity, equity ratio and profit to the book value ratio. Grading also diminishes the number of shares offered, debt-equity ratio and earnings before interest, dividend and tax, fixed assets ratio, and has much impact on ex-ante uncertainty. But they also mentioned that IPO
grading is important to capture firm size, business group affiliation and firm’s quality of corporate
governance. Their findings revealed that in the emerging markets, a regulator’s role to signal the
quality of an IPO contributes to market welfare.

Evidence on Selected Criticisms of the Agencies” assessed the validity of widespread criticisms of the
large, “nationally recognized” credit rating agencies (CRAs). The accounting scandals of 2000-2002,
in particular the highly publicized failure of Enron in December, 2001, led many to question their
competence and the value of their ratings. He evaluated important criticisms of the CRAs discussed in
a recent SEC staff report by using evidence from empirical research studies, and suggests many
promising subjects for future research.

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NRSRO designation given to credit rating agencies (CRAs) and demonstrate that it was not intended to
be an oligopolistic mechanism or to reduce investor due diligence, but rather was intended to protect
consumers. They concluded that although CRAs were indirectly constrained by their reputation among
investors, the lack of competition allowed for greater market complacency.

Steinar Holden, Gisle James Natvik and Adrien Vigier in “An Equilibrium Model of Credit
Rating Agencies” developed a model of credit rating agencies (CRAs) based on reputation concerns.
Ratings affect investors' choice and, thereby, also issuers' access to funding and default risk. They
showed that -in equilibrium, the informational content of credit ratings is inferior to that of CRAs'
private information. They found that CRAs have a pro-cyclical impact on default risk: in liquidity
boom CRAs help resolve investors' coordination problem, and lower the probability of default; in
liquidity crunch CRAs raise the probability of default.

John Kiff, Sylwia Nowak, and Liliana Schumacher in “Are Rating Agencies Powerful? An
Investigation into the Impact and Accuracy of Sovereign Ratings” found that Credit Rating Agencies
(CRA)’s opinions have an impact in the cost of funding of sovereign issuers and consequently ratings
are a concern for financial stability. While ratings produced by the major CRAs perform reasonably
well when it comes to rank ordering default risk among sovereigns, there is evidence of rating stability
failure during the recent global financial crisis. They analyzed that these failures suggest that ratings
should incorporate the obligor’s resilience to stress scenarios. The empirical evidence also supports
reform initiatives to reduce the impact of CRAs’ certification services, more stringent validation
requirements for ratings if they are to be used in capital regulations and more transparency with regard
to the quantitative parameters used in the rating process.

Siegfried Utzig (2010) in “The Financial Crisis and the Regulation of Credit Rating Agencies:
A European Banking Perspective” examined that Credit rating agencies (CRAs) bear some
responsibility for the financial crisis that started in 2007 and remains ongoing. This is acknowledged
by policymakers, market participants, and by the agencies themselves. He also clarified that, given the
depth of the crisis; CRAs would not be able to satisfy policymakers by eliminating flaws in their rating
methods and improving corporate governance. Although the CRAs were more or less unregulated
before the outbreak of the financial crisis, after the crisis started, politicians became increasingly vocal
in demanding regulation. Finally he concluded that after the November 2008 G-20 summit in
Washington that state regulation could no longer be avoided. In Europe, the course had been set in this
direction even before then. Since European policymakers saw the crisis as evidence that the Anglo-
Saxon approach to the financial markets had failed, they believed they were now strongly placed to
have a decisive influence on shaping a new international financial order. But it can do nothing to
address the repeated calls for greater competition or for CRAs to be made liable for their ratings.
Problems with rating agencies

Ratings are very important for borrowers as well as lenders. But there are many problems which are associated with these agencies.

1.) Many credit agencies are based on developing and developed countries. Many bailed out companies of US and European had good ratings, even at the time of recession. Bankrupt bank also have good ratings. Asian and Indian and Asian country’s companies get rating from European country’s agencies. Should US and EU credit agencies allowed to rate the performance of the Asian economies? Are they giving proper rating to Asian countries? They rated Indian and Asian companies in context of what is happeing in the world.

Prime Minister’s key economic advisor has said that there is no case for lowering India's credit rating and the global agencies need to look at the international scenario before taking any rating action. "The rating agencies also need to recognize the fact, we have taken some strong actions in the recent period therefore I believe the rating agencies do not have a strong basis for reducing the rating of India," Prime Minister's Economic Advisory Council (PMEAC) chairman C Rangarajan said.

2.) The other problem is that there is no separate and specific method to give rating to micro, small and medium enterprises. S.Muhnot, chairman and managing director of SIDBI, said that SIDBI is partnering with credit rating agencies to make an independent assessment or grading of a loan proposal such that the banks get an assessed SME proposal helping them to significantly enhance their lending to this sector.

3.) There is ‘conflict of interest' at rating agencies. This is also very important issue with rating agencies. This fear was raised recently, when CRAs assigned bad ratings to those entities who could not give favour to them.

SEBI is working on new guidelines to solve the conflict of interest so that transparency level of the credit agencies can be maintained.

4.) Multiple rules and regulations are the problem with rating agencies. In India, credit rating agencies (CRA) are approved by two regulators, Securities and Exchange Board of India (SEBI) for capital market operations and by Reserve Bank of India (RBI) for rating of borrowers of banks. And as it is said dual control is no control. The existing regulations in India are not comprehensive enough to take care of the present crisis caused by many of the issuers dragging the rating agencies to courts on grounds of bias, manipulation and lack of transparency or sheer incompetence. There are rising many cases on rating agencies not only in India, but in many other part of the world also. It is big question mark on the regulators all over the world.

5.) It is difficult to decide whether CRAs should be self regulated or government regulated. They are not accountable for their rating as they follow their own methods. It also has been proved during the financial crises that self-regulation model of credit rating agencies were not successful.

6. Lack of transparency is also the big problem with credit rating agencies.

Research methodology

It is descriptive research. Mainly secondary data has been used to analysis the worth of rating agencies. Some case studies have also been discussed to prove that there is some problem with these agencies. Many issues have been encountered from different part of the world. This paper will try to bring some issues and how things have been changed for credit rating agencies. Some suggestions have been given to solve some of these problems.

Case Studies

Some cases have been analyzed to check the problems with credit rating agencies.

Case 1: S&P violation of standard and manipulated ratings

The US department of Justice files a suit against Standard and Poor are rating service. The main issue was that S&P inflate the rating of subprime mortgage-backed securities, which gave false impression to the investors.
Sixteen states and the District of Columbia have joined the federal suit. The damage amount asks is at least $5 billion.

This is the first federal case against credit rating firm. Moody and S&P, both played significant role in this fraud and speculation, which turned to the Wall Street crush.

Details of the case:

Credit ratings agencies like Moody’s, S&P etc. are private company and their main motive is to make profit. It was investigated that S&P and Mood’s earned huge profits from 2004 to 2008. They earned these profits by giving rating to residential mortgage backed securities and CDOs of Wall street banks. These instruments were sold all over the world.

Wall Street drove mortgage lenders to sell high-risk, high-interest subprime home loans to people who could not afford them, bought up the loans from the mortgage companies, bundled them into RMBS and CDOs, and sold off these toxic investments, making massive profits in the process. Their RMBS and CDOs were given AAA ratings by S&S and Moody’s. It was a fraud with the investors as such a high risk instrument cannot get AAA rating. The changes of default risk were very high. These credit rating agencies had some personal benefits as they were paid high by these banks. CRAs gave value to their personal interest.

Consequently, the credit rating firms compete for a share in the lucrative financial derivatives market, which includes mortgage-backed securities, by proving to their bank paymasters that they will deliver the top ratings the banks need to maximize their profits.

It was a clear case of deliberate fraud. It cost billions of dollars to the investors and tax payers. S&P made false representation to the investors and gave false rating by using manipulated rating models and methods.

“This alleged conduct is egregious—and it goes to the very heart of the recent financial crisis.” It was also highlighted in this case that S&P is not knew the fact that what banks are doing but it helped them to do so. S&P own internal reports showed that rating of RMBS would not hold its quality on which CDOs are based. It brings down the economy of US and triggered the deepest slump and depression.

The government spent four months in talks with S&P in an attempt to reach a settlement and avoid going to court. Talks reportedly broke down in the last two weeks when S&P rejected any deal requiring it to admit wrongdoing and objected to a cash payment above $100 million. The justice department gave reports about S&P violation of standard and manipulated ratings.

In the report “The Financial Crisis Inquiry Report,” issued in January of 2011 mentioned that three agencies were responsible for financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval.”

The Senate Permanent Subcommittee wrote in his investigations that: “It was not in the short-term economic interest of either Moody’s or S&P, however, to provide accurate credit ratings for high-risk RMBS and CDO securities, because doing so would have hurt their own revenues.”

The same credit rating companies continue to make millions by giving top ratings to high-risk bonds and derivatives and helping conceal violations of securities laws by the banks, creating the conditions for another, even more catastrophic financial crisis.

Case study 2: Legal case threatens international credit ratings agencies' bottom line: A case of conflict of interest

A question was raised by Litigation funder IMF Australia on the credit worthiness of the major credit rating agencies of the world. The issue was that Fitch, Moody’s and S&P gave higher rating to the CDOs of the investment banks. The estimated claim was more than the net tangible assets of these CRAs.

Australia’s Federal Court found that S&Ps responsible for multi-million dollar losses suffered by Australian councils. S&P misrepresentation leads them to do investment in downgraded financial product (which was very risky).
Australia's Federal Court ordered gave order to S&P, Fitch and Moody’s to pay 20 million dollars to 13 council, who purchased the product because of them misrepresentation by these rating agencies. IMF Australia is also taking legal action in Europe against S&Ps and the investment bank ABN Amro with a subsequent filing in the UK planned against Moody's. Nevertheless, the US first amendment defense is not applicable outside the US.

CASE STUDY 3: Enhancing the Accountability of CRAs: The Case for a Disclosure-Based Approach

Previously credit rating agencies were important for debt issue corporations only. But now they play an important role in other financial instruments also. Market participants consider credit rating also before investment. Such an important entity is running without regulatory framework. Private regulations are running these agencies.

Recent scandals raise questions on their efficiency and how useful these ratings are for different market player. Lawmakers and regulators examined the effectiveness and role of these agencies. They found that the main problem was the integrity and reliability of these CRAs. These potential problems are worrisome given that CRAs wield considerable power over issuers and investors through the information disseminated in their ratings.

The main issue is the accountability of these CRAs towards market players. Fundamentally in perfect market, they are accountable for them but in real world (imperfect market) it may lead to a divergence between interest of CRAs and market participants.

There is gap in potential accountability of credit rating agencies. It is important to ensure that CRAs accountability should be clear towards investors and issuers. Regulators have examined the possible methods for enhancing the accountability of CRAs. The International Organization of Securities Commission (IOSCO) published the Code of Conduct Fundamentals for Credit Rating Agencies with the purpose to maintain integrity and quality. The Securities and Exchange Commission (SEC) has also proposed some norms and conditions after satisfying that only CRAs can obtain national recognized statistical rating organization designation. This shows that there is lack of accountability and norms for CRAs.

CASE STUDY 4: Indian Corporate Srei Infrastructure Finance (SIFL) Vs. Fitch Ratings

SIFL filed a suit against Fitch rating agencies and got stay order on publication of downgrading its bonds obligations from Calcutta high Court against Fitch ratings.

Calcutta High court allowed Fitch Ratings to publish the rating but only after satisfying the conditions of SEBI (as SEBI is the regulatory board of CRAs). SEBI allowed Fitch rating to publish the rating, but SIFL is still not agreeing with this and it is again filing the petition in high court regarding this. As per SIFL, Fitch rating is inaccurate conjecture.

CASE STUDY 5: Videocon Industries Vs India Ratings: (Formerly Fitch Ratings, India): A conflict of interest

Videocon industry obtained a stay order from Calcutta High court against the publication of rating by Fitch rating agencies.

Videocon Industry also said that India Ratings had not made any rating from the last two years and the main purpose of their rating is just to help its rival company in Mozambique in Africa. But Indian ratings gave this argument that there is some contractual obligation to rate Videocon and some outstanding loans are still pending to be rated.

The court finally decided that it will be stayed continued until the further order will come. This is also a case of conflict of interest.

Suggestions

1.) The rating agencies must take a balanced and objective view of the borrower’s financial situation and capacity to service/repay the debt.
2.) The regulations require credit rating agencies to keep their sales and research functions completely separated by 'Chinese Walls' like structures, so that income received from their clients do not affect the ratings being assigned to them.

3.) The rating agencies should do their job with honesty and integrity and the issuers should have a remedy when they find that something is amiss in the rating proposed by the rating agency.

4.) It is important that credit rating agencies should not only competent but also capable to show high standard of corporate governance. So that they can generate confidence and trust in rating methods and tools itself.

5.) Investors should not accept everything that rating agencies Says. They should apply their own logic and rationality before taking any decision. They should not entirely depend on these ratings only.

6.) CRAs should give significant importance to the role of non-financial factors in internal credit rating because of their potential use for determining regulatory capital adequacy for banks.

**Conclusion**

It can be concluded that there are many problems and issues associated with credit rating agencies. At the time of financial crisis, the role of credit rating agencies were negative and many questions has been raised on the accountability and worthiness of these agencies. Some cases are won by CRAs but others are not. So it can be said that some more strong regulations are required. Also some agencies should be there, who will monitor the performance of these rating. But still is it right to say that investors are over expecting from these agencies or CRAs are not performing their duties very well.

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