Journal of Indian Research (ISSN: 231-4155)
Vol.1, No.4, October-December, 2013, 60-65.

Finance

A TALE OF TRANSITION – EVOLUTION OF CREDIT RATING AGENCY INDUSTRY AMIDST A DECADE OF CRISIS

Dhruv Priyadarshi Nijhawan*
Stuti Priyadarshni Nijhawan**

ABSTRACT

During the last decade, the global financial regulators have witnessed some large multinational organizations collapse and onset of massive bankruptcy. The major failure of giants like Enron, Lehman Brothers and AIG, to name a few, was never anticipated before it struck unceremoniously. The aftermath of Credit Crisis in 2008 and Subprime lending turmoil in 2009-10, witnessed the evolution of rating agencies from a mere egg shell of allocating credit ratings to policy consulting agendas. More recently, the rating agency Standard & Poor stunned the world by stripping the U.S. government of its prized AAA bond rating. The downgrade of long-term U.S. Treasury threatened to spread panic and chaos in financial markets. This drove up U.S. interest rates, pushing the dollar down, scaring investors away from stocks and into that traditional refuge for the investor: gold. The purpose of this research paper is to understand the evolution of credit rating industry amidst changing regulatory cycle of reforms in the last decade with reference to some major caselets including both developing and developed nations.

Keywords: American Tax-Payer Relief Act, Credit Rating Agency Industry, Dodd-Frank Act, Subprime Lending.

INTRODUCTION

The Process of Credit Ratings

A credit rating is an assessment as to the likelihood of the obligor's default in repayment of lent funds. The higher the rating (e.g. "AAA"), the less likely that a default will occur. Credit ratings are forward-looking, summarised opinions about a borrower or a security's creditworthiness. These ratings recapitulate the conclusions of a rating agency's credit analysis, which its analysts explain in a published report. Such reports are commonly called a **Credit Scorecard**. There are three major rating agencies, which account for the oligopolistic nature of the industry across the globe: *Standard & Poor's Ratings Services Inc., Moody's Investor Service Inc, and Fitch Inc*. The challenge for a rating agency is to ensure that its methodology properly considers the diverse factors that contribute to a security's creditworthiness in a way that is useful to investors.

It is imperative to understand that ratings are opinions and not recommendations to purchase, sell, or hold any security. In the United States, rating agencies assert that they have the same status as financial journalists and are therefore protected by the constitutional guarantee of freedom of the press. This has traditionally defended them from investor litigation and until recently prevented direct regulation of their operations.

***Dhruv Priyadarshi Nijhawan** is a Senior Analyst at RocSearch India Private Limited. E-mail: Dhruv.nijhawan@gmail.com
****Stuti Priyadarshni Nijhawan** is an Assistant Professor at Subharti University, Meerut , U.P.

Credit ratings are aimed at reducing information asymmetries by providing analytical viewpoint on the rated security. In addition, ratings can solve collective action problems of dispersed debt investors by helping them to monitor performance, with downgrades serving as a signal to take action. A credit rating is influenced by the underlying outlook carried by economic environment of the related entity, generally gauged by Country Risk Assessment (CRAS) framework. Credit ratings are typically among the main tools used by portfolio managers in their investment decisions and by lenders in their credit decisions. *Altman Z-score* is the most common credit model used for the purpose.

The Discipline of Credit Analysis

Credit Analysis studies and quantifies credit risk and default point of any organizational credit psychology. The *default point* of any major credit deal is the financial threshold that depicts the breach in the financial payback capability. As the default point is approached, the expected default frequency increases. *Expected Default Frequency* (EDF) is a term which is denoted by a percentage and measures chances that a particular entity will not entertain its assigned credit limit conditions. Both the default point and EDF are inversely proportionate to credit worthiness quotient of an entity. These terms are used widely in credit markets for both the Government bonds and corporate debentures.

Credit Analysis encompasses various financial and strategic techniques to evaluate underlying asset quality. The analysis comprises working on historical financial statements and carrying out fundamental research, advanced ratio analysis, trend analysis and preparation of financial performance index or composite credit score index. On the strategic part, the process includes study of organizational structure, SWOT Analysis, PESTLE Analysis, Peer Review and GAP analysis, Sector and Industry outlook and RISK-MITIGATION landscape.

Traditional Credit Ratings Industry

- Rating agencies originally emerged to assist discrete investors in monitoring issuers in the debt capital markets. They allotted an objective measure of credit quality to debt issues, based on independent analysis of issuer-supplied financial information.
- A look at the origins of credit ratings reveals that the statutory mention of national rating agencies first came into use in 1975 in US, when the U.S. Securities and Exchange Commission (SEC) introduced the concept as part of the amendments to the broker-dealer net capital rule under the Securities Exchange Act of 1934.
- Furthermore, the rating agencies developed as information businesses and contributed by the operation of markets by following market efficiency theory.
- Essentially, credit ratings reduce the ability of one investor to outperform another by making better judgments about creditworthiness.

Situational Context of Credit Rating Agencies in US and Europe (2000-2005)

In the earliest context of rating agencies, the SEC did not formulate any type of substantive regulation. The SEC did not even adopt a definition of Nationally Recognized Statistical Rating Organization (NRSRO). In fact, the only regulation of the credit rating agency market was the NRSRO designation process which was controlled by the SEC. The criterion for NRSRO designation was unclear and the rationale supporting the SEC's decision-making process lacked transparency to a great extent. Additionally, the timeframe for a decision was often very lengthy. The extreme reliance on ratings by market participants and the part that such ratings played in the collapse has resulted in a resounding cautionary call for tougher regulation of credit ratings altogether. The NRSROs have also been criticized for their lack of independent verification of information received from third parties where such information was used to issue ratings for structured finance securities.

Initial Regulatory Regime - *Demise of Enron :"The Elephant Fall"*

The early 2000s witnessed the sudden downfall of several large, prominent, well-rated companies. Some of the more notable, recognizable names included Enron and WorldCom. The demise of these companies caused Congress to focus on the role of the largely unregulated NRSROs and this resulted in *International Organization of Securities Commission issuing Statement of Principles* regarding the activities of Credit Rating Agencies in 2003 and the *Code of Conduct Fundamentals for Credit Rating Agencies, 2004* that highlighted four categories of voluntary principles for rating agencies which are:

- Quality and integrity of the rating process,
- Independence and avoidance of conflicts of interest,
- Responsibilities to the investing public and issuers, and
- Public disclosure of their own code of conduct

The IOSCO Code did not address government regulation of rating agencies or include an enforcement mechanism, though several rating agencies voluntarily developed their own codes of conduct along similar lines.

Post -2005 Mid-Tier regulatory reforms in Ratings Market

In 2006, the U.S. Congress passed the *Credit Rating Agency Reform Act.* The Act required rating agencies to comply with certain requirements as:

- Periodic reporting on activities and the public disclosure of information on laid down standards and policies.
- The act also empowered the SEC to conduct on-site inspections of rating agencies and to take disciplinary action for violations of the law.

Regulation in the European Union

Before 2009, the regulation of rating agencies in the European Union relied largely on voluntary adherence to the IOSCO Code as overseen by the Committee of European Securities Regulators.

Critical Developments leading to Post- Crisis Role: Reformation of Credit Rating Agencies

- In 2001 rating agencies were rating Enron “investment grade” just four days before it went bust. Lehman Brothers, AIG and Washington Mutual had similarly stable ratings right up until September 15, 2008 i.e. till the moment they collapsed.
- The worldwide credit crisis of 2008 was an interrelated series of events that continued to magnify financial mayhem. The crisis encompasses seize-ups in markets for asset-backed commercial paper and auction-rate securities, depressed Treasury bond yields and drove up corporate credit spreads.
- The continuation of Credit defaults lead to Subprime crisis in 2009 with mortgages going bad and Collateral Debt Obligations turning junk.
- Furthermore, the three big rating agencies- Standard and Poor’s, Moody’s and Fitch- were considered to be the main cause of the financial crisis in European Union in 2010-2011 with sovereign defaults from Greece, Ireland, Portugal and Spain. This eventually lead to high debt to GDP ratio (more than 100% for most of EU nations), which resulted in driving up market rates, prohibiting the countries’ access to financial markets and undermining the rescue operations of the IMF and the EU.

Post- 2008 Regulatory Framework for Credit Rating Agencies in US and Europe

Due to the financial disaster in the global commercial centers of the world, fresh need for new regulatory requirements was felt as the crisis ramified. This led to a series of governmental statutory interference in regulatory environment of rating agencies such as:

1. **International Organization of Securities Commissions (IOSCO)**

While reviewing the role of rating agencies in the structured finance debacle, International Organization of Securities Commissions (IOSCO) revised the Code of Conduct Fundamentals for Credit Rating Agencies in 2008 which included measures like

- Improvement in the quality of the rating methodology,
- Ensuring proper monitoring and control over timelines of ratings,
- Prohibit the involvement of analyst’s view in the design of structured securities,

- Increase public disclosures, like periodical review of compensation policies, and
- To differentiate structured finance ratings from others.

2. G-20 Leaders Summit (2009)

During the April 2009 *Declaration on Strengthening the Financial System*, the G-20 leaders agreed that all credit rating agencies whose ratings are used for regulatory purposes should be subject to an oversight regime that includes registration and consistency with the IOSCO Code. They also agreed that rating agencies should differentiate ratings for structured products and increase disclosures. Eventually, the Basel Committee was asked to review the role of external ratings in prudential regulation and identify adverse incentives that needed to be addressed.

3. Regulation by SEC in the United States

In 2009, the U.S. Securities and Exchange Commission (SEC) amended its regulations for rating agencies to require enhanced disclosure of performance statistics and rating methodologies, disclosure on their Web site of a sample of rating actions for each class of credit ratings, enhanced record keeping and annual reporting, and additional restrictions on activities that could generate conflicts of interest.

4. Regulation in the European Union

European Parliament and EU Commission in May 2009 decided that all rating agencies issuing credit ratings in the European Union need to apply for registration to the Committee of European Securities Regulators (CESR) and be supervised by it along with the relevant member state. Credit ratings by rating agencies operating exclusively from non-EU jurisdictions may be acceptable on a case-by-case basis if the oversight framework of their country of origin is deemed to be equally stringent. The CESR also decided to establish a central repository, accessible to the public free of charge, with historical data on the rating performance of all registered rating agencies.

Impact of Dodd-Frank Act, 2010 in repositioning Credit Rating Agencies

In the USA, the *Dodd-Frank Act* (June, 2010), requires regulators to remove from their rules any references or viewpoints pending decisive criteria to determine credit ratings. In June 2011, the Federal Reserve Board in US issued a report to the US Congress reviewing references to credit ratings mainly related to capital adequacy measures for banks, such as risk weight allocation. The Fed also proposed certain amendments to remove references to credit ratings from its capital requirements. It further suggested the use of substitute standards of creditworthiness for capital calculations that relied on external ratings. This was a big blow to imagery of Credit Rating Agencies (CRAs) and thus, an ice-breaking shift was required in the role of CRAs.

Role Evolution of Credit Rating Agencies post-Financial Crisis Era

The Credit rating agencies throughout the world have not only become more objective in their assessment of organizational entities, but also they have made themselves more pronounced and proactive to global incidents. They now follow framework of Incident Analysis, which has lead to their transition as a global whistleblower. Some necessary transformational steps taken by Credit Rating Agencies with stringent implementation are:

- *Improving the quality of rating methodologies*, particularly for structured finance instruments like Collateral Debt Obligations, Credit Default Swaps, and Hybrid Mortgage Instruments etc.
- *Introducing direct government oversight* to replace self-regulation by Rating Agencies.
- *Implementation of Hybrid payer model* (representing both issuer and investor bodies) rather than Issuer-pay model towards rating fee, thus providing more independence in expression of credit opinions.

The role of a whistleblower in financial markets by Credit Rating Agencies was quite evidently witnessed initially in **a** landmark case of **Pakistan Steel Mills Corporation** in 2009-2010**.** The rating agencies not only assigned a clear downgrade but also carried out a new economic growth forecast for the sovereign status of the nation.

Caselet 1: Pakistan Steel Mills Corporation *(Impact in Asian Economy during sub-prime crisis)*

Theme of Caselet – Exposure of faulty economic indicators by Credit rating agencies during 2009-2010

Pakistan Steel Mills Corporation (PSMC) is a good example of Asian economy which is considered better off relative to its peers in recent times of crisis. This organization is a 100% government owned company and the largest steel enterprise in the country. Although being a part of strong Asian economy and enjoying implied support from the national government, PSMC did not live up to the expectations of being a healthy trade counterparty in year 2009-2010. The credit rating agencies iterated ground breaking reasons for PSMC's credit deterioration, which were

- PSMC has been exposed to political instability, with extremely weak financial position reporting around Rs 20 billion losses in 2008-2009, or the first time in nine years. The accumulation of losses was due to less than target production and sales, import of raw material at exorbitant rates and global economic crisis.
- The country risk has been assessed by rating agencies high (*S&P* rating of B- and B3 by *Moody*'s, one notch above implied default). Moreover, the major economic risk to Pakistan's national policy was caused by massive flood in August 2010. This all concludes the heavy impact that economic and political stability has on trade policies.
- Although, the company is the largest public sector undertaking in the industry in Pakistan, yet it had negative trade connotations for corporate deals. At this point, it was for the credit agencies to come out with a substantial analysis for rating purposes and help trading companies to avoid impending default.

Development of New Tools by Credit Rating Agencies

After the financial apocalypse witnessed in the previous years of 2008-2011, the International credit rating agencies have evolved their armor and weaponry to fight fraudulent practices and critical hints of commercial misfit. Some major development in this area has been taken up by *Moody Rating agency* and *S&P*, which have new measures to crack potential threat to sovereign debt ratios:

- A key development by Moody Credit Rating is progress on enhancement of financial forecasting trend software like **Credit Edge and Risk Calc**. Risk Calc is an important model that has default prediction methods for regional private firms. It supports decision-making process for extending loans, managing portfolios and pricing debt securities when there is little available market insight into a firm's prospects, as is the case for middle market credits.
- Another important measure developed overtime is **EDF magnitude forecast.** This calculator measures Expected Default Frequency of entities along with change in default points with respect to their credit ratios like Debt Capitalization (in case of corporate) and Sovereign Debt over Gross Domestic Product (incase of Nationalities).

Caselet 2: American Taxpayer Relief Act of 2012 (US Economy & Sovereign Credit Rating)

Theme of Caselet – Extended vigil over matters of International importance

In the wake of signing of *American Taxpayer Relief Act of 2012*, popularly known as *Fiscal Cliff Bill*, the credit rating agency *Moody* has advised US sovereign to speed up fiscal measures so as to save itself from a rating downgrade.

- The *Fiscal Cliff Bill* that extends lower tax rates on a more or less permanent basis on annual household income under $450,000 with postponement of the Budget Control Act's sequester for two months has been signed by the US President Barrack Obama in January 2013 by an autopen.
- *Moody*'s Rating is of the viewpoint that in order to secure its "AAA" debt rating from its negative outlook, the US sovereign has to take up additional measures to lower US budget deficits and lower the trajectory for a longer duration.
- Meanwhile, the *S&P* has taken an unprecedented action of lowering the US debt rating to AA-plus from AAA, as *S&P* was prompted by the financial calamity in the US to do so.

CONCLUSION

Credit Ratings are a type of information, in the form of independent opinions about the creditworthiness of issuers and securities. They fulfill their role by adding to the mix of information that investors and lenders can use when analyzing and trading securities. The real role of credit ratings in the financial system is to improve the functioning of markets by reducing information asymmetry between issuers who need funding, lenders who can provide it and the public at large. Credit ratings help to make markets more efficient by putting all lenders and investors on more equal footing, thereby minimizing variations in returns that can arise from differential credit judgments. Moreover, rating agencies sometimes differ in their assessments of a given issuer or security, either because they calibrate their rating scales differently or ascribe greater or lesser weight to different factors in their analyses. Accordingly, the greatest reductions in information asymmetry come from the presence of multiple ratings on a given issuer or security, in combination with other sources of information and independent analysis.

On certain occasions, misuses of credit ratings such as "rating shopping" by issuers, the regulatory use of ratings, and the use of ratings as a substitute for an investor's own analysis, have all contributed to distortions of a credit rating's true role. And when such misuses are widespread, the market may fail to realize the full value that credit ratings can offer. The hope is that greater understanding of what credit ratings really are and what they aim to do can benefit all market participants and create a stronger and more efficient financial system.

REFERENCES

1. Adelson, M. (2012). "*The Role of Credit Ratings in the Financial System*", Standard & Poor's, May 2012. Accessed online on 19th December, 2013 at http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245333790527
2. Adelson, M., Ravimohan, R., Griep, C., Jacob, D., Coughlin, P., Bukspan, N., & Wyss, D.(2009). "*Understanding Standard & Poor's Rating Definitions*", Standard & Poor's, June 2009. Accessed online on 19th December,2013 at http://www.standardandpoors.com/spf/upload/Ratings_US/Role_Of_Credit_Ratings_In_FS.pdf
3. Hunt, John Patrick (2008). "*Credit Rating Agencies and the Worldwide Credit Crisis: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*", September 14, Accessed online on 19th December,2013 at http://www2.wiwi.hu-berlin.de/finanz/skript_semfin/t12.pdf
4. IOSCO (International Organization of Securities Commissions) (2008). "The Role of Credit Rating Agencies in *Structured Finance Markets,*" Technical Committee Final Report.
5. Joint Forum (2009). *Stocktaking on the Use of Credit Ratings*. Basel: Bank for International Settlements.
6. Katz, Jonathan. Emanuel Salinas, and Constantinos Stephanou(2009). "*Credit Rating Agencies, No Easy Regulatory Solutions*", Note number 8, Financial and Private Sector Development, Vice Presidency of the World Bank Group, October 2009. Accessed online on 19th December,2013 at https://openknowledge.worldbank.org/bitstream/handle/10986/10227/530410BRI0Cris10Box345594B01PUBLIC1.pdf?sequence=1
7. Tichy, Gunther(2011). "Credit Rating Agencies: Part of the Solution or Part of the Problem", *Intereconomics Journal*, Vol.**46**(5):232-45., Sept/October,2011 Available online at http://www.ceps.eu/files/article/2011/10/Forum.pdf