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Information Services and Beyond: Expanding Horizon of Credit Rating Functions

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Concept of Credit Rating:-

Credit rating is an independent assessment of the creditworthiness of a borrower in respect of a debt instrument by a credit rating agency (CRA). It estimates the probability of timely repayment of principal and payment of interest on the debt security. The Rating Agency Reform Act, 2006, of the US Securities and Exchange Commission defines credit rating agency to be a "person (a) engaged in the business of issuing credit ratings on the Internet or through another readily accessible means, for free or for a reasonable fee, but does not include a commercial credit reporting company; (b) employing either a quantitative or qualitative model, or both, to determine credit ratings; and (c) receiving fees from either issuers, investors, or other market participants, or a combination thereof".

As per SEBI (Credit Rating Agencies) Regulations, 1999, credit rating means "an opinion regarding securities, expressed in the form of standard symbols or in any other standardized manner, assigned by a credit rating agency and used by an issuer of such securities, to comply with a requirement specified by these regulations". Moody's defines its credit rating as the opinions of the credit quality of individual obligations or of an issuer's general creditworthiness, without respect to individual debt obligations or other specific securities. According to Standard and Poor's (S&P), credit ratings are forward-looking opinions about credit risk. S&P's credit ratings express the agency's opinion about the ability and willingness of an issuer to meet its financial obligations in full and on time.

It is a symbolic, namely alpha-numeric representation, of a CRA's opinion on the relative capability of the corporate entity to timely service its debt obligations with reference to the rated instrument. Evaluation of capability of an issuer involves estimation of both its ability and willingness to make contractual repayments. The higher the credit rating, it is presumed, the higher is the degree of safety associated with the concerned instrument. Higher rating is also linked with lower cost of raising funds. Thus, credit rating serves both the issuers and investors, although it is the issuers who directly pay for the same. However, it is ultimately borne by the investors through the process of allocation of associated costs over the cost of securities. That is, issuers reap the benefits of rating at the cost of investors. Although rating is meant for guiding investors, it always comes with a disclaimer that it is not a recommendation to buy or sale a security. These words of caution relieve rating agencies of any responsibility for the wrong assessments-and consequent losses suffered by the investors. Again, as issuers pay for the ratings, they have a better bargaining power with CRAs. Thus, there is an obvious scope of conflict of interest and consequent moral hazard problem in the entire process.

Credit Rating as a Subsystem of the Financial System:-

The system of credit rating can be interpreted as a subsystem of total financial system of a country. Again, as a country's financial system operates within the ambit of global financial system, so does a national rating framework. In other words, national credit rating framework is a subset of global financial system and global credit rating framework, in particular. Credit rating system draws its relevance from the efficient growth of the financial system within which it operates. The credit rating sub-system is built up of several components, namely, credit rating agencies, issuers of securities, investors, rating products, instruments or financial securities to be rated, regulators of the financial market, rating process and methodology or techniques of rating exercise. Credit rating is an inter-play among all these components while its primary focus is on issuers and investors.

Issuers value credit ratings because it lowers the costs that issuers incur for raising capital. On the other hand, credit ratings reassure the investors both about the risks they face when making an investment and about the competence and responsibility of the issuer's management. "In fact, the benefits to issuer accrue as a result of potential benefits to investors and in many ways they share the benefit of wider, healthier and more efficient debt markets, attributable to the role of CRAs" (Reddy, 2004).

Credit rating plays a very crucial role in case of securitization. When repayments are backed by receivables, credit rating helps the issuer to raise funds at rates finer than what its own independent ratings would indicate. Investors use ratings to supplement their own credit evaluation process, particularly when they do not have adequate expertise, time and access to management or other resources to undertake independent risk analysis. Even when investors have some perception regarding a debt security of a particular issuer, credit rating acts as a proxy for a check against investors' own research and analysis. Ratings serve as a guide to investors willing to enter financial market, whether domestic or foreign.

Institutional investors too use credit rating to quantify credit risk exposures. They may also use credit ratings to construct bond indices against which they monitor the performance of fund managers (TOSCO Report, 2003). Similarly, broker dealers, investment advisors and underwriters and investment banks may use credit ratings to determine acceptable counterparties and set collateral levels for outstanding credit exposures. Private parties like creditors and other businesses may use CRA ratings in private contracts for a variety of reasons. Frequently noticed among them are "rating triggers" in financial contracts in the West.

All the components that make up the global financial system are bound together in a moral framework. Rating agencies being at the core of rating operations also have an attachment to this moral framework. Credit rating is a task of evaluating credibility of a borrower. It measures the trustworthiness of a borrower. But the interesting puzzle in this process is that the firm whose instruments are rated pay for these services. Investors, the ultimate beneficiaries of ratings, do not directly pay for it. Moreover, the rating industry, all over the globe, is a regulated-oligopoly leading to an unhealthy competition. These two facts lead to an obvious problem of *moral hazard*. Thus, rating agencies themselves should have a strong moral foundation. They deal with people's trust, that is, are considered as the most sensitive feeling, and breach of which may render one traumatized and bereft of a stable a economic state. Therefore, rating agencies need to orient themselves to the values—namely, honesty, integrity and sincerity-so as to do justice to their moral citizenship.

Credit Rating Agency in india:-

Indian credit rating industry mainly comprises of **CRISIL**, **ICRA**, **CARE**, **ONICRA**, **FITCH** & **SMERA**. **CRISIL** is the largest credit rating agency in India, with a market share of greater than 60%. It is a full service rating agency offering its services in manufacturing, service, financial and SME sectors.

Credit Rating Process:-

Credit rating starts with the receipt of a formal request for rating from a prospective issuer. At the beginning of the rating process, the work is assigned to a primary analyst of the concerned CRA who works with the support of a back up analyst or a group of analysts. Analysts gather inputs from all possible sources and hold dialogues with the required personnel. The analysis is based on information obtained from the issuer and on an understanding of the business environment in which the issuer operates. It is carried out within the framework of clearly spelt-out rating criteria. The analysis is presented to a rating committee comprising members who have professional competence to assess the credit. The committee usually consists of 4-7 members depending on the volume and intricacy of the assignment. Ratings are finally assigned and reviewed by this rating committee. Rating methodologies of a CRA may vary across the rated objects and their tenure.

Functions of Credit Rating Agencies:-

Credit rating is a measure of relative risk of an issuer's ability and willingness to repay both interest and principal over the life of the rated instrument. Ratings generally signify the default probability of the rated instrument. Ratings are accompanied by detailed rationale, which helps the users of the reports to get the nuances of the assessment. CRAs assess the credit risk of corporate or government borrowers and issuers of fixed income securities. They attempt to make sense of the vast amount of information available in respect of an issuer or borrower, its market and economic circumstances in order to give investors and lenders a better understanding of the risks they face when lending to a particular borrower or when purchasing an issuer's fixed income securities (IOSOCO, 2003).

Availability of timely and accurate information is vital for efficient functioning of financial markets. Asymmetry of information between lenders and issuers is generally observed as the borrowers naturally possess more inside information than the lay investors. For savers, gathering of relevant information is costly and time-consuming. Further, they may not have adequate knowledge of how to judge the creditworthiness of the borrower. "In a global environment, this asymmetry is even greater and the cost of collecting information is even higher. The practice of credit rating and the emergence of CRAs for the purpose are meant to help mitigate this problem of asymmetric information" (Reddy, 2004). Credit rating agencies are in the business of predicting default probabilities of various debt instruments. Ratings reflect the likelihood of timely repayment of debt by the issuer. But this is not the only task done by the CRAs.

The major functions of credit rating agencies are summarized

(i) Information Function

CRAs can be regarded as information intermediaries as per the neo-institutional finance theory. They intermediate informational asymmetries between issuers and investors by generating information. Investors have very little or no information about the issuer while the issuers have complete knowledge about their own capabilities and intentions. Issuer has information superior to the investor. But the issuer is not able to cheaply convey the information about his own credit risk to the investors. Moreover, "because he (issuer) may profit from supplying the investor with wrong information, investors will not trust the reliability of such information. Thus, they require a risk premium which increases the cost of transaction" (Dittrich, 2007). Interest rate paid by the issuer rises. Issuers with low credit risk and offering low return find difficulty in obtaining credit. Thus, there appears a wide gap of information between fund-seeker and potential lender. CRAs try to bridge this gap by providing the investors with such information, which would otherwise not be accessible to them. In this process, the investors are provided with a screening mechanism, which reveals hidden information about the issuer to reduce information asymmetry.

According to Campbell and Kracaw (1980), CRAs disclose the implications of various private- information to the market while maintaining confidentiality about the information itself. They stress that during the rating process, an issuer's management is routinely consulted for non-public information. An empirical study conducted by Jorion and Zhu Liu (2005) reveals that US ratings have gained greater information value since 2000, when *Regulation Fair Disclosure* (FD) provided rating agencies with special access to private information. Regulation FD, implemented on October 23, 2000, prohibits the US public companies from making selective non-public disclosures to favoured investment professionals. Regulation FD has a number of exclusions, but included disclosure of non-public information to CRAs. As a result, the credit analysts of rating agencies have access to confidential information that is no longer made available to equity analysts, potentially increasing the information content of credit rating (Jorio, Zhu and Shi, 2005). Therefore, it may be said that access to adequate private information is key to GRAs' success. This, in turn, lowers the risk premium expected by the investors. Investors are willing to accept lower risk premium than they would without a rating. On the other hand, issuers buy rating as long as "the price paid by them is lower than the value of interest payment saved" (Dittrich, 2007). Institutional investors may, however, have their own mechanism of assessment of the issuer. In that case, they use ratings as checks against their own internal research. But for the retail investors, employing their own assessment exercise is quite problematic, if not impossible, given their limited resource, and poor accessibility to private information. Rating agencies make their tasks simple by exploiting vast economies of scale in information production (Grundman and Kerber, 2001). Thus, GRAs create value by reducing information costs in the market.

(ii) Certification Function

Besides acting as information intermediary, CRAs perform a second major function. Ratings serve as a regulatory tool in financial market oversight. Regulators of financial markets make use of rating in their regulatory frameworks. These rating-based regulations entrust rating agencies with the function, commonly called 'certification function'. "In this view, rating agencies not only assign a credit evaluation but they also issue a 'license' to access the capital markets or to lower regulatory burdens" (Partnoy, 1999). Regulators tend towards rating-based regulation primarily as a protection against systematic risk. The State intends to prevent the accumulation of too much risk at certain points in the financial system in order to prevent the contagious effects such as bank runs.

(iii) Monitoring Function

During the lifetime of the securities, credit ratings function as a monitoring mechanism. This is done so as to ease out the moral hazard problem after a credit has been granted. In the absence of monitoring, issuers may act opportunistically at the cost of investors. Following up the issuer throughout the span of the securities' life is simply beyond investors' capacity. Thus, GRAs monitor the actions of the issuers and issue periodic updates to their initial ratings.

(iv) Standardization Function

Sociologists such as Kerwer (2004) and Sinclair (2005) maintain that the relative nature of CRAs' risk assessment creates a value by itself. They create a value by standardizing the credit assessment process, regardless of the information value of the ratings. Rating agencies act as coordination firms establishing a common understanding of creditworthiness. From this point of view, CRAs are not only information providers, but also offer a standard of creditworthiness that can be voluntarily adopted by the investors. Moreover, risky investments of all possible classes and countries can be compared easily by comparing ratings (Dittrich, 2007).

(v) **Equilibrating Function**

According to Boot and Milbourn (2002), credit ratings can serve as 'focal point', which means that credit ratings help fix the desired equilibrium in an environment for which multiple equilibria would otherwise exist. When a firm seeks to raise fund from the financial market, the market cannot readily observe the quality of the firm's investment opportunities. Depending on the beliefs of the market, the firm might be induced to choose high-risk or low- risk strategies. If the market anticipates a risky project choice, it will demand a high coupon rate in the debt contract. Thus, once the firm is confronted with the high funding cost, it will optimally engage in the risky project. Alternatively, the firm might be induced to choose the low-risk strategy if that is what the market anticipates. Thus, multiple equilibria may be present(and depending on which project is the first best, the equilibrium is dissipative. If a sizable portion of investors follow the credit rating and base their investment decisions accordingly, others will follow as well. This can solve the multiple equilibria problem and substantiate the focal point role of credit ratings.

Inadequacies inherent in credit ratings:-

All over the world, CRAs have been subjected to severe criticisms in a number of occasions. Their independence, validity, impartiality, authenticity, integrity and the system of credit rating itself have been questioned from many quarters. Why should a private body corporate be given such an important place in market regulation, is a matter of debate among the market participants and experts.

The criticisms concerning GRAs can be viewed from two angles:

Conceptual Inadequacy:-

A basic problem lies with the definition of credit rating. While ability of a borrower to make timely repayment of debt can be judged subject to certain preconditions, willingness can hardly be anticipated. Willingness may not necessarily follow ability. Most of the corporate collapses demonstrate the dearth of willingness, not ability. Thus, the basic premise on which the superstructure of the concept of rating is built up appears faulty. And, coming to the question of ability, it is very hard to make any long-term prediction as it rests on many externalities beyond one's control and which change with time and context. Moreover, the fact that ratings are just the opinions of the CRAs and, therefore, CRAs are immune from liability of misinformation, add to further ambiguity.

Operational Inadequacies:-

Most of the difficulties concerning ratings pivot around the application of the concept. After all, it is a business run with profit orientation. Therefore, various human factors may lead to some operational bias. Conceptual foundation remaining sound, flawed applications may lead to undesirable consequences. That is, the problem lies not with the concept, but mostly in the way the concept is translated into practice by CRAs. Operational or application oriented deficiencies of CRAs all over the globe far outweigh the conceptual ones.

Problems of applicability again may manifest in two ways: *Firstly*, efficient application of the concept of rating is constrained by the socioeconomic and cultural character of the country. As for instance, lack of large scale investor awareness constrains the dynamism of CRAs. Instead of bringing about much innovation, rating agencies, in such a situation prefer to go by convention. Similarly, regulatory dependence on rating delimits the efficiency of rating exercise.

Secondly, CRAs themselves have inadequate ethical foundation and training which lure them to compromise for short-term gains. Despite being a moral agent, CRAs have indulged in opportunist collusion many a time, even at the cost of their reputational capital. Most of the corporate fiascos bear the testimony of this argument. The frequently cited criticisms against CRAs in respect of their operational inefficiencies are conflict of interests, authority without responsibility, herding tendency, inadequate monitoring, cultural bias, pro cyclic ality, discriminating attitude.

Conclusions:-

Credit rating agencies hold a key position in the financial market not only for providing information about the credibility of the borrowers but also in terms of monitoring, standardizing and equilibrating various financial activities. Therefore, rating services need to be evaluated in a broader economic perspective. While conceptual inadequacies inherent in the very idea of credit rating are difficult to mitigate, the operational deficiencies can be addressed by sound monitoring by the market watchdogs as well as by the practice of higher ethical standards by the rating agencies themselves.

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