Emerging Issues in Credit Rating: A Review

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Abstract

Credit rating is a useful tool for the investors as it helps them to minimise or avoid default risk and also for the issuers as a marketing tool. There are many other merits which enhance the utility of credit rating. But at the same time, there are certain critical issues which are subject to lot of discussions and researches.

The present paper discusses utility of credit ratings for the players in the process. It deals with the impact of credit rating announcements and also with the information content in the credit rating symbols. The paper finally identifies certain issues and studies each such issue in the light of empirical evidence.

Key Words: *Ratings, Credit rating, Unsolicited Ratings, Bond rating*

Introduction

Credit rating is a process which involves assessing the capacity of the borrower to pay the interest on the borrowed sum on time and also repay the principal on due date at the end of the contractual period. In India there are four credit rating agencies which provide such rating about the credit worthiness of the borrowing organisation viz, Credit Rating Information Services of India Ltd. - CRISIL, Investment information and credit rating agency of India Limited - ICRA, Credit analysis and Research Limited - CARE and Fitch. The agencies provide their services of credit rating at the behest of the corporations issuing corporate debt instruments like debentures, bonds, fixed deposits and commercial papers. The agencies assess the capacity of the borrowing companies to fulfil the debt service obligations by making a detailed analysis of various aspects of the company like financial strength, the quality of the accounting information, the information about the market share of the company, market capitalisation, composition of the board of the directors, quality of management, fulfilment of the legal stipulations etc.

The rating agency considers all these information and gives its opinion about the borrower's capacity to perform the debt obligations, in the form of alpha numeric symbols like AAA$^+$, B, C, D etc. The highest rating assigned by a rating agency is AAA while the lowest is D. The various symbols that are assigned and the meanings conveyed by them are as under:

Symbol	Meaning
AAA	Highest safety
AA	High safety
A	Adequate Safety
BBB	Sufficient safety
BB	Inadequate Safety
B	Susceptible to default
C	High risk
D	Default (junk)

The ultimate purpose of the Credit Rating Symbols is to help the decision maker in taking effective decisions by considering the credit rating symbols as inputs while taking the investment decisions. The users of the credit rating symbols may be:

- Individual investor
- Institutional investor
- Government Agencies
- Lending Agencies like Banks and Financial Institutions

Objectives of the paper

The following are the aims of the present research paper:

1. To discuss the usefulness of credit rating symbols.
2. To study the impact of announcements about the change in the rating assigned to any security.
3. To know the informational content in the credit rating symbols.
4. To identify the major issues in area of credit rating.

This paper initially gives a brief conceptual introduction about Credit Rating, the usefulness of credit rating symbols, informational the contents in Credit rating symbols, the impact of credit rating announcements on the market behaviour. It then discusses about issues as identified by the researcher. There are many issues involved but four critical issues have been identified in the research and discussed elaborately.

The Usefulness of Credit Rating Symbols

Credit rating is helpful for the investors as an indicator of default and also to the issuer in better and easy mobilisation of funds as a marketing tool. They are also used by the government agencies and lenders.

In an early study, Hickman[1], using US data found that bond rating was a useful indicator of default risk. Response of bond prices to rating change announcements is a test of the usefulness of ratings. If bond prices react to rating change announcements, it is an evidence of new information conveyed to the market by such announcements. Empirical evidence based on this argument is mixed. This credit rating is useful not only to the investors but also to the issuers of the debt instruments. David J[2] says a good rating is likely to make it easier to attract investors and will almost certainly allow funds to be raised at an attractive cost. Indeed their possession will undoubtedly enhance the prospects of successful issues.

According to Mohan[3] Credit rating has gained importance over the years owing to the deterioration in the quality of earnings of the corporate. Kumar[4] asks to look out for credit rating when a deposit is being made. Company deposits with steady, reasonable returns are safe bets for the average investor who can have his cake and eat it too. But one must guard against those who default in principal payments. He further suggests the factors to be considered before he invests in debt instrument like what is the company's main business? Is the company operating in a competitive market to sell its products or in a sheltered market?

According to Jewell and Livingston[5], issuers, investors and government regulators have long considered bond ratings an important part of the credit-certification process in the issuance of public corporate debt. Credit Risk is an important risk as far the debt instruments are concerned. According to Coyle[6] the scale of the credit risk will be reflected in the credit rating for the bonds. Investors can minimize their credit risk by investing in investment grade bonds rather than in high yield junk bonds. Rousseau[7] says, Credit rating agencies play a vital role in enabling financial markets to operate efficiently by acting as informational intermediaries specializing in the appraisal of the credit worthiness of corporations that issue debt.

Scott[8] says rating agencies do a fundamental analysis of issuers and individual issues, thus saving investors from performing this task themselves. Individual investors rely heavily on published ratings, so that the rating of a particular issue has a major impact on the interest rate that must be paid in order to sell

the debt issue. Receiving the higher rating on a debt issue can save an organization millions of dollars in interest expense over the life of the issue. New issues of bonds are relatively difficult to market without a rating so that organizations wishing to issue debt securities are willing to pay rating agencies to grade their debt and make the grading public. While this payment on the part of the organizations seeking a rating for their debt issues seem to pose a conflict of interest, rating agencies can only survive by preserving a reputation of high ethical standards and accurate evaluations. But however Fisher and Jordan[9] say that ratings do not totally solve the investor's problem of default risk discrimination between bonds. Letter grades assigned by rating agencies serve only as general, somewhat coarse form of discrimination.

The Information Content in Credit Rating Symbols

The rating change announcements have an impact on the market behaviour. This impact on the market behaviour implies that the rating symbols contain some information which is not in the public domain. This is because the credit rating agencies have an access to confidential information which is not available to the public freely. There is certain useful information content in the credit rating symbols.

Crabbe and Post[10] are more unequivocal in their conclusion that rating change announcement provides new information to the market and are, therefore, useful. They examine the impact of a set of downgrade announcements of commercial paper on the volume of such paper outstanding. The volume of such commercial paper outstanding experienced abnormal declines following the downgrades. Since such declines in volume were not observed prior to downgrade, Crabbe *et al* conclude that the announcement of downgrades has information content. There were studies conducted, to explain that ratings can be used to predict the default risk.

According to Jewell and Livingston[11], issuers, investors, and government regulators have considered bond ratings an important part of the credit-certification process in the issuance of public corporate debt. The evidence provided by Reiter and Zeibart[12], and Ederington, Yawed and Roberts[13] and Liu and Thakor[14] shows that ratings bring information to the marketplace beyond that conveyed by publicly available financial information alone.

Pinches and Singleton[15] test for the information content of rating change announcements by examining their impact on equity returns. Their samples of 207 rating change announcements are classified into portfolios based on whether they are upgrades or downgrades. Their study finds significant changes in equity prices preceding the rating change announcements indicating that the rating agencies lag the market. However they also find that there is an adjustment of prices subsequent to the announcement of the rating changes indicating some information content in the rating change announcements.

Credit ratings continue to present an unusual paradox: rating changes are important, yet possess little informational value. According to Partnoy[16] Credit ratings do not help parties manage risk, yet parties increasingly rely on ratings. Credit rating agencies are not widely respected among sophisticated market participants, yet their franchise is increasingly valuable. The agencies argue that they are merely financial journalists publishing opinions, yet ratings are far more valuable than the opinions of even the most prominent and respected financial publishers.

The Impact of Rating Change Announcements

Any announcements about the changes in the ratings given to a company whose debt has been already rated and any announcements about the ratings for a fresh debt being issued, have an impact on the bond prices in the market. The rating announcements have an impact on the stock prices also. Such changes are more in case of down grading than upgrading.

The usefulness of rating change announcements is supported by conclusions of the Bi and Levy[17] study. They examine stock price reaction to a set of announcements of rating downgrades. They also classify the firms whose bonds were downgraded into two categories: those, which subsequently filed for bankruptcy and those, which did not file for bankruptcy till the time of study. They find that "... downgrading of bonds, on average, conveys new information to the market resulting in an excess return. In this respect, the agencies provide important information to the market. However, when we take a matching sample with identical bond down-gradings which are not followed by Chapter 11 filing (i.e., bankruptcy), we find that for the matching sample the excess negative return is almost zero. Thus, the stock market differentiates between two identical downgrading. This implies that the agency rating services do not provide sufficiently refined ratings, or are unable to distinguish between the two evolutionary patterns of financial distress.

Weinstein[18] found that corporate bond returns were unaffected by rating change announcements, which suggests that markets view ratings as reflecting information that is already available. However other studies, such as, Grier and Katz [19] Ingram, Brookes and Copeland[20] and, Wanseley and Clauretie[21] find significant bond price reactions to rating change announcements.

In a study covering both stock and bond prices Hand, Holthausen, and Leftwich[22] find that the negative impact on bond prices and stock prices following a down grade is significant. The effect of upgrade on bond prices is weaker and negligible on stock prices. Hand *et al* also classify rating change announcements into those which are non-contaminated i.e., the first news of the rating change was from the rating agencies concerned and was not reported in the press earlier, and contaminated i.e. rating change announcements which were preceded by news in the press and other sources which anticipated the rating change. Surprisingly, their sample of non-contaminated rating change announcements showed a statistically insignificant effect on bond prices for downgrades. The positive effect on bond prices following upgrades was significant and more pronounced for the non-contaminated sample compared to the entire sample. The results provide only a weak support of the usefulness of the rating change announcements.

Emerging Issues in Credit Rating

There are certain issues in the area of credit rating which raise serious discussions about its utility. These issues have been subject to lot of criticisms and debates. Some of the issues are as under:

1. The differences in the perspectives of the issuers and the investors.
2. Autonomy of credit rating agencies
3. Unsolicited ratings
4. The requirement of regulation for Credit Rating agencies
5. The default of Rated Debt Instruments
6. The issue of multiple rating
7. Value of Multiple Ratings

8. Accuracy of Ratings
9. Timeliness of Ratings
10. Ratings and the issuer's creditworthiness

However, for the present study, the first four issues are being discussed along with the available empirical evidence:

1. The Issuers Vs Investors

Bond issuers and investors, the two most important participants in the credit rating industry, assess credit rating agencies. Issuers are the agencies' 'suppliers' while investors represent their 'consumers.' This approach permits looking at issues related to bond ratings from different sides of the rating process. As suppliers, corporate bond issuers rely on credit ratings to ensure the best possible interest rate for their securities; as consumers, bond investors depend on credit ratings to determine the creditworthiness of companies in which they invest.

The issuers and investors often view bond ratings from different perspectives. For example, issuers often obtain ratings from three or more agencies, but investors usually require only one rating. Investors, unlike issuers, would like to see ratings updated immediately to reflect all relevant information, even if a change is likely to be reversed in the near future.

Issuers and industrial investors differ in their assessments about whether agencies maintain timely ratings and whether ratings accurately reflect creditworthiness. Most issuers believe that agencies maintain timely ratings, but most investors think ratings lag the current status.

- **The Evidence**

The study conducted by Baker[23] *etal* showed the differences in assessments of rating agencies by issuers of bonds and the investors in corporate bonds. In an Indian study, Ranadev Goswami et al[24] reveal that the institutional investors possess a superior knowledge and understanding about the ratings than individual investors.' In his study Ellis[25] has sought answers from both issuers and investors. His findings suggest that issuers and investors often view bond ratings from a different perspective. The results of the study by Baker and Mansi [26] suggest that fundamental differences exist between the role of ratings for issuers and investors. This finding helps to explain why issuers typically obtain multiple bond ratings while investors require by policy only one or at most two ratings.

2. Autonomy of Credit Rating

All the Indian Credit Rating Agencies are promoted by leading Financial Institutions. The question of autonomy and integrity gains importance when it comes to rating the debt instruments of the promoting institutions come. Credit rating agencies, such as CRISIL, CARE, ICRA, Moody's or Standard & Poor's, are private firms that charge borrowers for evaluating their creditworthiness and for making that information available to investors in the form of a concise summary, i.e. a credit ratings. As these rating agencies charge fees for the rating service provide by them, the question of autonomy seems to be more relevant.

- **The Evidence**

Sen et al[27]feels that since the revenue streams are derived primarily from the companies that are being rated this may raise problems of perception regarding their autonomy. Similarly, YV Reddy [28] felt that, since Credit Rating Agencies charge the issuers for the ratings, the independence of Credit Rating becomes questionable. Satish[29] expressed his doubts as to how far Indian Rating Agencies

having been promoted by leading Financial Institutions could act impartially and rate their own promoters' debt instruments

3. Unsolicited Ratings

Unsolicited ratings involve rating assigned by a credit rating agency at its own behest without any request from the issuer of an instrument. Though this is not much practised in India, it is in practise in countries abroad. Much controversy exists over the issuance of unsolicited ratings. Proponents claim that unsolicited ratings help to avoid 'rate shopping', which occurs when companies hire only those agencies that offer favourable ratings. Critics claim that unsolicited ratings are less accurate than those paid for in the traditional manner because the rating agency does not have access to confidential information as part of the traditional rating process.

- **The Evidence**

According to Thomas[30] even though these are not beneficial to the companies, the Credit Rating Agencies involve in 'arm twisting'. In his empirical study to analyze the controversy of unsolicited ratings, Winnie[31] finds that the unsolicited ratings are lower than the solicited ratings and also that those issuers who choose not to obtain rating services have weaker financial profiles. Byoun and Shin[32] say Rating agencies have been criticized for the use of unsolicited ratings as punishment of issuers for not hiring them to rate their issues. They find that many unsolicited ratings are speculative grades while most solicited ratings are investment grades. The results of study by Poon and Firth[33] show that there is a significant difference in the distributions of ratings, and the shadow group has lower ratings.

4. Regulation for Credit Rating Agencies

This is another aspect which is discussed a lot – whether there should be regulation on credit rating agencies about their functioning or not. Although investors and regulators perceive credit ratings as accurate indicators of credit risk, legislators, courts and regulators in the U.S. and the E.U. consistently define them as opinions and consider that there should be no substantive regulation of credit rating methodologies

The fact that credit ratings should be considered as opinions for the time being does not necessarily entail that Credit Rating Agencies should not be regulated at all. But enacting and establishing a professional code of conduct could be done.

- **The Evidence**

According to Weiss Ratings Inc.[34], to eliminate the conflicts of interest among credit rating agencies, NRSROs (Nationally recognised statistical rating organisations) establishment of a regulatory body is required. On the same lines, Goel[35] argued that Credit Rating Agencies need a regulator and probe deeper than balance sheets. But such ideas were opposed by Thomas[36] who says, investors and market intermediaries should encourage multiple ratings so as to get the benefit of more than one opinion and also that there is no need to regulate the rating agencies that have life on their credibility.

The Indian Scenario of Credit Rating

The importance of the services of the credit rating agencies in the Indian debt market cannot be underestimated, especially considering the noteworthy growth in the past decade in the number of Indian companies raising funds through long-term borrowings, which was accompanied by growth in the volume of trade of debt instruments in secondary markets in India. Their role becomes doubly important after taking into consideration the Indian financial markets' inefficiency, much like that of most

developing countries, as information relevant to determining creditworthiness may not be publicly available.

The role of the credit rating agency becomes increasingly important as a source of current information concerning the creditworthiness of the corporations under watch. Recently, credit rating agencies have come under sharp criticism for failing to respond to events and downgrade suspect companies with sufficient speed. Enron is perhaps the most well-known example, as credit rating agencies in the United States maintained investment-grade ratings for that company until as late as a month prior to its Chapter 11 filings.

In India, CRISIL, the country's oldest and perhaps most reliable credit ratings provider, performed a comparably unreliable action when it downgraded BPL Ltd's long-term debenture from A to D after the company had already defaulted on that rated obligation. This incident occurred a mere few years following a mass downgrade of nearly one hundred Indian companies by CRISIL and ICRA in reaction to public criticism of their ratings practices in 2000. In a country in which illiteracy is high, and in which a significant portion of common investors do not know how to correctly interpret and analyze the information contained within public financial statements, the reliability of credit ratings as a means of evaluating potential fixed income investments becomes increasingly important. In addition to the common investor, Indian commercial banks often use published credit ratings as a step in a new loan evaluation, provided that the borrower in question is tracked by a ratings agency.

Credit Rating Related Problems in India

In part, the problem of the Indian credit rating agencies may lie within the rating process itself, which is by nature highly dependent on historical data, perhaps largely blind to macroeconomic complexities and potentially limited in knowledge of industries and businesses. However, blame lies with the agencies as well, as the rating agencies substantially overestimated the financial flexibility of traditional corporate houses in the aforementioned mass downgrade.

Past research has also shown that the ratings provided by the two primary Indian bond rating agencies, CRISIL and ICRA, are becoming extremely variable over time. The majority of these ratings changes are on the downside, with potential price risk implications for investors. The consistency of determinant financial ratios between rating classes also points to probable weakness in rating methodologies, as the significant financial factors fail to discriminate across rating classes. That is, while the key financial ratios desirably do not vary for companies belonging to the same ratings class, they also do not vary across companies belonging to different ratings classes.

Conclusion

Thus there are many issues which have an impact on the usefulness of credit rating. These issues pose a threat to the usefulness of the credit rating symbols and raise serious questions on the reliability of the credit rating agencies.

It is clear that the above mentioned credit rating areas have been researched in mature markets abroad and to a very limited extent in India. In particular, issues of credit rating related to the investor both individual as well as institutions have been relatively ignored. There is no comprehensive study about the investors' aspect in Credit Rating. There is a scope for such studies in the developing economies and especially in Indian market.

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