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A LITERATURE REVIEW ON CREDIT RATING AGENCIES - NATIONAL & INTERNATIONAL PERSPECTIVE

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Abstract:

The development of any nation depends on the growth of its industries, infrastructure, people, trade, etc. But all this could flourish, if there is sufficient finance available. Finance is the basic need for any activity and hence, its avenue and trusted sources play a vital role. Creditworthiness of any individual, company, industry, or nation is an important factor for determining the exact estimation of the economy. Thus, creditworthiness enhances the trust among the investors or debtors and helps them in making investment decisions by managing the credit risk to the optimum. Hence, to evaluate the creditworthiness there are some specialized companies called as Credit Rating Agencies (CRA). They evaluate the risk on various aspects. The concept of CRA emerged in the USA and later was adopted by all the nations. Many experts and authors have worked on the CRAs at national and international level. Extensive literature is available to satisfy one's inquisitiveness to learn more about these agencies. This research paper is nothing but an attempt to describe the CRA from both Indian and Foreign context. It covers the various concepts related to CRA and put forth the research work done by the several researchers over this concept.

Key words - *Creditworthiness, Investors, Default, Rating Agencies, Indian and Foreign context etc*

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I. INTRODUCTION

A credit rating agency (CRA) is an institution that rates debtors based on their ability to pay back their interests and loan amount on time and the probability of them if they can default. These agencies may also analyse the creditworthiness of debt issuers and grades them by giving credit ratings to only organisations and not individual consumers. The assessed entities may be companies, special purpose entities, state governments, local governmental bodies, non-profit organisations, and even countries.

The ratings may be carried by CRAs in respect of government bonds, corporate bonds, Certificate of deposits, municipal bonds, preferred stock, equity shares issued by company and collateral securities, such as Collateral Debt Obligations (CDO) and Mortgage-Backed securities (MBS). Other than debt instruments CRAs also rate Country, Real Estate Builders and Developers, Chit Funds, Rating of banks, rating of states. The value of credit ratings for securities has been interest rate that a security pays out, with higher ratings leading to lower interest rates and vice versa. Credit ratings establish a link between risk and return.

They thus provide a yardstick against which to measure the risk inherent in any instrument.

II. OBJECTIVES-

a. Describing the Credit Rating concepts to quench the thirst of the learners in the topic of credit ratings.

b. To summarize and explore the research work conducted in this area by the researchers and authors.
c. To bring the Indian & Foreign contexts in light through explaining the existing sources of data with qualitative comparison of the both.

III. CONTEXTS FOR REVIEWING LITERATURE-

A literature review is a search and evaluation of the available literature on the chosen topic or area. It is always based on secondary sources. For the present study various research papers, articles written, & published by the experts, reports by the regulatory bodies, articles from various websites, documentaries and movies, etc. was reviewed. That helped to gain detail knowledge about credit ratings, CRAs, its evolution, various developments in them & their working, their usage in financial markets, etc.

The current study the literature review is being written on the basis of National (Indian) and International Context. Taking the research work in both these contexts will give us the inception of the rating agencies, their journey from there to around the globe and in India. The literature review is divided in three parts-

- Indian Context (09 articles/research papers)
- Foreign/International context (10 articles/research papers)
- Review of Movies & Documentaries (1 movie)

IV. VIEWS FROM THE INDIAN CONTEXT-

Work done by Indian experts in the area of financial services provider i.e. the credit rating agencies is being reviewed. The methodology adopted by them, implementation of various tools is closely examined, so as to understand the drawn conclusions in a better way. Indian context gives us the insights about the roadmap that they have travelled and the developments it has achieved in these 3 decades. Indian perspective is taken into account by taking into account the Indian market scenario. The IL & FS crisis, DHFL fall makes the study of these rating more and more significant.

1. Jaggi, 2014 have published a concept paper on Credit rating, wherein she has tried to explain the basic terminologies in credit rating, process and criteria of credit rating and the role played by the credit rating agencies and concerns specifically in India. Rating is the opinion of the CRA about the willingness and ability of an issuer to fulfil the financial obligation on time. Rating process followed by S&P is explained. Rating criteria depends on fundamental quantitative and qualitative elements, analytical methodologies and some assumptions. Rating reduces “information asymmetry” between issuer and borrower. Concept of rating shopping is highlighted. Rating industry follows an oligopolistic nature and till 2014 there were only 6 rating agencies in India. No liability is charged for inaccurate rating to CRAs. Hence, post subprime crisis strong regulations governing CRA have come into picture.
2. Gupta, (2017) has made an attempt to show the impact of rating downgrade of the debt instruments of the Banks. In her study she has analysed the returns of the stock 45 days before and after the rating change announcement and in addition the “average abnormal returns” determined aims to provide a clear picture regarding the impact of rating change. Author has adopted “event study methodology” for the study. The study concludes that the downgrade of rating has an impact on the debt instruments of the bank.
3. Gupta, Bhalla & Mittal, (2010) have tried to critically examine the role played by the credit rating agencies in the subprime crisis. It highlights the weak areas where credit rating agencies fail to perform the basic function of timely & accurate rating of bonds. It also aims to analyse the reasons for the emergence of the subprime crisis and role played by the credit rating agencies towards it. The regulatory framework of the CRA needs to be strengthened as it is a self-regulated industry.
4. Sharma, (2015), have tried to evaluate the performance of the credit rating agencies in India through the case study.

Secondary data from the authenticated sources has been used for this study to give meaningful conclusions to the research. The study explains various types of ratings offered by the CRAs to various types of securities and the procedure/ stages followed by these CRAs. Three major players (Moody's, Standard and Poor's and Fitch Ratings) capture 94% of the international credit rating markets.

5. Kirthy, (2015) study emphasizes on the rating methodology, process, symbols and services provided by four Indian rating agencies CRISIL(Credit rating information service Ltd.),ICRA(Investment information and credit rating agencies) ,CARE(Credit Analysis and Research Limited), and Fitch India Ltd. The first rating agency that started in India was in 1987, CRISIL jointly promoted by ICICI nationalized and foreign banks and insurance companies.
6. Vairava Subramanian, (2012) in his study has highlighted how the SMEs in India are not only running short of funds for expansion but also are short of working capital requirement. The SMEs find it difficult to approach the banks and request for loan, as the formalities to be complied with banking system is cumbersome and takes most of their time, leaving very minimal time to concentrate on their business. So, the Government of India took an initiative of credit rating the SMEs to boost the growth. Ratings on small and medium enterprises (SMEs) reflect the rated entities overall creditworthiness, adjudged in relation to other SMEs. The authors have made an attempt to analyse all the information related to SME rating, its necessity, growth opportunities, challenges, and future growth of SME sector.
7. Charumathi B, 2017 made an attempt to highlight the need of standardisation in rating scales and the comparison of revised rating scales with the previous ones. They have also emphasized on the different rating scales and non-standardised rating scales given by the CRAs to various entities or instruments and invite the global views on the same issue. Comparative study of rating scales of various entities and instruments is done which are still not standardised by regulators. Four criteria are used for standardization or no standardisation: uniform rating symbols, same number of rating grades, agency identifier on prefix and same definition of symbol. The US SEC does not feel the need to have a standardised rating.
8. Gupta et al (2017) tried to study the financial determinants of credit rating assigned to Indian companies by the top three CRAs of India viz. CRISIL, CARE and ICRA. Credit rating is (Chahal, 2017) the dependent variable whereas, seven financial factors viz. Size, liquidity, profitability, interest coverage, leverage, growth and net cash flow are taken as the independent variables. The analysis from the study indicates that the likelihood of credit ratings to be on higher side is more with increase of size, liquidity, profitability, interest coverage, growth, net cash flows and with a decrease in leverage. The analysis in the study shows that only four variables, namely: size, profitability, interest coverage and leverage are statistically significant ,out of seven independent variables; while the other three variables, including a relatively new variable analysed in the present study i.e. net cash flow, are statistically insignificant.
9. Adhikary. S (2017) majorly focused on to decide regarding the consistency in rating methodology of individual rating agency by taking firms happiness to same cluster in Asian country. Bond Rating has been analysed by eight variables, viz. four liquidity and solvency ratios (Current ratio, quick ratio, debt-equity ratio, Interest coverage ratio) and 4 profitability ratios (Return on capital employed, Return on net worth, PAT/ TI, PBDITA/ TI). And accordingly the conclusions are drawn.

V. <u>VIEWS FROM FOREIGN CONTEXT-</u>

CRAs originated in the US and later were adopted by other countries too. So, the study of international literature becomes crucial & contributions made by the international authors, would add more value to the current research. The Enron Scandal, global crisis 2008 brought the role of the CRAs into scan as the highest safety rating grade of "AAA" overnight went to "D" the junk rating, the top investment banks went bankrupt. Many experts from different fields and sectors carried their research on this topic. Their work is published in the form of research articles, blogs, columns in newspapers, editorials, etc. Some documentaries and movies were also produced to highlight the facts in regards to ratings and the CRAs. The reasons of negligence on the part CRAs lead to collapse of largest economy and hence, an initiative is taken to bring the related work into picture.

1. Bayar, (2014) aim was to evaluate the adequateness of the regulations of CRAs in times of Global Financial crisis and Euro zone sovereign debt crisis. Credit ratings market follows oligopolistic market structure as only 3 players dominated 94% market share. Until 1970 CRAs followed "investor-pays" model where investor paid for the credit ratings, later from early 1970 US recession till date it follows "issuer- pays" model, where the company raising funds pays for the rating grades. There were no significant regulations on CRAs nationally and internationally until 2000, i.e. before the global financial crises and European sovereign debt crisis credit rating market was unregulated.
2. Kam Chan, (2010) have examined the impact of credit ratings on long term IPO performance considering two hypotheses to give the fair conclusions (a) Information asymmetry hypothesis (b)Manipulation hypothesis. The former predicts that providing credit rating before IPO issuance speeds up price correction, improves market efficiency and also reduces the information asymmetry. Later, says that the managers of IPO firms can manipulate market expectations and IPO prices with the use credit ratings. The study infers that providing credit rating prior to IPO issue helps investors to know the fair market price of the firm and also reduces asymmetry of information.
3. Hill, (2010) highlights the bad ratings job done by three international credit rating agencies Moody's, Standard & Poor's, and Fitch in rating the subprime securities. In Spite of having a far low credit quality, the securities enjoyed the highest rating grade by CRAs. Majorly such securities defaulted and the ones whose ratings were prone to high risk were downgraded significantly just in preceding years of the crash. But, "why did credit rating agencies do such bad job of rating the subprime securities?" The reason might be the "issuer- pay" model that highlights the "conflict of interest" where issuer of the security pays the rating fees to the CRAs. Downgrades in ratings not necessarily indicate bad performance but "Issuer" paying for the rating might give rise to a concept of "Rating Shopping".
4. Nijhawan, (2013) has tried to explain evolution of the credit rating industry in line with the changes in the regulatory reforms over a decade. Initially, the CRAs were unregulated by the SEC (securities & Exchange Commission) but the over dependence on them resulted in collapse of big players in the market. That called for regulations in this industry. IOSCO (International Organization of Securities Commissions), in 2003 issued a statement of principles for CRAs; Code of Conducts Fundamentals in 2004 and in Mid-tier post 2005, CRA Reform Act was passed in 2006. IOSCO once again came up with the fresh regulations & new code of conduct in 2008, when the Credit crisis resulted in 2008 and subprime crisis in 2009 with mortgages going bad and Collateral Debt Obligations turning junk. This new work emphasised on quality improvement in rating method, timely watch on ratings, and increase in public disclosure etc. G20 summit was formed in 2009 where all leaders decided to have new regimes for CRAs and Dodd Frank Act was passed in June, 2010. Post financial crisis era brought transition of CRAs as a global whistle-blower and in this way the authors concludes the evolution of CRA.
5. Annalisa et el, 2011 attempts to compare the conflict of interest and reputational concern of CRAs in regards to subprime crisis. Authors argue that when markets prospers the rating levels are affected by alignment across CRAs and "Rating Shopping's" might take place by the issuers, but when the markets are unfavourable the distortions disappear and CRAs are more worried for their long term reputation. Evidences conclude that the harsher downgrades come from S&P which initially gave the higher ratings.
6. J.White, 2018 has tried to explain that CRAs play a crucial role in the financial system despite extensive criticism and the journey of CRAs from 1909 to 2018. Large lenders may be capable enough to gather and assess the

information about the securities with help of experts which is not possible with small lenders, where in they need the agencies like CRAs which help them as an information providers. The highest security grades given by the CRA's to the subprime securities contributed to the crisis. It also reveals that initially it was a 'borrower -pay' model later it became an 'issuer-pay' model that encourages CRAs to give higher ratings as the issuer is the payer for the rating service.

7. Partnoy Frank, (2009) has provided the institutional investors perspective on redesigning the regulations of credit rating agencies at global level. He mainly focused on 2 areas and provided recommendations on same. a) **Oversight**: Where he says new Credit Rating Agency Oversight Board (CRAOB) must be created as they no longer provide consistent reliable information about credit risk and b) **Accountability**: The rating agencies exemption from the liability should be eliminated. The study infers that the NRSRO should disclose fees charged by CRAs, access to inside information and the methodology of rating which can help investors to understand the probability of default.
8. Paolo Volpin, 2009 in their study has tried to show the role played by the CRA in the subprime crisis, that emphasis 2 aspects that contributed to the boom & burst of the markets for the ABS (Asset Backed Securities); "Rating Inflation and Uneven Information Disclosure". Inflated rating is an incentive problem: as it's a 'Issuer- pay' model so the interest of CRA is more with the issuer than with the investors. The policy suggested overcoming such problem in future by shifting from the 'issuer pay' to 'investor-pay model'. Implementation problem may arise, it may also result into reduction in size of market and liquidity, but still it will restore the investor confidence on securitization process. SEC at the public meeting in Sep 2009 voted to propose rules to bar the companies doing "rating shopping". Finally, authors conclude that investors may forgo an independent evaluation and once again trust the CRAs.
9. Maris, 2009 says that the credit rating industry has reached unprecedented heights since the 1990s till date as the number of instruments making use of NRSRO concept multiplied. CRAs have no rigid regulations and they don't bear any liability for misstatements in registration statements. Increase liability on CRAs could lead to defensive ratings, making it more liability proof. CRAs would be regulated on ad hoc basis or they could be self-regulated. Traditionally, CRA regulation unduly relied on informational and certification role of ratings but, in last 20 years CRAs have a significant role of systemic proportions. Reasons for such transition were: Use of credit rating in loan covenants as well as in structured finance. Conflict of interest also resulted as the issuer pays the rating agency. The study concludes that is that with regards to structured finance, CRAs have been functioning like "gate openers" rather than gatekeepers.
10. Ed deHaan (2017) aims to investigate the performance of corporate credit ratings in the ''pre-crisis'' period (2004-2007) relative to the ''during-crisis'' period (July 2007–June 2009) and ''post-crisis'' period (July 2009–2013). The study also reveals that the corporate rating performance improves during and after the crisis, consistent with the CRAs positively responding to public criticism and regulatory pressures. The market participants decrease their reliance on corporate ratings in debt contracting after the crisis.

Movie/ Documentary Reviews

Movies and documentaries have always played a great source for gaining knowledge in regards to a particular concept, situation, or condition. The review of the movies is written as follow:

The BIG SHORT:

The Director, Adam McKay's movie "The Big Short" released in 2016, in (India), is incredible piece of work on the US subprime crisis 2008. The meltdown that collapsed the US economy brought fortunes to some of the traders and hedge fund managers. Dr Michael Burry (Christian Bale) the genius at analysis and number crunching predicted the burst of the US housing bubble long back. The Mortgage Backed Securities in the form of bonds were made up of combination of mortgage loans. Some of these loans carried a huge risk, in spite of being into a bunch of securities they were rated AAA- highest safety grade by the CRAs. After coming across the terrifying data Michael concocts an idea to "short" these mortgage bonds. To be secured on these he convinces the bankers to create a kind of bond insurance policy. During the stability of the markets Burry paid the huge premiums, but the collapse of the markets earned him stupid money. The failure could not be avoided even if it was predicted long back. Failure on role of CRA cannot be neglected, as they contributed to the meltdown giving rise to concept of "Rating Shopping" and "Conflict of Interest".

Conclusion:

Credit Rating Agencies came into existence in the second half of the 1980 in India and globally they were originated in US. As of now, there are six credit rating agencies registered under SEBI. CRISIL is the largest credit rating agency in India holding major market share of greater than 60%.

Literature Review is done with 09 research papers from Indian context, 10 from foreign context and movie review. This shows the importance of the topic and the scope for the same. The authors have described the Credit Rating concepts to quench the thirst of the learners on the topic and research work conducted in this area by the researchers and authors is summarized. By elaborating the Indian & Foreign context the qualitative comparison of the concept has also been done by the authors.

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