Credit Ratings - The Road Ahead

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Introduction

Rating agencies provide an opinion, as on a specific date, regarding the credit-worthiness of an entity's financial obligations. During the last few decades, the importance of these opinions to various market participants, has increased significantly. A number of factors account for this – the increase in the number of issuers, the advent of complex financial instruments, globalization of financial markets and growing use of credit ratings to help monitor the risk of investments held by regulated entities. The opinions impact the issuers access (- or ease of access) to capital since the opinions have a bearing on the ability of different entities to make these investments and reasonably often on the structure of transactions.

In sharp contrast, the recent levels of defaults, fallen angels, high–profile bankruptcies, increasing instances of fraud and questionable accounting policies have all resulted in heightened credit sensitivity, and have spurred public questioning and scrutiny as to the ability of traditional analytical methods to deal with these unusual conditions. Despite some recent criticisms, market acceptance for the role of ratings and rating agencies has largely been validated by the quality and timeliness of analysis and ratings continue to remain the "best guide" to the creditworthiness of an entity. Rather than viewing the recent period as a 'new reality' that requires dramatic change to rating policies and analytical conventions, these patterns need to be seen as a part of a market evolution, throwing out a new set of challenges. I will focus on two current debates concerning the rating industry. The first is: Can market price movements be a better predictor of credit quality than the analyst-intensive fundamentals-based methodology adopted by credit rating agencies. The second is regarding the regulatory treatment of rating agencies.

The Shift to Capital Markets

Since the early 1990s, the provision of credit, particularly in the United States, has shifted away from commercial banks into the capital markets. Relationships between credit providers and issuers are less present as technology has smoothed the way for faster commoditized transactions. Bonds are less frequently purchased by 'buy and hold' investors, but are increasingly pooled into transactions and tranched for risk appetite. Loans fly off the balance sheets of banks into mutual funds, insurance companies, and even synthetic structures. Credit providers, who are marking to market their exposures on a real time basis, are now less patient in seeing a troubled credit through to recovery as commercial banks had done in the past.

A common criticism of rating agencies is that they are too slow to react to credit events. In particular, rating action usually lags a correction in market prices. By implication, therefore, the markets are considered a better indicator of a company's intrinsic credit worthiness.

Although market prices can and often do reflect credit fundamentals, they are usually myopic in nature, responding to many other factors not necessarily related to a company's long-term core creditworthiness – for example, general market liquidity, sentiment, or acquisition speculation. As a result, any rating system based purely on market prices will inevitably produce volatile results. However market participants prefer stability to ratings rather than frequent changes i.e. they do not want ratings to exacerbate an already volatile market.

This is not to say that market prices do not contain valuable credit information and that such data should not be factored into the credit rating process. As already mentioned, deteriorating market prices, such as a company's share price, can reflect a fundamental change in credit quality. In addition, market prices are an important liquidity indicator, providing useful data on a company's ability to refinance itself in either the debt or equity markets. Clearly, such funding factors can directly impact a company's rating. It should be stressed though that this information is seen as complementary to the ratings process, not as an alternative. By their very nature, ratings are highly qualitative and cannot be replicated by simply analysing market data.

It is important to remember that while ratings are not infallible, they have proved to be fundamentally correct and over time proved to be the best indicator of credit. Thus credit analysts should monitor market information - price, volatility, volumes – from both the equity and debt markets, but this should be just one of the inputs that the analyst uses and not the primary factor to be relied upon.

Both markets and regulators recognize that although ratings are not infalliable, they have proved

to be fundamentally correct and have proved to be the best indicator of credit over time.

The performance of ratings, as discussed in Table 1 below, by all three rating agencies, is quite similar – not surprising, given that all use the same fundamental credit analysis to rate entities. And although the market does use alternate methods for assessing credit quality – spreads, volatility, equity prices etc., I believe that although valuable, this analysis lacks the simplicity, stability and track record of performance to substitute ratings as an assessment of credit quality.

Regulatory Treatment of Credit Rating Agencies

No one can deny that ratings play a very significant role in the investment decisions of investors – consequently they have a very significant bearing on the issuers access to funds. Investors – banks, mutual funds, insurance companies, retail investors etc., use credit ratings as an important input to their credit analysis for risk management and trading purposes. Often the ratings themselves form the basis of credit decisions e.g. the (regulatory) requirement to invest in AAA paper. (External) ratings are used for calculating risk weightage and are an "important pillar" of the Basel II norms.

Issuers too use ratings primarily to improve the marketability and pricing of their liabilities.

As ratings play a growing role in financial markets the rating agencies role, systems and processes will come under increasing scrutiny. Rating agencies will need to be increasingly transparent about the due diligence undertaken, the criterion for ratings and the reasoning behind the rating decisions, as well as the methods and timeliness of disseminating ratings.

Central to the debate that markets know best, as well as regulatory oversight over the rating agencies is the performance of the rating agencies, that is captured in the data given below

Table 1: Fitch Ratings Average Annual Default Rates

	Corporate Finance* 1990-01(%)	Structured Finance** 1991-01(%)
AAA	0.00	0.00
AA	0.00	0.01
A	0.04	0.01
BBB	0.27	0.11
BB	1.55	0.31
B	1.68	1.24
CCC-C	21.97	20.88
Investment Grade	0.09	0.02
Non Investment Grade	3.01	1.27

* for Global corporate debt issues
** for US structured finance bonds

The regulatory oversight too recognizes that rating organizations possess the competence to develop accurate and reliable ratings; the market acceptance of these protects against the rating companies randomly issuing investment grade ratings to low quality securities at any time. Without the acceptance of rating companies, many important capital adequacy and eligible investment rules used in financial institutions regulations would be ineffective.

However, it is worth remembering that the "market" remains the best judge of the work done by the rating agencies and of the value of ratings. If rating agencies begin to disappoint investors, they will stop using them as a tool to assess credit risk, and the ensuing market will demand an alternate – and better way to assess credit risk.

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