UNIT 3: CREDIT RATING AGENCIES AND THEIR ROLE IN FINANCIAL MARKETS

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Credit Rating Agencies and Their Role in Financial Markets

Unit 3

The objective of this chapter is to understand the role of credit rating agencies (CRAs) in the financial market, including their importance, regulation, different rating systems, rating transition matrix, and credit rating mechanism in Nepal's securities markets. The chapter also covers concerns and criticisms regarding CRAs.

Credit Rating Agencies

- **Credit rating**: an assessment of the creditworthiness of a borrower or a security, which reflects the ability of the borrower or the issuer to fulfill its financial obligations.
- **Credit rating agencies**: independent commercial organizations that evaluate the creditworthiness of a borrower or an issuer of financial securities, such as bonds.
- primary function of CRAs is to provide investors with a benchmark for evaluating the default risk

- **Role of CRAs in the Financial System**:
  - provide a critical function in the financial system
  - Reducing information asymmetry* in the market for debt obligations and private contracts
  - improving market efficiency and allowing a reliable interest rate structure
  - determining compensation for exposure to different degrees of default risk.

Issuers have more information than buyer

The Role of CRAs in the Financial System

- Creditworthiness is an attribute: that is not directly observable
- Buyers access creditworthiness by:
  1) performing their own analysis,
  2) retaining the services of a third party, or
  3) using ratings provided by CRA to the public.
- the third party provides a private evaluation on the fee
- CRA evaluation is publicly available and does not require to pay fee by the buyer.
- the issuer pays a fee, a practice that has raised the problem of a potential conflict of interest

- **US & European Regulation of CRAs:**
  - In the US, the entities authorized by SEC (Securities and Exchange Commission) to assign ratings are known as **NRSRO** (Nationally recognized statistical rating organizations)
  - SEC's Office of Credit Ratings (2006) reviews entities seeking NRSRO classification based on market position & operational capability.
  - Market position: assessed for national recognition.
  - Operational capability: evaluated for organizational structure, rating procedure & methodology, financial resources, staff size & quality, & independence from rated companies.

US and European Regulation of CRAs

- Office of Credit Ratings registers and monitors NRSROs.
- Periodic examinations conducted on registered NRSROs for regulatory compliance.
- License to one or more of five categories:
  1) financial institutions, brokers, or dealers;
  2) insurance companies;
  3) corporate issuers;
  4) issuers of asset-backed securities; and
  5) issuers of govt. or municipal securities, or securities issued by a foreign government.

- The 10 CRAs registered as NRSROs as of March, 2023 are:

NRSRO	Date of Registration
A.M. Best Company Inc. ("AMB")	Sept. 24, 2007
DBRS Inc. ("DBRS")	Sept. 24, 2007
Egan-Jones Ratings Company ("EJR")	Dec. 21, 2007
Fitch Ratings Inc. ("Fitch")	Sept. 24, 2007
HR Ratings de México, S.A. de C.V. ("HR")	Nov. 5, 2012
Japan Credit Rating Agency Ltd. ("JCR")	Sept. 24, 2007
Kroll Bond Rating Agency Inc. ("KBRA")	Feb. 11, 2008
Moody's Investors Service Inc. ("Moody's")	Sept. 24, 2007
Standard & Poor's Ratings Services ("S&P")	Sept. 24, 2007
Demotech, Inc.	July 11, 2022

European Regulation of CRAs

- CRAs failed to accurately rate subprime mortgage-backed securities.
- This led to the collapse of the subprime MBS market and had a ripple effect on the global economy*.
- European regulators sought to strengthen the regulatory framework for CRAs in response.
  - In 2009, the EU established a regulatory framework for CRAs.
  - The framework required registration of CRAs, transparency in the methodology used, and avoidance of conflicts of interest.
  - In 2013, the rules were amended to address concerns about sovereign ratings and perceived weaknesses in the CRA rating methodology.
  - Seek to reduce the overreliance of investors on ratings

Credit Rating System

Table 3.1. The rating systems used by three major CRAs (Moody’s, S&P, & Fitch)

Moody’s	S&P	Fitch	Brief Definition
Aaa	AAA	AAA	Gilt edge, prime, maximum safety
Aa1	AA+	AA+	
Aa2	AA	AA	Very high grade, high quality
Aa3	AA–	AA–	
A1	A+	A+	
A2	A	A	Upper medium grade
A3	A–	A–	
Baa1	BBB+	BBB+	
Baa2	BBB	BBB	Lower medium grade
Baa3	BBB–	BBB–	
Ba1	BB+	BB+	
Ba2	BB	BB	Low grade, speculative
Ba3	BB–	BB–	
B1	B+	B+	
B2	B	B	Highly speculative
B3	B–	B–	

- symbol **AAA** is used to designate the highest-grade debt obligations
- **high grade** means low default risk
- S&P and Fitch use plus or minus signs to provide a narrower credit quality breakdown within each class, and
- Moody’s uses 1, 2, or 3 for the same purpose.
- These refinements in the ratings are referred to as rating “notches.”
- Debt obligations rated triple A (AAA or Aaa) are said to be **prime**;
- double A (AA or Aa) are of **high quality**;
- single A issues are referred to as upper medium grade, and
- triple B are medium grade.
- Lower-rated debt issues are said to be **distinctly speculative**.

Credit Rating System

Moody's	S&P	Fitch	Brief Definition
	CCC+		
Caa	CCC	CCC	Substantial risk, in poor standing
	CCC–		
Ca	CC	CC	May be in default, extremely speculative
C	C	C	Even more speculative than those above
	CI		CI = Income bonds; no interest is being paid
		DDD	Default
		DD	
	D	D	

- **investment grade**: If a debt obligation has a rating in the top four categories, otherwise **noninvestment grade** (junk debt).
- investment guidelines of institutional investors may prohibit the purchase of noninvestment-grade debt obligations.
- **split rating**: If a rated entity receives a different rating from two or more CRAs
- **downgrade risk**: the risk that there will be a change in a credit rating that results in a lower score. Such, is said to be *under credit watch*.