What is... a rating agency?

BANKTrack

A rating agency is a company that specializes in evaluating a company or government's capacity to repay debt ("creditworthiness"). Most often they give ratings to debt instruments like corporate and sovereign bonds, but they can also rate commercial loans. The rating is expressed by a code, ranging from AAA as the highest level of creditworthiness, and C or D as the lowest (see box). Rating agencies earn their money by charging the companies and governments they rate a fee, and by selling their findings to the public. Currently, there are over a hundred credit rating agencies operating worldwide. However, in practice, three of them dominate the market: Standard & Poor's, Moody's and Fitch Ratings. All three of them have headquarters in the US.

Importance

Rating agencies have existed for over a century. Their prominence has grown enormously as bond markets have started to expand in recent decades. Previously, bank loans used to be the main form of debt financing for companies and governments, and banks used their own credit risk measurements to determine client creditworthiness. With bonds, however, all potential bond buyers must assess the credit risks involved, and often they lack the capacity to properly do so. Therefore, rating agencies have become increasingly important in providing this information.

Investors often will not even consider purchasing bonds from borrowers that don't have a rating from one of the major agencies. Companies and governments that wish to borrow on capital markets thus are completely dependent on credit raters, and are willing to pay substantive amounts of money to be rated. For borrowers, the fees for obtaining a rating can be over a million US dollars.

Other credit rating institutions

The rating agencies mentioned are not the only institutions that assess borrowers' creditworthiness. Banks also have their internal mechanisms to assess the risk associated with potential loans. Although the methods used by banks are similar to those of rating agencies, the results of banks' assessments are not made public, and only impact banks' own credit decisions.

In addition, some governmental institutions also rate borrowers. National Export Credit Agencies (ECA's) are especially active in rating countries. These ECA's provide their country's exporters with insurance for the products and services they export. If the destination country fails to pay for its exports, the ECA's will reimburse the exporter. Thus it is important for ECAs to know which countries are more likely to pay their bills than others.

The rating process

In order to assess a borrower's creditworthiness, rating agencies gather a broad range of financial and non-financial data. Ratings are based on different kinds of criteria. First, the particular financial circumstances of the firm or government are assessed. For example, the raters examine a borrower's payment history and its outstanding debt. In addition, a borrower's economic outlook is taken into account. For this, rating agencies perform industry studies to assess how a certain industry will evolve and how profitable a company will be in the future. Finally, rating agencies make a determination about the quality of a borrower's management. A country with massive debts and a government that is unlikely to take actions to reduce them, for example, will not earn a high rating. Rating agencies rely on information from other auditors, regulators, financial analyst research, the issuers themselves, and the rating team's own research.

Trends & Critical issues

- Increasing power for rating agencies. The role of rating agencies has particularly increased with the increasing popularity of corporate and sovereign bonds. With borrowers' heavy reliance on their credit ratings, many companies and governments are very concerned about the judgements of ratings agencies. A change in rating can make or break investors' confidence, and will enormously raise borrowing costs for the issuer. Some institutions' investment portfolios directly rely on ratings of the major agencies. For example, pension funds are often only allowed to

The ratings by the two main rating agencies

Moody's	Standard & Poor's	Grade	Risk
Aaa	AAA	Investment	Lowest risk / highest quality
Aa	AA	Investment	Low risk / high quality
A	A	Investment	Low risk / upper medium quality
Baa	BBB	Investment	Medium risk / medium quality
Ba	BB	Junk	High risk /low quality
B	B	Junk	High risk /low quality
Caa	CCC	Junk	Highest risk / highly speculative
Ca	CC	Junk	Highest risk / highly speculative
C	C	Junk	Highest risk / highly speculative
C	D	Junk	In default

What can be rated?

Rating agencies rate both companies and governmental institutions.

- All kinds of **companies** can be rated, although most often it is large multinationals who issue bonds in international capital markets. **Banks** can also receive credit ratings, based on their capability to repay deposits to customers and to interbank loans from other banks. The financial position of insurance firms can also be assessed by credit rating agencies.
- Of **governmental institutions**, central governments are the most important borrowers that receive credit ratings. They issue sovereign bonds on capital markets, and investors like to know how sound these debts are. Municipalities also receive credit ratings and issue bonds. **Governmental loans** can also be rated. Finally, international governmental institutions that borrow on capital markets can also request ratings agencies on their debts. For example, the World Bank is a major international borrower at capital markets; it raises 80% of its funds on capital markets and thus also needs a rating to provide confidence to potential creditors. World Bank bonds have a triple A rating (the highest).

hold bonds rated at investment grade, which is not below Baa/BBB (see box). A lowering in an issuer's rating can thus have an enormous effect if pension funds have to sell those assets. In the future, the power of rating agencies will only increase as a new international banking regulatory framework comes into force ("Basel II"). According to the Basel II framework, banks can use data from credit rating firms or ECA's to determine how risky loans will be, and thus the amount of reserves a bank has to hold to against those loans.

- Failure to adequately rate borrowers. In the past, rating agencies have proved unable to anticipate decreasing or improving creditworthiness of borrowers. A major example was the collapse of companies like Enron and Parmalat. According to rating agencies just prior to these companies' collapse, Enron and Parmalat's bonds were not at much risk of default. Only after the true financial state of these companies became public did the agencies lower their rating. Standard & Poor's, one of the major rating agencies, continued to give Parmalat a high rating until December 2003, despite the fact that the company's 10 billion Euro fraud was becoming public knowledge. Similar oversights occurred during the Asian financial crisis. Prior to the crisis, country ratings were at reasonable levels. When the crisis erupted, rating agencies dramatically lowered the ratings of the countries concerned, which according to many, further aggravated the crisis because it caused more investors to immediately pull out of the region.
- Conflict of interests. Private rating agencies get paid to rate a company or state. Rating agencies stress that it is in their own interest to remain completely independent, since their sound reputation is key in attracting business. However, in the absence of many competitors, conflicts of interests may still arise. In the aftermath of scandals like Enron and Parmalat, investors claimed they had been misled, and many argued that this was due to the raters' lack of independence.
- No sustainability indicators. To date, rating agencies do not systemically include a company's environmental and social behaviour in their rating methodologies. A handful of specific rating agencies aim to take these social and environmental issues into account, and give a company a rating purely on this basis. However, most specialist firms that companies on sustainability grounds do not combine this with an assessment of their capacity to repay debts. Thus, they will not have a substantive impact on creditors looking for information on creditworthiness.

CSR issues:

Investors have heavily criticized ratings agencies for issuing misleading ratings during the Parmalat and Enron crises. In the years after the crises, the US Congress dedicated several meetings to this issue. Congress has pressured the responsible US regulator (Securities and Exchange Commission, SEC) to make the agencies more transparent, to prevent conflicts of interests and to increase competition in the sector. Since the SEC is responsible for the US market, it covers all three main rating agencies.

So far, not many efforts have been made to tackle the other issues mentioned above. The power of rating agencies is still increasing, and this will probably continue in the future when Basle II is implemented. In addition, the credit rating agencies currently still exclude sustainability indicators in their risk assessments.

Glossary:

Bond: promissory notes that oblige the issuer to pay back a certain amount of money within a certain time (with or without regular payments, or 'coupons').

Investment grade: good quality debts; there is a low risk that the debt will not be paid back. In practice, this concerns ratings from AAA to BBB (or Baa at Moody's).

Junk grade (speculative grade): low quality debts; there is a high risk that that the debt will not be paid back. In practice, this concerns ratings below BB (or Ba at Moody's).

www.moodys.com www.fitchratings.com www.sustainability-indexes.com

www.eca-watch.org www.sec.gov www.standardsandpoors.com

This fact sheet was produced by SOMO, centre for research on multinational corporations -www.somo.nl-
for BankTrack, the campaigners network tracking the private financial sector.
T: +31-30-2334343, F: +31-30-2381112, E: coord@banktrack.org, www.banktrack.org