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What Do Credit Ratings Do And Why Are They So Important?

By George Theocharides - ***Credit Rating Agencies (CRAs) are companies that investigate the general creditworthiness of issuers of loans/bonds and provide ratings and opinions that can be used by investors.***

These issuers can be companies (e.g. Bank of Cyprus), special purpose entities, non-profit organizations, state and local governments (e.g. State of California, County of Orange, etc.), as well as sovereigns (e.g. Cyprus or Greek government bonds). Using a quantitative as well as a qualitative analysis, CRAs assign a rating to each entity based on the perceived riskiness of its creditworthiness. The higher the risk implies a lower rating.

CRAs role is to help make the markets more efficient by improving transparency and disseminating information to investors, thus lowering borrowing and lending costs. They also make it possible for small companies/governments, start-up companies, or other relatively unknown entities to raise capital by having their debt rated by the agencies. Ratings prove useful also to the issuers as they provide an independent source of verification for their level of credit-worthiness, as well as to government regulators (such as the Central Bank, or the Securities and Exchange Commission).

Improving transparency in the market and helping to disseminate information is considered the traditional CRA model. Another explanation behind the need for CRAs is based on a 'coordination theory', which states that agencies provide a coordinating role between issuers and investors. That is, investors receive enormous amount of information and the agencies provide a guiding hand to make the right decisions. At the same time, the agencies act as a compass in the complex world of financial markets to the issuers as well. A third explanation behind the role of rating agencies is the transformation of inside information (that they may have due to the close contact with the issuer) into public information, that can be used by investors, regulators, etc.

One would think that due to technological advancements and the improvement in the quality of information provided to investors, the role of the rating agencies would be diminished in recent times. On the contrary though. They have become increasingly important.

One reason is globalization. Nowadays, companies and individuals have the choice to invest their money in places far away from their home soil (main reason is to diversify their portfolio). Thus, rating agencies help to provide useful information that otherwise would have been difficult to obtain. A second reason is the introduction of highly complex financial products that investors do not have either the expertise or the time to analyze the risk embedded in these

securities. A third explanation behind the increasing role played by the CRAs is the wave of financial scandals that led to the loss of billions of investors' money. Thus, despite some of the shortcomings of rating agencies, they still provide an important source of defense mechanism for investors against the abuse by senior management.

Traditionally, CRAs were earning their money by publishing the ratings and charging a subscription fee. This still seems to be the case with smaller CRAs. However, the major agencies earn now their money by charging the issuer for the services they offer. This method obviously can produce a conflict of interest as it could provide an incentive for the agencies to provide favorable ratings to companies with strong business ties. However, proponents of this approach argue that using a "subscriber-based" fee structure would eventually lead to a vast number of bonds being unrated since investors would only be interested in the ratings of the larger and more liquid bonds. When a rating is requested by the company that is issuing it, it is called "solicited" rating and the requesting company needs to pay a fee for the services offered to it. If the rating is assigned by the agency without any request, it is called "unsolicited" rating and the issuer does not need to pay any fees for that.

There are a number of rating agencies around the world, even in Cyprus (Capital Intelligence, based in Limassol, provides credit analysis and ratings to emerging markets). However, the "big three" are: Standard & Poor's (S&P's), Moody's and Fitch. The first two which control the majority of the market are U.S.-based while Fitch has dual-headquarters in New York and in London.

S&P's and Fitch use a combination of letters and plus and minus signs for the rating notation (e.g. BBB+), while Moody's uses a combination of letters and numerals (e.g. Baa1). Note that a major change occurs when an issuer moves to BB+ or lower (for S&P's and Fitch) and Ba1 or lower for Moody's – this signals a change from an investment-grade rating to the "junk" market (also called speculative-grade, or high-yield market). This is important as it indicates to investors that the riskiness of the issuer has substantially increased, and there is now a higher probability of default.

Furthermore, regulatory requirements sometimes prohibit certain investors (e.g. pension funds, insurance companies) from owning high-yield bonds, thus whenever a bond is downgraded into the "junk" sector, they are required to remove it from their portfolio exerting even more pressure on the specific bond's yield (or price). Note also that an issuer with multiple bonds that have different characteristics (features of bonds, how they are structured, how they are secured, whether they are subordinated to other debt) implies separate ratings for each bond.

CRAs periodically will downgrade or upgrade the issuers by one or more notches. For example, recently Cyprus government bonds were downgraded two notches by Moody's, from Baa1 to Baa3. Often before downgrading/upgrading the issuer, CRAs will place the issuers first on "rating outlook" and then on "watch".

The outlook is an indication for the potential direction of an issuer's long-term rating in the next few years. CreditWatch is more urgent and implies that the issuer is being evaluated for a rating change. One would expect that the main impact on bond spreads to happen when the issuer is placed on "watch". This is when the bulk of the information is transmitted to the financial markets. However, the actual downgrade (which can happen weeks or months after

the issuer is placed on “watch”) still contains some information and will also have an impact (albeit smaller) on market spreads.

Furthermore, a number of times the rating agencies are late in analyzing information so they are forced to go ahead and make a rating change (even if the issuer has not been previously placed on “watch”). In many occasions (but not always) the changes by the three main agencies happen almost concurrently, with only short time lags between them. This is understandable given the fact that they analyze the same information. This implies for example that when Cyprus government bonds are downgraded by Standard & Poor’s, we should be expecting soon a corresponding downgrade by the other two main rating agencies.

Overall, and despite some very striking shortcomings of CRAs (presented in a recent article), they are still a very important player in the financial markets. Their actions affect the economic future of the issuers they rate, but also the investments of millions of individuals/companies around the world. Having a clear understanding of how they operate is extremely important for investors, regulators, and issuers as well.

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