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An assessment of strategic importance of credit rating agencies for companies and organizations

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Abstract

Recently CRAs have been affecting many new dynamics such as politics, governments and municipalities. We think that companies are also involved in this affecting process. In this study, the topic has been investigated from this strategic perspective. First, major CRAs have been presented along with their credit rating systems and grades. Later the roles of downgrades of CRAs has been discussed on Euro zone and US crises. Following this, we have disclosed negative and positive assessments by critics and defenders on CRAs and their ratings. For this reason, all the companies in the world mustn't be overlooked the CRAs and their grades and take them into consideration strategically and finally involve them into their stakeholders and partners. Finally we have come up with an assessment of strategic importance of CRAs and their rating for companies and organizations.

Keywords: Credit Rating Agencian (CRAs), Rating Grades, Negative and Positive Evaluations.

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1. Introduction

Companies as well as states, countries, local administration have to take many parameters into consideration besides their other partners and stakeholders such as government, local administration, consumers, NG0s(Non-governmental organizations) suppliers, media. One of those to be taken into consideration is CRAs (Credit Rating Agencies).

Recently CRAs have been affecting many new dynamics such as politics, governments and municipalities. We think that companies and organizations are also involved in this affecting process. For instance, almost all the Governments in EU downgraded by CRAs has changed via by- elections or resignations. This means CRAs' downgrades or upgrades have become strategic elements for countries. This view of point goes for companies. Because companies also in the countries downgraded or upgraded by CRAs are affected from the current evaluation. We can easily see and appreciate the affects of crises in EU and US on companies.

Just after the downgrades by CRAs all the stocks the companies have decreased. Stock markets across the world dropped from high levels to historic lows. Countries had difficulties to find fund or found the fund they needed with high interest rates. For this reason, all the companies in the world mustn't be overlooked the CRAs and their grades and take them into consideration strategically and finally involve them into their stakeholders and partners.

1.Some Definitions of Credit Rating Agencies

A credit rating is an independent assessment of the credit worthiness of a bond, a company, a country, a municipally by CRAs "A credit ratings agency is a company that assigns credit ratings to institutions that issue debt obligations (i.e. assets backed by receivables on loans, such as mortgage-backed securities). These institutions can be companies, cities, non-profit organizations, or national governments, and the securities they issue can be traded on a secondary market[1]

CRA can also be defined as firms that analyze the probabilities of the debt instrument returning all of the principal to the investor. Municipal credit ratings are opinions of the investment quality of issuers and issues in the municipal and tax exempt markets.

Another definition on CRA:

"A CRA is a company that helps inventors decide how risky it is to invest Money in a certain country and/or security ".[2]

The top three credit ratings agencies include Moody's, Standard and Poor's and Fitch Ratings.

[1] Credit Rating Agencies, www.wikinvest.com/consept-Rating-Agencies, 9.4.2012, p.1.

[2] www.investopiedia.com/ articles, 9.4.2012, p.1.

2. Rating Grades, Credit Rankings CRAs Have, and an Evaluation in Comparison

Rating Grades

Each rating agency has developed its own system of rating sovereign and corporate borrowers. Fitch Ratings developed a rating system in 1924 that was adopted by Standard & Poor's. Moody's grading is slightly different. Moody's sometimes argues that their ratings embed a conceptually superior approach that directly considers not only the likelihood of default but also the severity of loss in the event of default.

Long Term Credit Rankings

Fitch Ratings and Standard & Poor's use a system of letter sliding from the best rating "AAA" to "D" for issuers already defaulting on payments. [3]

Investment Grade

AAA : best quality borrowers, reliable and stable without a foreseeable risk to future payments of interest and principal

AA : very strong borrowers; a bit higher risk than AAA

A : upper medium grade; economic situation can affect finance

BBB : medium grade borrowers, which are satisfactory at the moment

Non-Investment Grade

BB : lower medium grade borrowers, more prone to changes in the economy, somewhat speculative

B : low grade, financial situation varies noticeably, speculative

CCC : poor quality, currently vulnerable and may default

CC : highly vulnerable, most speculative bonds

C : highly vulnerable, perhaps in bankruptcy or in arrears but still continuing to pay out on obligations

CI : past due on interest

R : under regulatory supervision due to its financial situation

SD : has selectively defaulted on some obligations

D : has defaulted on obligations and S&P believes that it will generally default on most or all obligations

NR : not rated

Moody's ratings follows a different system

Investment Grade

Aaa: Obligations rated Aaa are judged to be of the highest quality, with the "smallest degree of risk"

Aa1, Aa2, Aa3: Obligations rated Aa are judged to be of high quality and are subject to very low credit risk, but "their susceptibility to long-term risks appears somewhat greater".

A1, A2, A3: Obligations rated A are considered upper-medium grade and are subject to low credit risk, but that have elements "present that suggest a susceptibility to impairment over the long term".

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[3] Toni Straks and others, p.1-3.

Baa1, Baa2, Baa3: Obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such "protective elements may be lacking or may be characteristically unreliable".

Non-Investment Grade

Ba1, Ba2, Ba3: Obligations rated Ba are judged to have "questionable credit quality."

B1, B2, B3: Obligations rated B are considered speculative and are subject to high credit risk, and have "generally poor credit quality."

Caa1, Caa2, Caa3: Obligations rated Caa are judged to be of poor standing and are subject to very high credit risk, and have "extremely poor credit quality. Such banks may be in default..."

Ca: Obligations rated Ca are highly speculative and are "usually in default on their deposit obligations".

C: Obligations rated C are the lowest rated class of bonds and are typically in default, and "potential recovery values are low".

Others

WR: Withdrawn Rating **NR**:Not Rated **P**: Provisional

Description	Moody\'s	S&P	Fitch
Maximum Safety	Aaa	A AA	AA
High grade	Aa1	AA+	AA+
High grade	Aa2	AA	AA
High grade	Aa3	AA-	AA-
Higher medium Grade	A1	A+	A+
Higher medium Grade	A2	A	A
Higher medium Grade	A3	A-	A-
Lower medium Grade	Baa1	BBB+	BBB+
Lower medium Grade	Baa2	BBB	BBB
Lower medium Grade	Baa3	BBB-	BBB-
Speculative	Ba1	BB+	BB+
Speculative	Ba2	BB	BB
Speculative	Ba3	BB-	BB-
Highly Speculative	B1		B+
Highly Speculative	B2	B	B
Highly Speculative	B3		B-
Substantially risky		CCC+	CCC+
Substantially risky	Caa	CCC	CCC
May be in default	Ca	CC	CC
Extremely Speculative	C	C	C
Income bonds –not paying interest			CI
Default			DDD
Default			DD
Default		D	D

3-Opposite Assessments on CRAs

Especially after 2007 crisis and Debt Ceiling Crisis in USA and last economic and political crises in Europe, pundits and critics have been making different evaluations on downgrades and upgrades of CRAs including some negative and positive.

3.1. Negative Evaluations

Since the beginning of the credit crunch in early 2007 rating agencies have come order fire for their high ratings of mortgage backed securities that didn't reflect the financial stability of the borrowers. This has also reopened a discussion whether rating agencies, who get paid by borrowers for their rating, are in a conflict of interest. Because, major credit agencies, such as Moody's and Standard and Poor's perform and fulfill this rating service for a fee.

Critics of the ratings agency's power have pointed out flaws in Standard & Poor's sums and reasoning, arguing that far too much weight is given to the opinions of one private company. Leading the charge of critics is Nobel prizewinning economist and New York Times columnist Paul Krugman. In a blog post he took Standard & Poor's calculations to task and mocked it and other agencies for helping to inflate the recently burst housing bubble with poorly rated securities."It's hard to think of anyone less qualified to pass judgment on America than the rating agencies. The people who rated subprime-backed securities are now declaring that they are the judges of fiscal policy? Really?" Krugman fumed.[4]

An ironic assessment on CRAs by Michael Schuman, columnist on Time Magazine:"CRAs have long had reputation for locking the barn door after horse is out".

In Context of three major CRAs called Moody's, S&P and Fitch, Another negative evaluation on CRAs has been made as below by Protesilaos Stavrou:[5]

"They played a sinister role in the housing bubble in the United States, whose burst led to the collapse of Wall Street that caused the Great Recession. they provided top-notch ratings to investments that ended up being nothing but thin air, such as the infamous Collateralized Debt Obligations (CDO) of Lehman Brothers. This propped up the bubble, levered up banks, increased household debts, exposed more and more entities to the bubble, eventually causing what we have all been experiencing, ever since, not only in the form of the recession (reduced income - increased taxes), but also via massive bailouts to these same banks who took the money to then speculate against the hand that fed them - the states. The crash of 2008 has taught us two lessons with respect to Credit Rating Agencies: (i) that they were effectively tools to the crime by reinforcing speculation, (ii) that investors no longer show the same faith in them".

An Europe centered negative critique is this:[6]

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[4] Paul Harris,Credit Rating Agency's move causes Political Furore in US, The Observer, Sunday 7 August 2011,p.1.

[5] Protesilaos Stavrou, About Credit Rating Agencies and the root of the Crisis in Europe, December 31,2011.p.1-3,www.

Protesilaos.com/Access date:9,4,2012

"Reputational crisis of Credit Rating Agencies (CRAs) is ongoing and is putting into question whether CRAs are playing a credible role in Eurozone financial markets. The current Eurozone crisis supports the proposition of skepticism on the credibility of CRAs which did not properly disclose risks and thus contributed to pushing the global financial system to the verge of collapse. Politicians across the European Union have called for restrictions on the role of CRAs in rating sovereign debt and for increased regulation of CRAs".

An assessment of the crisis rising for CRAs during the discussion to increase the US debt ceiling was made by blog.euromonitor.com:[7]

In August 2011, credit rating agency Standard & Poor's (S&P) downgraded the USA's long term federal debt from AAA to AA+ for the first time since 1917 suggesting that US treasuries are no longer risk free assets. As the world's largest economy, biggest importer of goods and the US dollar being the world's reserve currency, the downgrade has far reaching implications for the global economy.

The US downgrade by S&P came despite the announcement in early August 2011, to raise the US debt ceiling (the legal limit on total amount of debts the US government can run in order to pay its bills) by US$2.1 trillion, from its existing limit of US$14.3 trillion eliminating the need for further increases until 2013. The government also outlined further plans of spending cuts worth US$2.5 trillion over a 10 year period.

According to S&P, the trigger for the reclassification was the failure of the US government to present a viable plan to manage its government finances, as opposed to any doubt over the ability of the USA to reduce its deficit. The government's budget deficit has increased from US$403 billion (3.2% of GDP) in 2005 to US$1.6 trillion (10.6% of GDP) in 2010. As a result, public debt rose sharply from 61.7% of GDP in 2005 to 91.5% in 2010.

The most immediate impact of the US debt crisis has been a loss of investor confidence and liquidity of global financial markets. Global stock market indices plummeted following the downgrade. Many investors were already trying to diversify away from the USA and the ratings change is likely to hasten this diversification;

The flood of investment into the Swiss Franc, Japanese yen and gold after the announcement of the US downgrade is indicative of the fact that the perception of the US dollar has been tarnished. By mid-August, gold prices almost reached US$1,800 per troy ounce from US$1,614 per troy ounce at the end of July 2011;

Other emerging market currencies such as Indonesia, Brazil and South Africa were already appreciating against the dollar before the downgrade due to high interest rate differentials that attracted foreign investments. For example, the Brazilian real has appreciated by 11.7% annually in July 2011.

Due to its world reserve currency status, US treasury bonds are owned by governments of many countries. According to the US Department of the Treasury, by June 2011 China was the biggest foreign holder of US treasury bonds at US$1.2 trillion followed by Japan (US$911 billion). The UK was the third largest foreign owner of US treasury bonds, at US$350 billion by the end of the same month, less than half of the value owned by Japan;

As the world's largest consumer of crude oil in 2010, the US downgrade had an immediate impact on crude oil prices. The debt crisis in the USA has renewed fears of slowing economy with crude oil prices

[6] John Rvan, Do we need CRAs, Social Europe Journal, 16.3.2012, www.social.europe.eu/2012/03,access:9,4,2012,p,1.

[7] Blog.euromonitor.com/2011/08:The US Debt Crisis and Downgraded Credit Rating has Global Implications, p.2-5.

(WTI Cushing) declining to US$79.32 per barrel by 8th August 2011, after reaching US$97.30 per barrel in July 2011.

The US downgrade came at a time when the US economy was slowing and consumer confidence continues to be below pre-crisis levels of 2007. As a result, consumer expenditure in the biggest consumer market in the world, is set to remain stagnant until the end of 2011 at US$10.1 trillion, unchanged from 2010;

The US downgrade is likely to worsen the EU debt situation. This is because the USA was previously seen by many as infallible, and the downgrade highlights the delicate state of the heavily indebted economies in the EU, especially France and the PIIGS countries (Portugal, Ireland, Italy Greece and Spain) in a worse light for investors. In a bid to contain the debt crisis in the EU, the European Central Bank (ECB) bought Italian and Spanish bonds for the first time in mid-August 2011.

As the world's biggest importer of goods in 2010, many emerging markets are likely to try to diversify their exports going to USA. Asia in particular, which accounted for 34.0% of total imports into the USA in 2010, has attempted to increase regional trade since the global economic crisis of 2008-2009. China and Mexico, accounting for 19.5% and 11.8% of US imports in 2010, will be affected the most as a result of reduced US demand for imported goods.

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An interesting assessment on CRAs by Mark Froeba who was a senior vice president at the time he left Moody's after 10 years of employment has come: [8]

"When I joined Moody's in late 1997, an analyst's worst fear was that he would contribute to the assignment of a rating that was wrong, damage Moody's reputation for getting the answer wrong, and lose his job as a result. When I left Moody's (2007), an analyst's worst fear was that he would do something that would allow him to be singled out for jeopardizing Moody's market share, for impairing Moody's revenue, or for damaging Moody's relationships with its clients, and lose his job as a result".

This change in corporate culture, one that eventually prioritized company profitability over corporate integrity, has been attributed to Moody's Corporation going public in 2000 after a split with its holding company Dun & Bradstreet. This led to two specific changes that arguably influenced corporate culture: First, after the company went public, senior managers were compensated in the form of stock options for the first time in company history. Second, the nature of taking a corporation public forces a company to worry about profitability on a quarterly basis. This pressure to please shareholders may have forced Moody's to prioritize short-term quarterly reports of profitability over ratings integrity.

[8] www.social.europe.eu/2012/03,p.3.

3.2.Positive Evaluations

Unlike the crisis in The US with respect to the role of CRAs on the Crises.
Protesilaos Stavrou has different perspective on Eurozone crisis: [9]

"A good doctor is one who is capable of diagnosing the source of the illness, so as to provide a cure to it, if such a remedy exists. Similarly an objective analyst will have to identify the source of the trouble in Europe to suggest a solution, if such exists. With all of the above in mind my account is that the crisis is not caused nor reinforced by the doings of Credit Rating Agencies. It isn't meant that they are not speculators, nor do I suggest that they are not to be blamed. İt isn't meant that the root of the crisis in Europe is internal."

The discussion against Credit Rating Agencies is but a red-herring, an attempt to put the blame on someone else. Yes they may be suspicious, yes they may be biased, yes they may be engaging in speculative behavior. But the source of the problem is the manner in which European integration was realized over the decades. It is the way in which Europeans envisioned their common future. It is the fault of Europeans who managed to create such a perverse and ill-shaped a structure, such as the whole European Union and in particular the Euro.

Europe will escape from the crisis only when it decides to face itself in the mirror. Only with self-criticism — with cynicism — will Europeans overcome their collective problems. Putting the blame on outside forces is an excuse that will cost Europe dearly.

Defenders of CRAs say that firms (CRAs) are only acknowledging what many other pundits have said for a long time: The US has too much debt and its fractious political systems see unable to solve it. [10]

4- The Strategic Importance and Benefits of The Ratings by CRAs

An comprehensive evaluation by Joseph Nguyen based on strategic importance and benefits of CRAs' Ratings for consumers, companies and countries is as follows: [11]

Credit Ratings are an important tool for borrowers to gain access to loans and debt. Good credit ratings allow borrowers to easily borrow Money from financial institutors or public debt markets.

At the consumer level banks will usually base the terms of a loan as a function of your credit rating, so the better your credit rating, the better the terms of the loan typically are .If your credit rating is poor the bank may even reject you for a loan.

At the corporate level, it is usually in the best interest of a company to look for a credit rating agency to rate their debt. Investors often times base part of their decision to buy bonds and stock on the credit

[9] Protesilaos Stavrous, p.2-3.

[10] Paul Haris, p.1.

[11] Joseph Nguyen, www.Investtoledia.com, accessdate: 9.4.2012, p.1.

rating of the company's debt. And usually investors will look at the credit rating given by international credit rating agencies as well as rating given by domestic rating agencies before deciding to invent.

At the country level, many countries rely on foreign inventors to purchase their debt, and then investors rely heavily on the credit ratings given by the CRAs. The benefits of a good credit rating for a country, include access to funds from outside their country, and the possession of a good rating can attract other forms of investment to a country

Such as foreign direct investment, for example a company planning to open a factory in a specific country may first take a look at the countries crating to assess its stability before deciding to invent.

According to Anupam A.Petkar, Credit Rating Agencies benefits for companies and especially for SMEs are explained as fallow:[12]

Some hurdles which hinder the growth of SMEs can be set by CRAs.

The rating can give an opportunity to companies to create benchmark in a financial and other parameters.

Various financial, non-financial parameters, past credit history and future outlook. as well as overall health of the company.

Rating process is a fairly detailed exercise. It involves, among other things, analysis of financial information, visits to the customer's office and works, intensive discussion with management, auditors, bankers, etc. It also involves an in-depth study of the industry itself. Ratings are based on an in-depth study of the industry as also an evaluation of the strengths and weaknesses of the company. The inherent protective factors, marketing strategies, competitive edge, level of technological development, operational efficiency, competence and effectiveness of the management, hedging of risks, cash flow, trends and potential, liquidity, financial flexibility, government policies, past record of debt servicing, and sensitivity to possible changes in business/economic circumstances are looked into.

Rating agencies also ensure that the rating process is insulated from any possible conflict of interest.

Another strategic benefit of CRAs for inventors is this. [13]

As investment opportunities become more global and diverse, it is important and difficult to decide not only which countries but also companies are good investment opportunities. There are advantage EU investing in foreign markets, but the risky associated with sending money abroad are considerably higher than those associated with investing in your own domestic market. It is important to gain insight in to different investment environments but also to understand the risks and advantages these environments pose. Measuring ability and willingness, of an entity-which could be a person, a corporation, a security or

[12] Anupam A.Petkar, Credit Rating: Features and Benefits for SMEs,www.bcsonline.org/articles, p.1-5.

[13] www.investopedia.com., what is a corparate credit Rating, p.1-3.

a country to keep into financial commitments or its debts, credit ratings are essential tools for helping you make same investment decisions.

Every company or country that has a rating will be affected in its borrowing costs, at least in public markets. A higher ranking means lower interest rates for the borrower and vice versa. The price of credit is set not only by relative credit ratings but also by the general supply of money and the specifics of an individual borrowing. A low-rated borrower, for example, can sometimes borrow more cheaply by securing the bond with a claim on specific assets, or by paying a third-party to insure the bond. Conversely, a highly-rated borrower may choose a structure that attracts a lower rating because of special characteristics of the issue, including its standing in the borrower's capital structure or the jurisdiction in which it is issued. [14]

Conclusion

At the broadest level, stakeholders for companies has been set below:[15]

Local communities
Owners
Suppliers
Governments
Employees
The public at large
Customers
Trade associations

CRAs must be involved in this portfolio because they deeply have affected the organizations.
Just as companies have responsibilities to regular stakeholders and shareholder, than have responsibilities to CRAs as well.

CRAs and their affects must be investigated on the economy, politics and companies. In this perspective, companies and organizations must accept CRAs' effects on their operations and the future projects and therefore be used to living and surviving along with CRAs.

An EU based assessment with respect to CRAs which are thought to exaggerate their evolutionary by EU officials across EU countries is this: [16]
A recent new draft report from the European Parliament Economic and Monetary Affairs Committee has proposed giving the European Union sweeping regulatory powers that include the right to ban sovereign credit ratings if countries do not want them. The European Parliament draft report will be used in negotiations over legislation for the European Union will also calls for recommendations on setting up a fully independent public European Credit Rating Agency.

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[14] Toni Straka and others, Credit Rating Agenies, www.wikinwest.com/consepts p.1-3.

[15] Alex Miler, Strategic Management, Third Edition, Boston, 1998, Irwin/McGraur-Hill, p.5.

[16] John Rvan, Do we need credit Rating Agencies, Social – europe. Ey.2012 / 03, p.3.

Other proposed changes could include a provision to reduce excessive reliance on credit ratings by removing from European Union laws all references to the need for ratings for regulatory purposes. Banks, insurance companies and other financial institutions would have to make their own credit risk assessments without relying solely on credit ratings. “No rating outlook should be published with respect to sovereign debt,” the document adds. “This implies that their ratings should be treated as information to be taken into account, but that agencies should not themselves enjoy special status or automatically influence the activities of economic and financial operators and public institutions.”

The European Parliament Economic and Monetary Affairs Committee report will almost certainly be amended before it becomes the official position of the European Parliament Economic and Monetary Affairs Committee on 21 May 2012 and then will be voted on by the European Parliament. Then it will be used as the basis for negotiation with the European Commission and the European Council, where the national governments meet. The European Parliament has equal legislative rights to the other institutions. The CRAs, financial actors and some national governments are likely to lobby hard to tone down the European Parliament draft report through amendments. Do we need CRAs with their poor prediction record and business model that contains conflict of interest and a lack of due diligence? The lack of their value and usefulness has become apparent over the last fifteen years. Yet it still seems that market players are addicted to these organizations. If we have to accommodate them in the near future, there is a need to encourage private sector initiatives to create new CRAs in order to increase competition and diversity in the market.

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