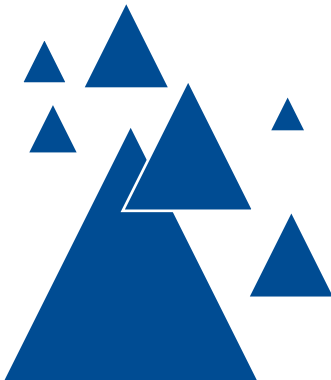




Credit Rating Agencies: Meeting the Needs of the Market?

Executive Summary



Researchers: Angus Duff
Sandra Einig

First Published 2007
The Institute of Chartered Accountants of Scotland

© 2007

This Executive Summary is published for the Research Committee of The Institute of Chartered Accountants of Scotland. The views expressed in this Executive Summary are those of the authors and do not necessarily represent the views of the Council of the Institute or the Research Committee.

No responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication can be accepted by the authors or publisher.

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopy, recording or otherwise, without prior permission of the publisher.

A copy of the full report is available to download from the ICAS website - www.icas.org.uk/research - or can be purchased by contacting the Research Centre - 0131 347 0237 or research@icas.org.uk

ISBN 978-1-904574-20-0
EAN 9781904574200

EXECUTIVE SUMMARY

Background

In the past decade, interest in the activities of credit rating agencies (CRAs) has grown significantly. This reflects: (i) the global growth of ratings services, driven by new debt issues and structured finance products such as credit derivatives; (ii) criticisms of the CRA industry's seeming inability to forecast the Asian crisis of 1997, and the well-publicised corporate scandals of the early part of this century, including the recent subprime mortgage crisis creating turmoil in financial markets; and (iii) the perceived duopolistic nature of competition in the CRA industry, with domination by two CRAs: Moody's, and Standard & Poor's (S&P).

In response to these issues, commentators have suggested greater self regulation of the industry, with the United States debating the need for formal regulation. However, only a small amount of research exists which considers what constitutes quality in the provision of ratings services. This is in contrast to studies of the audit and assurance industry, where an accumulation of literature has developed the concept of audit quality.

Purpose of study and research approach

The purpose of this investigation is to apply the audit quality literature to conceptualise those desirable qualities of CRAs. These theoretical qualities were refined by undertaking 16 interviews with issuers of debt who use ratings services, debt investors, and a range of other interested parties. The interviews and audit quality and related literatures were used to develop a 71 item questionnaire relating to potential CRA qualities. The 71 items relate to 14 underlying characteristics of ratings quality, labelled: co-operation; expertise; independence; investor orientation; internal

processes; issuer orientation; methodology; reputation; responsiveness; timeliness; transparency; trust; values; and service portfolio.

This investigation was conducted in the period 2005 to 2006. The questionnaire was sent to 2,400 interested parties representing three primary groups using CRA services: financial managers in UK corporations that are issuers of debt; debt investors (bond holders); and other interested parties (accounting and finance academics, accountants in corporate finance functions, corporate and investment bankers, financial journalists, and treasury consultants).

Key findings

Relative importance of ratings quality characteristics

There was a broad consensus across the three groups regarding the usefulness of the 14 ratings quality characteristics. These characteristics were generally rated in the following order: reputation, trust, and values, followed by the relatively clustered characteristics of transparency, timeliness, expertise, investor orientation, methodology, co-operation, independence, issuer orientation, internal process, and responsiveness, with service portfolio ranking last and well-behind the other characteristics.

Relative importance of 71 individual questionnaire items

The items rated most highly by all stakeholder groups tended to be related to the integrity of the CRA, their ethical standards and credibility. Rated almost as highly were items which directly related to the competence of CRA outputs such as accuracy of ratings and associated reports, and the education and qualifications of staff. The lowest ranking items related to the ability of the CRA to provide specialised ancillary services.

Absolute importance of 14 ratings quality characteristics

In general, the financial manager group rated the 14 characteristics as more important than the 'other interested parties', with debt investors

located between these two groups. This result perhaps reflects that the primary relationship is between the financial manager of the issuer and the CRA, with debt investors and other interested parties somewhat detached from this process.

Differences between the three groups

When making inter-group comparisons between the three groups, the most polarised differences exist between issuers and debt investors. Other interested parties views fall between the views of issuers' financial managers and debt investors. As expected, financial managers rate issuer orientation higher than debt investors, and debt investors rate investor orientation higher than issuers. Financial managers also rate the characteristics of trust and methodology higher than debt investors. These characteristics reflect the one-to-one relationship that financial managers usually have, in their role as issuers, with the CRA. Debt investors and financial managers have differing views of what 'timely' means in terms of rating updates. Debt investors would like to see a rating updated as soon as possible. Issuers prefer stability in their rating, as volatility in ratings may breach financial covenants in bank borrowing agreements.

When financial managers are compared with other interested parties, differences relate to four characteristics: issuer orientation; responsiveness; trust; and timeliness. Similar to the financial manager-investor comparison, issuer orientation, responsiveness and trust relate to the close relationship between issuers of rated debt and the CRA. Also, timeliness means different things to financial managers and other interested parties, with financial managers preferring stability in ratings and other interested parties preferring ratings to reflect current events.

Finally the differences between debt investors and other interested parties are in items that are investor-specific or issuer-specific. That is, those items that focus on the service and attention that the particular group receives from CRAs.

Financial manager issues

Sixty one per cent of responding financial managers issue debt in public markets. Two-thirds of financial managers maintain a relationship with a CRA, either for debt issuance or investment purposes. Moody's and/or S&P are used by 95 per cent of financial managers maintaining a relationship with a CRA. However, the position is far from a duopoly, with 52 per cent of respondents indicating that they use Fitch or another CRA, either with Moody's and/or S&P, or as their sole CRA. Multiple CRA relationships are commonplace: 48 per cent of respondents use two CRAs and 33 per cent use three CRAs.

Debt investor issues

Only one-third of responding debt investors indicate that it is policy to require a rating before making a debt-related internal investment. Although a majority indicate that a rating is important, 54 per cent indicate 'it was just one input of many'.

Other interested parties issues

Two-thirds of other interested parties indicate that they make regular use of ratings produced by CRAs. This validates expectations that a wide range of stakeholders make use of ratings information. The most common uses are: research, teaching and training (18 per cent); advising clients (17 per cent); assessing the creditworthiness of clients/suppliers (17 per cent); and for investment decisions (14 per cent).

Discussion and policy implications

Background research conducted for this project identifies the strong growth in the ratings industry enjoyed by just a few CRAs. This growth, combined with recent corporate scandals of a global nature not foreseen by CRAs and the recent subprime market crisis, has stimulated demands

for greater scrutiny and regulation of CRAs work. This project explores relevant background issues to the ratings industry, and elicits what constitutes quality in CRAs work.

The questionnaire survey identifies 14 quality characteristics desirable in CRAs. A great deal of consensus exists among the three groups suggesting that each of these stakeholders are looking for similar qualities in CRAs. As the most important characteristics relate to the reputation, credibility and integrity of the CRA, it is essential that CRAs do not allow their standards to slip in the light of their expansion.

Behind those characteristics relating to the standing of the CRA in the market are those aspects that reflect: technical qualities of the CRAs service provision; the timeliness of ratings upgrades/downgrades; the transparency of CRA decision-making; and their expertise and methodologies. CRAs interviewed went to great lengths to explain that their methodologies were disseminated via their websites and available to all parties. However, issues relating to communication were apparent in many interviews. CRAs could therefore benefit from making additional efforts to explain their methodologies to stakeholder groups. These could include: presentations to issuers about the conditions needed for ratings upgrades, and what might precipitate a downgrade; presentations to investor groups about their distinctive methodologies; and 'open doors' sessions to other members of the financial community to create a greater understanding of their work.

Surprisingly, those items relating to the characteristic of independence did not score highly in the surveys. However, it would be dangerous to interpret this as meaning that independence is not an important characteristic of a CRA. Interviewees all believed that CRAs were independent, and that it was one aspect of their work that they were entirely confident about. The most appropriate interpretation of these findings is that, independence is a *sine qua non* of CRA work. This is one finding that CRAs and all market participants must take great comfort from.

The characteristic of CRAs ranked least important was their service portfolio. The provision of added-value ancillary services by CRAs was not seen as particularly valuable by any of the user groups. The fallout from

the subprime crisis has reiterated calls to separate ratings and consulting arms. CRAs either need to better communicate the value of these services, or stick to their core business of providing ratings information.

A finding of this research is that a large number of stakeholder groups make use of ratings information for a variety of purposes. However, it is apparent that many individuals do not have a significant understanding of what the ratings industry does or of the ratings process. Issues of communication have already been addressed. However, one avenue for CRAs to explore would be to educate potential members of the financial community, and develop stronger links with universities and professional bodies in the accounting and financial services sector. As well as improving an understanding of the industry, courses or programmes focusing on the analysis of debt securities and structured finance could increase the supply of junior analysts.



CA House • 21 Haymarket Yards • Edinburgh • EH12 5BH

Tel: 0131 347 0237 • Fax: 0131 347 0110

Email: research@icas.org.uk • Website: www.icas.org.uk/research