SUMMIT AFRICA

RATING AGENCIES EXPLAINED

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WHAT ARE CREDIT RATING AGENCIES (CRA), AND HOW IS IT RELEVANT TO SOUTH AFRICA?

Credit rating agencies are private companies who assess the ability of borrowers, either governments or private enterprises, to repay their debt. The agency issues a credit rating based on the borrower's solvency.

Investors take credit ratings along with other criteria into account to help manage their portfolios. A rating downgrade indicates a higher risk for the lender, and depending on how sensitive markets are, investors may require a higher return to protect against this risk.

Sovereign credit ratings inform investors of the level of investment and political risk a country carries. Countries with a low sovereign debt credit rating of BB or lower by Standard & Poors or Ba or lower by Moody are considered non-investment grade or junk bond status.

Junk bonds are considered speculative investments by investors which is why investors demand higher interests on the capital borrowed. The consequence of the higher-priced capital trickles down to consumers as money moving through the economy becomes more expensive and harder to come by.

Pension funds and other savings may potentially lose value as higher interest rates impact economic conditions, which in turn affects a company's ability to generate profits.

HOW DID CREDIT RATING AGENCIES COME TO PLAY SUCH A CENTRAL ROLE IN THE FINANCIAL MARKETS?

Today, the three biggest global rating agencies are Fitch Rating Ltd, Moody's and Standard and Poor's. Between them, they control 95% of the market.

A Brief History of the Big Three

In the mid-1800s, railroads were some of the largest corporations in the United States. The rapid expansion of the railroads across the American continent quickly outstripped the funding capacity of banks, and so the railroads and other corporates began issuing corporate bonds. As the bond market grew, so did the need for better information about the debtors and debt security.

S&P is the oldest of the big three. It started in 1860 when Henry Poor wrote and published an investor's guide to the US railroad industry, recording financial data about the railroad and canal industries. By 1923 the Standard Statistics Co. began rating mortgage bonds providing investors with essential information on the bond market. And in 1941, Poor's Publishing Company merged with Standard Statistics Company to form Standard & Poor's.

The financial crisis of 1907 increased the demand for independent market information and analysis of bond creditworthiness. In response, financial analyst, John Moody issued a publication in 1909 focused solely on railroad bonds. His ratings became the first to be published widely in an accessible format, and his company was the first to charge subscription fees to investors. In 1913, Moody's rating publication underwent two significant changes: it expanded its focus to include industrial firms and utilities, and it started a letter-rating system. It was the first time public securities were rated using letters to indicate their creditworthiness.

The smallest of the big three, Fitch Inc. was founded by John Knowles Fitch December 24, 1914, in New York as the Fitch Publishing Company. He published the Fitch Bond Book, the Fitch Stock and Bond Manual, and other services furnishing daily and weekly statistics on the New York Stock Exchange and the American and Canadian corporate security field.

By 1936, rating agencies were firmly rooted in financial landsape. US banks were permitted to hold only "investment grade" bonds. And it was the ratings of Fitch, Moody's, and Standard & Poor's that legally determined which bonds were investment grade. And In 1975, the US financial watchdog, the Securities and Exchange Commission (SEC) began to specifically reference credit rating requirements carried out by Nationally Recognised Statistical Ratings Organizations (NRSRO).

In doing so, they acknowledged S&P, Moody's and Fitch as the first of these NRSRO's who became known as the big three. Ratings provided by these companies are used by investors to assess investment risk and as benchmarks by federal and government agencies.

Further credence comes from the fact that some regulated investment funds are mandated only to hold bonds and investments that have a high rating from an accredited rating agency. Consequently, in the event of a downgrade in ratings, regulated funds would need to sell off these assets.

HOW ARE CREDIT RATINGS ESTABLISHED AND USED?

Today, the big three are hugely successful agencies generating income in the upper hundred million in USD. How do they do it?

Two standard models under which agencies collect fees are the subscription model, started by John Moody in 1909, and the debt issuer-pays model.

Under the subscription model, investors such as in the financial analysis department of a bank or a financial institution will pay a subscription fee to receive access to the ratings of a business or government. These ratings are not made available for public use.

In the debt issuer-pays model, credit rating agencies collect a fee from the entity, either a business or government, seeking to receive a rating. In this instance, agencies make their ratings freely available to the markets.

In 2009, a World Bank report proposed a hybrid of these two models. It would require issuers (borrowers) who pay for ratings from credit rating agencies to source additional credit rating scores from other credit rating providers where those providers only release the credit rating information to paying subscribers.

Although there is no standard rating scale, credit ratings are typically expressed by letters corresponding to the potential risk. The highest rating is represented by AAA and the lowest rating by C or D. In addition to a letter grade, a credit rating might also contain a “forecast” describing how a rating may change in the future. For example, a credit rating with a negative outlook may indicate a future downgrade.

Each rating agency has its method to calculate its ratings. These methods take into account quantitative (financial data), qualitative (business strategy for a company or political stability for a country) and contextual criteria (changes in industry for a company or public finances for a country).

HOW DID S&P DETERMINE SOUTH AFRICA'S CREDIT RATING DOWNGRADE?

When analysing the credit risk of a country, S&P has a 5-8-member team that analyses the following aspects to decide on the credit rating of a country:

Political risk - are there any issues from a political standpoint that impede the country from paying or servicing its debts? A country in turmoil or at war is unlikely to pay back anything.

Regulatory risk - do the policies and regulations make sense for the environment and investors? Are the custodians of such policies and regulations adequately experienced and committed to these policies and regulations?

External risk - is there a threat of war or trade sanctions, termination of trade agreements or concessions?

Fiscal risk - is the government borrowing too much and does it spend too much on non-productive expenditure?

Economic risk - Is the productivity of the country decelerating and the GDP growth slowing? If the economy is in turmoil, the government can collect less revenue from companies and individuals.

When it comes to assessing businesses, S&P considers the following list of indicators:

The quality of the assets – entails an assessment of the quality and value of the assets against which the institution is borrowing. It assesses if there are sufficient assets to cover the debt which could be used as collateral should the borrower fail to repay.

Quality of the management team - the calibre of management and their ability to drive business growth as well as their ability to manage debt and risk is considered.

Quality of the business - this takes into account the performance of the business and whether or not it is growing and also if there are any external market, political or economic risks it faces.

Financial balance sheet - does the business have any existing debt and are they in a position to service this and take on more debt and continue to repay this additional debt?

The S&P ratings range from AAA* to D (fail grade). In the international bond markets, most countries and businesses are rated this way.

S&P apply the following scale

AAA - Highest Safety	Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.
AA - High Safety	Instruments with this rating are considered to have a high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.
A - Adequate Safety	Instruments with this rating are considered to have an adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.
BBB - Moderate Safety	Instruments with this rating are considered to have a moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.
BB - Moderate Risk	Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.
B - High Risk	Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.
C - Very High Risk	Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.
D - Default	Instruments with this rating are in default or are expected to be in default soon.

ARE CREDIT AGENCIES RELIABLE?

Do credit rating agencies always 'tell it like it is' or are they accountable for having made some serious mistakes?

For example, credit rating agencies did not pick up the flaws in various debt-linked securities that triggered the sub-prime crisis, and they continued to rate mortgage-backed bonds as investment-grade right up until the crisis occurred.

Similarly, credit rating agencies rated Enron as investment-grade until four days before its collapse while the share price had been dropping for a considerable time before that. Popular reference is also made to Enron's Auditor at the time, Arthur Anderson, who was found guilty concerning their handling of the auditing of Enron.

Credit rating agencies and others have offered several explanations as to why inaccurate ratings and forecasts have occurred in the past. The reasons given at the time are summarised below from an article published by the Wall Street Journal:

- The methodologies employed by agencies to rate and monitor securities may be inherently flawed where they rely on inaccurate historical data. For instance, a 2008 report by the Financial Stability Forum singled out methodological shortcomings, especially inadequate historical data, as a contributing cause in the underestimating of the risk in structured finance products before the sub-prime mortgage crisis.

- The rating process relies on subjective judgments. Governments, for example, that are being rated, can inform and influence credit rating analysts during the review process.

- The credit rating agencies' have an inherent conflict of interest to please the issuers (borrowers) of securities, who are their paying customers and who benefit from high ratings. Issuers (borrowers) stand to benefit from higher ratings in that many of their customers (retail banks, pension funds, money market funds, insurance companies) are prohibited by law or otherwise restrained from buying securities below a particular rating.

- The credit rating agencies may be significantly understaffed and thus unable to assess every debt instrument accurately.

- As credit rating agency analysts may be underpaid relative to similar positions at investment banks, it has been suggested that credit rating analysts have migrated to these higher-paying jobs, taking their inside knowledge of rating procedures with them. From this vantage point, it is easier to facilitate the manipulation of ratings by issuers.

- The practical use of ratings as regulatory mechanisms may inflate their reputation for accuracy.

In all fairness, these challenges are equally applicable to all independent professional practitioners that engage and express an opinion on a company, issuer or security. While not wholly fail-proof the role of credit rating agencies is widely accepted as indispensable to both issuers and investors. Their quantifying of risk and predicting uncertainty does provide a clearer and more efficient approach to investing in the global market.