

Credit rating agency: impacts of regulatory changes



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How rating agencies operate, and recent regulatory changes.

Credit rating agency is a private company that is assigned to detect the creditworthiness of businesses, individuals or other organizations. It uses very many factors to assess the ability of the borrowers to repay their debts. It is majorly based on the borrower's solvency. The main instruments rated by the rating agency are the government bonds, corporate bonds, stocks exchange, municipal bonds and security collaterals. These obligations to assess the creditworthiness is issued by the companies especially banks in order to give loans to other business or companies. The agencies have been in practice for a long period since the 20th century. The agencies have certain regulations that governance its operations. This work explores the activities of credit rating agency how they operate and reasonable regulations that have changed recently (White, 2010).

The main purpose of the rating agencies is to give the rating to businesses that issue debts, which involve Private Corporation and the national government and other forms of government. The agency has proved to be important in the lending, and the financial industry as information is for the investors to demand to receive adequate compensation for the risk involved in any particular investment is critical (White, 2010).

Investors take into account the credit rating to help manage the range. Lower rating translates to greater lending risk by a lender. In consideration of the market trends, the investors may lend at larger rates in higher risk to protect against the risks thus, having an overall effect of raising the lending rates.

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Credit rating agency is also essential as the information they provide are used to determine the interest to be charged on loans given or possible returns expected. Business with a low rating and high risk would attract high-interest rate while the high rating and low risk would attract the low-interest rates. The investor seeks such opinions from the rating agencies in order to make appropriate investment decisions.

In history, as from the beginning of the 20th century, three companies, Fitch, Moody, and standard and poor's were formed to help the investors to access the ability of other individual be able to repay loan or assistance given to the by such institutions. For Fetch, it had a unique characteristic of publishing its finding on the stock and bonds financial statistics. The standard and poor it had the same approach as for the Fitch Moody's company but was a bit different, as it was proving its rating on the government bonds. The companies help so many organization and business to consolidate their asset and operation thus improving lending among the companies (Pinto, 2006).

Creditworthiness, being the capability and willingness to make full payment of debt in required time, some companies due to financial constrain cannot be able to make such commitments. In order to determine the timely debt payment a number of factors are considered, the financial risk, industry risk, business and risks associated with management. This factors if not put into consideration a business cannot repay the debt. With the factor in place, certain criteria are used to assess the credit rating process (White, 2010).

In order for any business to repay debt, the venture should be able to generate sufficient cash to fund all its operation and still have the excess to

be used for the repayment of the credit. And the most important is the ability to repay the debts in full within the stipulated time happens is what most credit rating the company's main point of interest (Pinto, 2006).

Certain factors are use in determining the rating for businesses, these factors considered can be grouped as either qualitative or quantitative. These factors also depend on the type of business in question. Different businesses have different fundamentals and management structures. The environment of operations also marks an important factor. Business can prosper quickly or perform poorly based on the area it is situated. The industry in which the company operates is also important as some industries attract more risk than others or have a varying degree of requirements to run. The extent of market dominance as it provides the positions and influence in its operations. With all these factors in place, it's possible to determine and make a comparison between the financial and business risk (Pinto, 2006).

Quality analysis

The environment of operation is coupled with the company itself before rating the company. It is important to have a detailed analysis of any operating risk of the issuer which involves its internal and the external business environment. Then there is analysis to evaluate the financial risk involved. Assessing the financial risks would help to keep the potential of the firm to repay the depths.

Industry

An industry in which the issuer is active determines the external factors in which the business can be successful, or it can fail to perform in. This gives the credit a platform in which it can assess the business qualitatively. The rating takes into consideration the mode of the company cycle and its volatility as it a tool for the long-term assessment of the capabilities to repay the loan or debts involved. In this case, the level of capital intensity and competitiveness make the critical business environment; It influences the rating since in most scenarios these factors impacts on the cash flow within the firm and the timely debt repayment (Pinto, 2006).

To arrive at a rating, a real business profiling is conducted which involve in-depth analysis of the finances and the business itself; this profile is in conjunction with the riskiness in the particular industry. If a company operates in a relatively risky industry there a possibility of slightly lower rating irrespective its of the financial performance (Pinto, 2006).

To case study on the industry, an oilfield service company is considered. The industry involves the companies that drill, provide oil services and gas exploration. These companies do suffer if done profile do not incur financial risk, but in case it is there it's in low level, but instead, they have the business risk. It's characterized by the firms being highly specialized thus limited product are offered, the risk they are involved in are hard to avoid, the risks are spillages, contaminations, environmental risks and political risk. There is no barrier to entries posting possibility of stiff competition among other critical factors.

The business risk assessment; the size of the rating would be able to tell if it will be able to withstand the petroleum price that is extremely volatile. In these feeds of operations, the economies of scale matter a lot since for the business with large sizes are not significantly affected by the changing prices. Other factors that are used include; operating efficiency which involves the cost of operation and the influence due to the ever-changing prices, capital intensity, sovereign governance, and the corporate governance. Other important factors considered are contractual position, diversification in customers, environmental factors and workforce enterprise (Pinto, 2006).

In the rating, the financial and the business risk are blended to come up with the best rating. In most case, in such an industry the business risks are more than the financial risk. However, at some low level of rating the financial risk take precedence to environmental factors.

The position in the market

Market position in most cases may override if the business that operates in highly competitive environment which happen when assessing the industry. The critical factors to be considered include, the ability to influence or maintains prices in the market, for the sake of customers who are key and the products are diversified, in case there is competitiveness in the market and above all to what the business market share (Pinto, 2006).

Taking business size into consideration only is only helpful in rating if the size has an influence on the cash flow regarding cost, operation efficiency, and the economies of scale which mainly experienced in oil industry
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explained above. Market position is, therefore, important in gauging the ability to cope with changes or disruption factor influencing its existence. If a business is a dominant business in a particular environment, it means that the firm can easily carry its operations but still manage to pay its debts obligations within time. This is because such business has a broad customer base so they can have good returns within a short period. Assessing based finance would give high results result.

Business management

The way business is managed greatly determines the creditworthiness. The analyst would consider the management skills in their ratings. Excellent managerial skills to business have many benefits to the success of the firm. However, in rating management, it is evaluated in more comprehensive perspective more than just operational success. The tolerance is a critical determinant. Tolerance in business manage is the ability to sustain the business running despite other factors that may hinder smooth business operation. Factors that would rate the company include maintaining market positions with a well-established management's track record, the long-term financial performance of the venture, having established efficient operating system form the basis of qualitative analysis if the rating.

Rating base on management further takes into consideration the following. The company policy, establishment of policies should be in line with the objective of the business. These should stipulate the financial risks that are involved and incase the do exist, the appropriate ways to mitigate them. An

analyst would particular concentrate on the financial risk polices created by the company.

Organizational considerations

The senior management plays a significant role in determining the success of the business. The management is the core decision makers, and the analyst relies most on the decisions they make to run the decision. The number of people involved in the process of decision making and the frequency of its adjustments. Problem crops in when old decision are still being used to influence a business that is in an ever changing market trends.

Adding to risk tolerance, the reliability and credibility in determining the creditworthiness are based on the tolerance. Businesses which are at high-risk financial aid are starting businesses. So many challenges are normally encountered in the business before it gains stability especially in a highly competitive environment. If the management can sustain such constraints and still be able to repay a particular loan with a stipulated time, then such a business could earn a higher rating in the credit rating agency (Pinto, 2006).

Management strategy, any successful business should be able to anticipate the future base on its past and present. Having a short and long term strategies that predict the future and maintaining the strategies chosen to form the best platform for analysis. The short term plans short be engineered to ensuring maximum earnings to the business (Langohr & Langohr, 2010).

Quality analysis of corporate governance firms

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Still, on the management of corporate firm have a bit complex management compared to other business as it has many people involve in senior management position forming the board of management of which must participate in decision making of affirms. The board should be effective. To ensure the effectiveness of the board its primary role of oversight and ability is important. Once the decisions have been made, then its implementation is by junior members. The analysis focuses on the capacity of the board to have a big oversight that would see smooth operation with emphasis on incentivizing management in the execution of the financial responsibilities (Langohr, & Langohr, 2010).

The board should also be independent. An independent director would participate in decision management with a clear focused mind. Those executives with some degree of loyalty to their seniors do not make rational decisions as their decisions are influence by their relations which may set back the corporate especially its finances which the main point of focus in the rating

Financial discipline and accountability is another major consideration by the credit rating of the business. Factors that are considered are the compensations within the organization. A corporate which grants remuneration far above what is normal in the market is likely to have low ratings. Money transaction among the stakeholders such as top management, the sister companies and between shareholder cannot be trusted as accountability is likely to be a problem (Langohr & Langohr, 2010).

Companies or nations

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In rating countries or companies, the following factors are considered. The political risk; most companies do have internal politics. Business politics is good if it only it can embrace diversity and allows people to share their different ideas get synergize them together to come up with better solution or leadership to the business. In cases where bad politics is present, the probabilities of financial impropriates are high which would give a poor rating.

National politics could lead to a country of peace which business operations are being carried on smoothly. In such an environment with political stability, a business can carry out its operations to get funds to pay their debt within time. This also applies to government borrowing. In case a country is in turmoil business are negatively affected thus their ability to repay their debts due to the risk involved is lowered therefore in such case the rating would relatively reduce irrespective of other factors.

Regulatory risk; the laws that are enacted by countries are supposed to create a conducive environment for enabling business. The government should adopt policies or sign trade agreements that protect the local investments. In such as case, the economy grows allowing business and the government to repay loan. Some countries do enact monetary policies that act like a bullet shooting them in the foot. These policies may affect the countries' internal and foreign investments.

External risks: These risks relate to the treat such as wars or trade sanctions. A country that is engaged in war is at high risk of punishment by trading blocks and other external countries. In case a country receives such treat the

implication is that it's not able to carry any business with other nations.

Which means it cannot be able to earn foreign exchange and which is used in repayment of government borrowings

Fiscal risk; this depends on the balance between the government borrowing and expenditure. Is the government borrowing too much and spending away? Majorly the problem of over borrowing is common in third world countries in which the government officials are corrupt. Government borrowing is supposed to be channeled to projects that could create the return to help repay such loans. Countries with poor quality fiscal policies are rated lowly by the credit rating agencies.

Economic risk; the economy of a country is determined by the gross domestic product. When there is a case of a poor economy such as in a case of civil wars, the government cannot collect taxes, and there are cases of inflation which affect the country's and company's ability to repay the loans (Pinto, 2006).

Accounting

Creditability and accountability of finances in an organization is shown by good accounting. The financial reporting is a clear indication that a business is financially disciplined. Credit institutions rely majorly on the accounting statements of a business. Accurate and transparent accounting books can motivate financial institutions to grant credit facilities to business. On the rating, unclear books of accounting that could be as a result of interference by the management or workers have a negative implication on the

assessment of the creditworthiness of the business. The agencies would also
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use the accounting theories in areas as depreciation, goodwill, consolidations and pension provisions that would demonstrate a true figure of financial performance (Pinto, 2006).

Quantitative analysis

Other than the qualitative analysis where there is detailed assessment of the finances is analyzed there is also a quantitative survey by the credit rating agencies. Quantitative analysis deals more with the cash generation ability of the issuers. To detect long-term sustainability an important ratio is considered, the profitability and the debt coverage ratio this requires the provision of financial projections for a period of next three or five years. The quantitative measure and development and trend are significant in the analysis.

Profitability

Profitability is determined a by a number of financial ratios. The ability to make profit is the main determinant of the level of credit protection and the degree of credit risk for investors. The potential to obtain capital internally and enter the external capital sources is directly proportional to the company's returns and operating margins. The margins i. e. operating income and sales provide the issuer's profitability as a result of revenue growth excluding the profits. Comparisons are possible due to companies of the same level (Kisgen & Strahan, 2010).

Cash flow

Payments of interest or principle are not made on the earnings Even though it seems to be connected to the profitability. When the operating cash flow is enough to services the debt and its operation that is the time it can be used to make payments.

In credit rating methodology, cash flow is being taken as the most important as an essential part of the analysis. It is not possible to cover underperformance or loses through funds from external sources. Specific attention is on the extent the issuer depends on external funds and cashflow from operations.

For companies to make future obligations, their cash flows are integral. It further focuses on the leverages, coverage, and earnings which are used accounting methods which are a particular and different valuation of assets. This implies that at no point it will mirror the correct financial position of the issuer and his ability to service the debt (Kisgen & Strahan, 2010).

Flexibility of finances

When the company is under constrains, they react in a particular way shown by the financial flexibility. The rating checks at the debt serving during the time in which the finances are volatile in the business and in case the company could be having any other sources considered as external. The financial flexibility is directly proportional to funding options that are available for business. The flexibility in the finances is affected by the debt levels especially the short-term debts. Other effects to financial flexibility are loans with more restrictive terms, possibilities of legal issues, insurance

covers missing and pensions which are not fully funded (Kisgen & Strahan, 2010).

Capital structure

This is the dependence of business on the external source of funds. This highly affects the debt serving ability. If a company entirely depend on the external source, it is hard to predict how it would be able to repay the debt (Kisgen & Strahan, 2010).

Pros and cons Credit rating agencies like any other agency have pro and con in its operations. The advantages include they help institutions get better rates. For institutions with higher grades are in a position to borrow many at the rates which are favorable, it is a kind of an incentive to the businesses with good management and whose creditworthiness is not doubted.

Help warn investors of risky companies; for the investors who want to invest in high risk, businesses are in a position to know the level of returns they expect from companies of low rating. It is due to this high risk that such investors are able to make surplus compared to the other normal investors.

Provision for a room for improvement as a good incentive for the business rated poorly, it is an opportunity for them to realize the areas they should change in. A common challenge is that such businesses are normally in denial of their debt status. However, for those that accept do get advice as an incentive to their improvements.

Since anything with advantage must have the other side, the cons of credit rating include evaluation being highly subjective; the rating between <https://assignbuster.com/credit-rating-agency-impacts-of-regulatory-changes/>

different companies varies considerably. This because there exist no known standard formula or guideline used by credit rating institutions in their work, the general rating is based on their judgments.

The possibility of a conflict of reference: In making reference to cases in the department of justice USA where there was a possibility of a conflict of interest in mortgage-backed securities that collapse in 2008. The rating companies at times provide their services to companies which make the private request. However, they can make such rating and give to investors even if the requesting company still pays them. Conflict of interest to occur when the business does not a company is given good rating they do not deserve on the basis that this rating company wants to retain them as their customers (Mulligan, 2009).

Lastly the ratings are in most cases not very accurate. For a long time the way the agencies rate have been subject to a lot of questioning. In as much as they do have a consistent rating, it does not translate to accurate rating. The inaccuracy can be case studied mortgage-backed securities that recessed despite the good rating it was given by then.

New regulations on the credit rating agencies

Reform Act has been enacted to with the aim of improving rating quality, investors protections and for the transparency, accountability, and competition in the credit rating market. I the USA the amendments geared toward the CRA include CRA reform act of 2006. The act raised the number of NRSRIs which lead to increase in competition among the CRA, in case there was no-action letter process in designation, then an agency can seek <https://assignbuster.com/credit-rating-agency-impacts-of-regulatory-changes/>

to designation by submitting applications to SEC with the new laws (Hill, 2012).

The CRA companies were required with the new regulation to adopt NRSROs of particular policies and procedures which would prevent misuse of non-public information, materials and on the issue of management potential of interest; SEC was mandated to inspect these adoptions by the CRAs

the new regulations further demand that NRSROs are to provide their procedures and methodology in which they use to in rating, provide the SEC with information regarding quality of information, accuracy and reliability, including the information from the third parts used in rating the issuance, the NRSRO was to have board of director who is independent as they give internal control which implements, maintains and enforce the policies, methodologies, and procedures of credit rating.

Right of action against ratings agencies can also be brought by the investors regarding the reckless failure to conduct a reasonable investigation of the fact or use of independent source to gain information. Qualifying exams and continuous education were enacted, and it was mandatory for the analyst to do and pass the exams.

Other international agencies also such as the European Union also stipulated some of the rules for the rating agencies. The new rule seeks to reduce overreliance on credit rating, which specifically was dependent on the external rating but instead, financial institutions were to strengthen their risk assessment programs. The credit rating companies were to be more

accountable for their activities in case there was intentionally or due to the negligence of other regulations.

Conclusion

The credit rating agency is important organs for the investor to base the decision in their rating as it gives the picture of the creditworthiness of the issuer. The investor can determine more accurately the returns from the investment and the risk involved in a particular investment plan. Financial institutions also can use the report from this agency to reduce the possibilities of high loan defaulters in their operation. However due to poor historical misconduct of some of the agencies and numerous disadvantages associated with such agencies companies have made losses and recesses as well. In line with this US government together other-other international bodies enacted laws and regulations to that strict governance the agencies and its operation by majorly making reference to mortgage-back securities.

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