

## Importance of Credit Rating

A credit rating estimates ability to repay debt. A credit rating is a formal assessment of a corporation, autonomous governments, individuals, conglomerates or even a country. Credit rating is evaluated on the basis of financial transactions carried in the past and assets and liabilities at present. Credit rating allows a lender or a credit granter to evaluate the ability of the borrower top repay a loan.

### Why Rate Risk?

A Credit Rating Agency plays an important catalytic role fostering the growth, stability and efficiency of global and domestic capital markets. A comprehensive analysis of a credit instrument and a subsequent impartial assessment of the credit risk of the instrument, offer numerous benefits to all parties in concern. Reasons for rating credit risk could be rationalised from the following perspectives:

#### 1. Country

##### ***Achieve a higher economic growth and a higher standard of living***

For a country to achieve high economic growth and a higher standard of living it is imperative to have a mechanism capable of attracting savings and channelling them efficiently to investments that create national wealth.

Credit ratings play a pivotal role in the disintermediation process. Ratings reduce uncertainty. Less uncertainty means greater saver confidence, which encourages bond market growth and greater market efficiency and liquidity. Ratings help reduce information costs and increase the ability of savers to determine the quality of the borrowers in the market. Essentially, the rating system fosters market efficiency by providing a universal language for credit risk evaluation and by contributing to the market's common body of analytical information on various fixed income borrowers. This increases the degree of 'transparency' in the financial markets, which itself serves several purposes. Greater transparency help savers to reduce the uncertainty about the credit risks of unfamiliar securities and issuers, which in turn help to channel more savings into national wealth creating projects leading to economic growth and a better standard of living for Sri Lanka.

Credit Ratings facilitate the development of long-term fixed-rate local currency bond markets that contribute to the management of financial crises and country risk. Local currency bond markets are the most stable type of funding that a Country can have. By spreading investments, risks among numerous widely dispersed investors local bond markets diversify more risks than bank finance whereby long-term finance for high-risk projects becomes possible. The issuance of longer-term bonds lengthens the maturity of liabilities of non-financial firms, shrinking the maturity mismatch. If commercial banks issue longer-term debentures, such corporate bonds also contribute to mitigating a maturity mismatch of the banking sector.

Further, fixed rate local currency bond markets compared to foreign currency borrowings act automatically to stabilise markets both when times are good and bad. When there is a crisis and interest rates go up, inflation often increases and value of the currency declines, thus reducing the real cost of fixed rate debt and therefore the debt burden of Corporates. As things get worse on the asset side, the liability side shrinks enough to reduce or even eliminate the debt burden. Borrowing in foreign currency or short-term local currency does the exact opposite; it makes good times even better, but causes bad times to spin out of control.

## **2. Investors / Savers**

### ***Default risk protection***

It is imperative for savers to find out from an independent third party the default risk of the fixed income investment prior to investing any money. In the absence of ratings, they will have to make their investment decision purely based on reputation and historical financial information of the borrower that may have little bearing to future financial condition of the borrower. From a saver's perspective, the ratings' central value is to serve as an accurate predictor of future default risk of the borrower. Further, credit ratings help savers to determine the risk premium that should be demand to compensate for the default risk when making fixed income investments. Savers do not pay any fees for credit ratings but need only to demand to know the credit rating of the borrower prior to investing.

### ***Not all guarantees are safe***

Although various investments are sold using the word “guaranteed”, the borrower itself cannot give a guarantee, only a financially strong third party can give a guarantee. If a debt instrument is guaranteed, the guarantee agreement should be thoroughly screened by the investor, to find out whether the guarantor is credible and whether the guarantee provides full credit substitution. One should question whether the guarantee is unconditional and irrevocable, enforceable in all circumstances, the guarantee and the indenture is structured so that in the event the borrower fails to make full and timely payment, the guarantor will do so on a timely basis before default occurs and before seeking other remedies and whether the guarantee provides for full payment without any carve-outs. The “small letters” matter a lot when investing in guaranteed debt instruments. Sometimes, even in a full and unconditional guarantee, the guarantor could be weaker than even the borrower. Unless the investors can perform a thorough due diligence on their own, it is sensible to request a rating before one invests in guaranteed debt.

### ***Enhance returns for Individual Investors***

Savers need to invest carefully to have sufficient money for the future for retirement, ill health, children’s education, marriage etc. without loss of value of their money due to inflation. The majority of savers in Sri Lanka are deceived by high-pressure savings account promotions and deem these as safe investments.

Increased awareness of the risk created by credit ratings would help savers to build their savings by diversifying into more suitable long term investments such as government bonds and high quality corporate debt instruments, and obtain increased returns above inflation.

### ***Compare risk and returns offered***

Credit Ratings clearly convey the default risks of various fixed income investment products offered to the public such as corporate debentures, Commercial Paper, Finance Company Fixed Deposits, Life Insurance Products, Certificates of Deposit, Promissory Notes, Preference Shares, etc. Therefore, investors would be able to compare the risk and return offered by one investment against risks and returns of all other investment opportunities, and select the most appropriate investments that meet the individual risk tolerances.

### ***Enhance Returns for Institutional Investors***

The absence of an independent and reputable rating system in Sri Lanka barred institutional investors such as pension & provident funds, insurance companies and unit trusts from investing in corporate bonds, which they viewed as highly risky and channelled their funds largely to Government debt instruments.

Further, institutional investors could make use of ratings to create “buy lists” based on their risk tolerance. For example, they could establish policy guidelines that stipulate that it may not buy or hold securities rated below a certain level, thus leading to better control over management of public funds. Institutional investors could also use ratings for comparative purposes - to compare risk-adjusted yields on a range of potential purchases or to monitor portfolio holdings in comparison with all other securities available in the marketplace at a given time.

### **3. Borrowers / Debt Issuers**

#### ***Reduce costs***

Profitable and well-managed Corporates can lower their cost of funds by borrowing directly from the public instead of borrowing from banks. This could result in substantial savings of financing costs, as they would be able to save a large proportion of the interest spread (difference between bank lending and deposit rates) charged by banks. Ratings help to differentiate risky Corporates with those that are not risky and remove investor uncertainty, thereby reducing risk premiums to their appropriate levels.

Corporates could also benefit significantly, under the new Central Bank regulations where licensed commercial and specialized banks are allowed to invest in investment grade rated Commercial Paper (CP). Corporates could not only save costs on the bank guarantee fees, which are higher than rating fees, but also free some of the collateral that would have been pledged to obtain such guarantees.

Substantial savings will accrue to frequent issuers of debt in the capital market. Outstanding credit rating opinions enable issuers to offer a regular, sizable and stable supply of bonds of high quality and uniform characteristics to the market. Investors will become comfortable and look forward to such issues and take less lead-time in deciding to purchase such issues.

Further, in a market with many ratings outstanding, an issuer is provided a benchmark in assessing investor demand and the pricing of his debt securities.

### ***Increase the flexibility of funding sources***

Credit ratings can be used as a 'credit passport' to communicate the credit quality to the investors to get access to wider sources of capital, and the most optimum form of

### ***Financing to match the tenure and risks of the investment.***

Issuers would be able to increase the flexibility of their financing sources by raising funds from institutional investors, particularly from EPF, NSB, unit trusts and insurance companies, using credit ratings and reduce their dependence on conventional banking sources. Capital market borrowing, unlike bank borrowing does not require land & buildings or machinery to be pledged as collateral. Borrowers could avoid being entirely dependent on Banks for their funding and assets could be kept free of lien. Therefore, at times of adversity, bank funding would be available at short notice for them as an alternative source.

### ***Advantages for both listing and private placement of debt***

When desirable, Corporates may consider a listing of their debt at the Colombo Stock Exchange and avoid the turnover tax and defense levy on interest applicable to bank loans. Alternatively, they may raise funds directly from captive sources through a private placement.

### ***Enhance corporate image***

A rating would also enhance the corporate standing when dealing with existing and potential foreign clients and partners.

### ***Unique independent third party appraisal***

The mere process of undertaking a credit rating will give Corporates, a comprehensive third party review of the Company's product market offering, adequacy of systems & controls and risks the company is exposed to. Considerable value addition, by way of ideas, strategies, and systems improvement advice is offered to the management to take appropriate steps to overcome any weaknesses. Additionally since the rating process identifies the main down side risk drivers, Corporates would be able to adopt appropriate strategies to enhance their shareholder value.

## **4. Intermediary**

Merchant bankers, underwriters and other intermediaries will find ratings valuable in the planning, pricing and placement of their clients' debt securities.

### ***Ratings facilitate the placement of debt issues to a wide investor base.***

The existence of a pool of rated debt securities may help to create a risk-based price structure in the market which would enhance the merchant bankers' ability to price a debt issue of a given credit quality.

Ratings also allow intermediaries to monitor the risk and pricing of debt securities that are held in their own portfolios.

## **5. Regulators**

An independent and well-run rating system will serve a number of quasi-regulatory market functions at less cost to the government:

A system of ratings that is publicly available and prudently and continuously updated can aid in counteracting the effects of rumours and speculation and increase the public confidence in the financial system, necessary for the development and stability of the financial markets.

The transparency promoted by ratings can open up a cost efficient means of financing the nation's private sector.

In some countries such as Japan, the United Kingdom and the United States, regulators use ratings to assign values to debt securities held in inventory under risk based capital guidelines for financial institutions.

Another important potential need for ratings exists in the privatisation of state enterprises. The privatisation process will create a need among foreign and domestic institutional investors for ratings during and/or after the sales of public companies.

The availability of rating services will also induce corporations to issue new structured instruments to create alternative sources of funds, thus stimulating financial innovations.

(Source Fitch Ratings Lanka)