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CREDIT RATING AGENCIES (CRAS)

This article covers "Daily Current Affairs" and the topic details " Credit Rating Agencies (CRAs)". This topic has relevance in the Economy section of the UPSC CSE exam.

GS 3: Economy

Why in the news?

Sovereign ratings provided by credit rating agencies are widely regarded as a reliable measure of the default and credit risks associated with a rated sovereign. These ratings, in turn, play a crucial role in determining the cost of funds borrowed by a country. However, a closer examination of the rating methodologies employed by credit rating agencies reveals several issues.

About Credit Rating Agencies (CRAs)

Credit Rating Agencies (CRAs) are independent organizations tasked with assessing the creditworthiness of individuals, corporations, and governments. Their primary role involves evaluating and assigning credit ratings to debt securities and financial instruments issued by these entities. The resulting credit ratings offer crucial insights for investors and other market participants, aiding in risk assessment.

Key Features of Credit Rating Agencies:

Credit Ratings:

- CRAs employ alphanumeric symbols or letter grades (e.g., AAA, AA, A, BBB) to rate debt instruments or issuers.
- Higher ratings indicate lower credit risk, assisting investors in gauging the safety of their investments.

Independence:

- Maintaining independence and objectivity is a core principle for CRAs.
- Unbiased opinions on credit risk are essential to facilitate well-informed investment decisions.

Issuer-Pays Model:

- Traditionally, CRAs were compensated by the issuers of the securities they rated.
- Concerns about potential conflicts of interest prompted efforts to improve transparency in the rating process.

Regulatory Mechanism:

- Many countries have regulatory bodies overseeing CRAs to ensure transparency, accuracy, and fairness in assessments.
- Regulatory oversight helps address concerns related to conflicts of interest and maintain the integrity of credit ratings.

Types of Ratings:

- CRAs provide ratings for diverse debt instruments, including corporate bonds, municipal bonds, government bonds, and asset-backed securities.
- Issuer credit ratings reflect the overall creditworthiness of a company or government.

Evolution of Major Sovereign Rating Agencies:

Pre-Bretton Woods Institutions:

- Sovereign credit ratings predate the establishment of Bretton Woods institutions.
- Globally recognized agencies, Moody's, Standard & Poor's (S&P), and Fitch, played crucial roles.

Moody's:

- Established in 1900, Moody's issued its first sovereign ratings just before World War I.
- Holds the distinction of being the oldest among the major rating agencies.

Standard & Poor's and Fitch Origins:

- In the 1920s, Poor's Publishing and Standard Statistics, which later evolved into Standard & Poor's (S&P), initiated the practice of assigning ratings to government bonds.
- These agencies have since become prominent players in the sovereign rating landscape.

Importance of Sovereign Ratings:

Creditworthiness Marker:

- Assess the creditworthiness of governments.
- Crucial indicator for global investors regarding a government's ability and willingness to repay debt.

Assess the Borrowing Ability:

- Similar to individual credit ratings, sovereign ratings impact a country's borrowing capacity.
- Higher ratings indicate more reliable borrowers.

Interest Rates Impact:

- Governments with strong repayment history and assets enjoy lower interest rates.
- Lower sovereign ratings lead to higher interest rates, affecting both governments and businesses within the country.

Set Safety Benchmark:

- Governments serve as a benchmark for safety in a country.
- Low sovereign ratings indicate higher risk, impacting the entire economic landscape.

Global Investments and Borrowing Costs:

- Poor sovereign ratings limit borrowing capacity for developing countries, hindering economic productivity.
- Affect global investments and a country's ability to attract capital.

Impact on Poverty and Economic Productivity:

- Favourable ratings facilitate easier borrowing, enabling countries to leverage resources for development.
- Poor ratings hinder economic growth, posing challenges to poverty alleviation and productivity.

Indian Government's Critique of Rating Agencies:

1. **Opaque Methodology and Bias Against Developing Economies:**
    - The Finance Ministry criticizes the lack of transparency in rating methodologies, citing biases against developing economies.
    - Highlights Fitch's bias favoring high foreign ownership in banking, disadvantaging nations with a public-sector-dominated banking industry.
    - Emphasizes the discriminatory nature of assessments, neglecting the developmental role of public sector banks in fostering financial inclusion.

2. **Transparency in Selection of Experts:**
    - The government raises concerns about the non-transparent selection of experts consulted for rating assessments.
    - Lack of clarity in the expert selection process adds complexity to an already intricate methodology.

3. **Unclear Assignment of Weights for Parameters:**
    - The Finance Ministry contends that rating agencies fail to clearly convey the assigned weights for each parameter.
    - Fitch's provision of numerical weights for some parameters is criticized for ambiguity, as these are deemed illustrative rather than definitive.

4. **Questionable Use of Composite Governance Indicator:**
    - The government questions the reliance on the composite governance indicator, weighted at 21.4, derived solely from the World Bank's Worldwide Governance Indicators (WGI).
    - The WGI, based on subjective assessments, is criticized for incorporating perception-based surveys on aspects like freedom of expression, rule of law, and corruption.

- Excessive reliance on subjective appraisals, coupled with the Qualitative Overlay, raises concerns about the objectivity of the rating process.

5. **Subjectivity and Arbitrary Indicators:**
   - Criticism is directed at the influence of the composite governance indicator and perceived institutional strength, surpassing the collective impact of other macroeconomic fundamentals in determining credit rating upgrades.
   - Developing economies are said to face the challenge of demonstrating progress along arbitrary indicators constructed from one-size-fits-all perception-based surveys.

Source:
[Dubious ways of rating agencies – The Hindu BusinessLine]

Q.1 Examine the impact of sovereign credit ratings on the borrowing costs of nations. How do these ratings influence economic policies and global investments in developing economies?

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