CHAPTER TWO THEORY DEFINITION

2.1 Credit Ratings

In the early days, business units were small and transactions were done in a very simple manner. Most of the business units were owned and managed by the owners themselves and capital for the business units were provided by the owners themselves or from friends, relatives, or moneylenders. With the advent of banks, owners of these business units obtained their borrowings from the banks in their localities respectively. At this stage collateral was used for borrowings from banks or on some solid evidence of sound business operations.

With the introduction of limited liability companies there was a change in the structure of the business units themselves. Shareholders or owners of business units entrusted the running of the business affairs of public limited companies to a board of directors who may or may not be the shareholders of the company. Shareholders themselves may or may not be holding onto their share-holdings, as regulations have been made easier for them to switch easily their holdings of investments. On the other hand, the ever-increasing need for funds made it difficult for business units to borrow funds from traditional sources as they became scarce and very costly.

The need to transfer funds from net savers to net users led to a proliferation of financial institutions that cater to the needs of both the lender and borrower groups. Technological advances in computers and telecommunications; deregulation in banking and commerce; and competition led to the present-day complex business environment. Today, we have financial markets like spot markets, futures markets, money markets, capital markets, mortgage markets, primary markets, secondary markets and even private markets which help in the efficient transfer of funds from people and institutions who are net savers to firms and individuals who need capital (Eugene et al, 1999). In this complex and sophisticated business environment there is a need for some orderliness in the marketplace to safeguard the interests of both the lenders and borrowers from abuse and misuse.

In addition, globalisation and the opening-up of markets worldwide under regional agreements and World Trade Organization or WTO agreements have led to increased cross-border flow of funds globally. For example, business units now located in one remote corner of the world may be able to obtain financing in another part of the world like the euro bond financing. Likewise, net savers from around the world seek for greener pastures by scouring the financial markets to maximise the returns on their funds. The Asian, Russian, Mexican, Argentine crises in recent years have shown how vulnerable investments and borrowings are in the world of globalisation. For example, some debt instruments like bonds may provide a very high rate of interest (or yield to maturity). But, what really matters is the probability of the investor receiving his principal intact upon maturity and the timely payments of interests periodically till maturity. On the one hand, investors need to safeguard their funds from being eroded by bad investment decisions; and on the other hand borrowers seek to obtain funds at a low cost of capital by seeking alternative sources of funding like the bond market at a lower rate of interest as compared to borrowing from the banking system.

So, what could help investors as well as borrowers of capital via the bond /money markets achieve their respective aims? One possible likely area is the ratings carried out by rating agencies. Credit ratings, carried out by rating agencies, is an unbiased, independent and objective assessment of a borrower's credit quality taking into account principally the financial and business risks of the borrowers. The credit rating gives a learned opinion as to the degree of certainty of timely payment of interest and principal on the debt instrument of the borrower or issuer of debt. The rating is basically expressed in alpha or alpha- numeric symbols with plus or minus signs in descending order. In short, it is a 'report card' on the creditworthiness of a borrower, reflecting the probability of default on the debt instrument by taking into account the present and future relative risks involved. The ratings are arrived at after taking into consideration both the quantitative and qualitative factors which include financial ratios, mortgage provisions, subordination provisions, guarantee provisions, sinking fund, maturity, stability, regulations, anti-trust, overseas operations, environmental factors, product liability, pension liabilities, labour unrest, accounting policies etc. Subjective judgements of rating agencies play a very important role in establishing a firm's rating. Researchers who have tried to predict bond ratings on the basis of qualitative data have only had limited success (Eugene et al (1999).

Why is credit rating important to the business community? Credit rating is one way of differentiating and distinguishing an issuer or debt instrument from another as product differentiation in marketing. For example, a debt instrument carrying an AAA is highly regarded compared to one carrying a rating of AA or lower. This differentiation helps both the investors and the borrowers of funds. As for the investors, a higher grade would mean better safety or security in investing either in the debt instrument or even the shares of the issuer as there is greater assurance of receiving their capital returns intact until the maturity of the debt instrument. Institutional investors, as a general rule, do not invest in non-rated securities and in those graded lower than BBB (so called speculative or junk bonds). Despite the high rates of return (yield-to-maturity) offered by these bonds, these bonds correspondingly carry high levels of default risks and are detrimental even to their share capital itself.

As far as the borrowers are concerned, a stronger rating would mean that they could not only attract capital but also at a lower cost (rate of interest) as the default risk is lower. This lower rate of interest would imply lower costs to the borrower. On top of this, these borrowers can also avail themselves to a wide range of funding alternatives, varying terms of maturity and diversity of lending institutions. Credit ratings also help borrowers of capital in negotiating leases or long term contracts on more favourable terms as well as to stand guarantee for their subsidiaries or related companies basing on the strength of their own rating.

Finally, but not the least, credit ratings give information to prospective investors in the borrower securities or even the industry in which it is in. As the rating is done by an independent rating agency or agencies their independent, unbiased and objective opinions would carry more weight, sometimes even more than stock market analysts. The rating agencies access to a wide range of research data including certain detailed information, like review of management policies, strategies and preferences otherwise not available to investors helps to supplement the investors' own analysis. Furthermore, these ratings likewise help the investors to make comparisons among competing securities.

Rating agencies have made their presence felt since the early 1990's in the United States. The three major rating agencies in the United States for the present are Moody's Investors Services; Standard and Poor's Corporation and Fitch Investors Service. Moody's Investors Services assigns ratings from Aaa, Aa, A, Baa under the investment grade and Ba, B, Caa and C under the speculative grade. On the other hand, Standard and Poor's Corporation uses AAA, AA, A, BBB for the investment grade; and BB, B, CCC and D for the speculative grade. Modifiers are used below triple AAA with plus and minus signs for the former and modifiers in the form of suffixes 1, 2 or 3 (in descending order) are used for the latter. The speculative grade carries a very high level of default risk. The ratings of these agencies are highly sought after by many investors and lenders of monies to corporations as well as borrowers of monies. Hence, these agencies play a very important role in the financial sector of the corporate world.

How is the Malaysian scenario? The introduction of rating agencies is a new phenomenon in the local scene. With the development of the stock market i.e. the Kuala Lumpur Stock Exchange, the government felt the necessity of developing the bond market that was at its infancy stage. In line with the robust economic growth in the 80's and 90's with the corresponding need to tap funds from other sources apart from the traditional sources of the banking system and the equity market, there was an urgent need to develop the private debt security (PDS) market. The rapidly growing private debt security market in terms of issues and value led to pressing need for transparency and confidence building in the market apart from protecting the interests of the investing community and providing a safe investment climate in the country.

According to Bank Negara Handbook (1999), as at the end of 1987 the outstanding value of private debt securities (including Cagamas bonds) amounted to only RM 395 million or around 0.5 % of Gross Domestic Product or GDP in contrast to the market capitalization of Kuala Lumpur Stock Exchange of RM 73.8 billion (about 91% of GDP). The private debt security market saw tremendous growth between 1988 till August 1999 of around 200 times or an average growth rate of 61.2% from RM 395 million at the end of 1987 to RM 80 billion at the end of 1999. From fixed rate Cagamas bonds and straight bonds, a vast array of sophisticated debt instruments were added viz. bonds with warrants, convertible bonds, Islamic debt securities, floating rate bonds, zero coupon bonds, bonds with step-up coupons, bonds with detachable coupons, bonds with call and put options etc.

According to Section 25, First Schedule, Part 1(e) of the Banking and Financial Institutions Act of 1989 Bank Negara Malaysia's approval is a requirement for all private debt security issuances. As an amendment to these guidelines was the inclusion of the credit rating requirement on 2nd May 1992. It also states that all private debt securities should be rated at least of an investment grade BBB (this was however relaxed and subsequently reduced to BB to facilitate debt restructuring schemes) for long term papers and P3/MARC 3 for short term papers. P3 is assigned by Rating Agency of Malaysia and MARC-3 by Malaysian Rating Corporation.

Securities Commission, set up in March 1993, entrusted to regulate the securities market, has also issued its own policies and guidelines, on issue or offer of securities. According to its Chapter 21 of these guidelines all private debt securities issues should obtain the rating status of their private debt securities from one of the rating agencies in Malaysia.

Hence, the above fast track developments taking place since 1988 underscored the urgency in developing a local rating agency. In November 1990, Rating Agency of Malaysia or RAM was born 'to provide independent opinions on the potential default risk of specific issues and/or issuers of debt securities and to disseminate widely all appropriate and timely information to existing and potential investors of private debt securities (Bank Negara Malaysia Handbook, 1999). In 1995, to supplement and to provide an alternative to RAM, Malaysian Rating Corporation or MARC was formed. RAM and MARC presently also undertake, apart from rating debt instruments that form the bulk of their activities, financial institution rating, claims paying rating and senior debt rating.

Long term papers carry ratings AAA, AA, A, BBB, BB, B, C and D. For ratings AA till C suffixes 1,2 or 3 are given in descending order of importance. A suffix 'bg' or 's' would indicate external guarantee and external support respectively.

MARC has similar ratings and factors taken into account like RAM in coming up with the required ratings for issuers. The only exception applies to the scale symbols for short- term ratings. It ranges from MARC-1 to MARC-4.

RAM initiates the rating process upon receipt of request from the issuer for a rating in any of the mentioned categories. The issuer provides information and RAM analyses the issuer's information as well as its own data gathered by its team of experts. RAM conducts site visits at the issuer's premises and holds meetings too with the issuer's management team. The findings of the team of experts are then reported and presented to the Internal Rating Committee and ɔsequently to the External Rating Committee. The rating decision is then ↑mmunicated to the issuer. The issuer has the option of appealing against the ing decision if it is not within its expectations or rejecting it outright. Appeals go ough the same process through the two committees. Issuers have the choice disagreeing with the rating decision and the rating relationship can be ended in ɔrecy. The accepted rating by the issuer will put the issue under continued ~veillance until the maturity of the issue.

w are ratings announced to the public at large by these agencies? Circulars each of the ratings done by RAM are faxed to Kuala Lumpur Stock Exchange d to the major newspaper offices in the country. The local dailies then publish rating announcements in a small tableau in the business column of these ilies. RAM's website too does inform the public as to the ratings accorded or anged.

rating agencies do review the factors making up their analyses previously m time to time for changes which may render the earlier given ratings ıppropriate. These factors can be general or they can be firm specific. These views are done throughout the maturity of the debt instrument or other rating ›es as mentioned earlier. These factors could be favourable or unfavourable d the agencies involved will accordingly change the ratings and inform the blic through the same means as explained earlier. These changes are what we ll upgrades, downgrades, reaffirmations or ratings-watch.

the case of debt instruments in Malaysia, the bulk of the ratings are for over-counter or OTC debt instruments. These instruments are not traded in the pital markets in the country. However, a small percentage of them are loan ›cks that are traded in the capital markets of the country. At the moment the mber of such loan stocks traded in the Kuala Lumpur Stock Exchange are ɔund 13 (The Star, 5 May, 2002).