CHAPTER 2

THEORY DEFINITION

CREDIT RATING

In the past most of the business transaction were done in a very simplified manner since the business unit were small. The business is commonly managed by the owner itself and the capital was generated for moneylender, friends relatives and etc. Through time lot of changes taken place, an institution called bank was created where borrowing were made simpler for the local business owners. The borrowings were given based on the soundness of the business operations.

Later, the business structured was designed whereby business affair of public limited companies were entrusted to a board of directors. Today, we have financial market such as spot market, futures markets, money markets, capital markets, mortgage markets, primary market, secondary market and even private market which provide a ongoing flow of fund to business. (Eugene F. Brigham, Louis C. Gapenski and Michael C. Ehrhardt, 1999 Pp 116).

Globalization and the opening of worldwide market enabled this business entity to obtain financing from another part of the world. As such it became important for borrowers and investors to achieve their respective aims through the rating system. Credit rating, carried out by the rating agencies is an unbiased, independent and objective assessment of borrower's credit quality taking into account the business risk. The rating is basically expressed in alpha or alphanumeric symbols with the plus or minus signs in descending order. To summarize, credit rating is done to identify the worthiness of the borrower in terms of the probability of default payment. The rating is arrived at after taking into consideration both the quantitative and qualitative factors which include financial ratios, mortgage provisions, subordination provision, guarantee provision, sinking fund, maturity, stability, regulations, anti-trust, overseas operations, environmental factors, product liability, pension liabilities, labor unrest, accounting policies and etc.

The reason credit ratings are being accorded importance by the business community is because it is the one way of differentiating and distinguishing an issuer from another. For example, a debt instrument carrying a AAA rating is highly regarded as compared to one carrying a rating of AA or lower. The rating simply allows the investor as well as the borrowers to position themselves in the market. As for the investor the higher grading would reflect the safety of the investment. Whereas for the borrower a higher rating means they could attract capital with a lower cost. Credit rating also helps borrowers of capital in negotiating leases or long-term contracts on more favorable conditions.

In the of Malaysian scenario, rating agencies phenomena are still at the infancy stage. In the 1980's and 1990's, there was an urgent need to develop the private debt security market. Based on the handbook of Bank Negara 1999, The central Bank and the Financial System in Malaysia- A Decade of Change 1989-1999", the outstanding value of the private debt was amounted at RM395 million or 0.5% of Gross Domestic Product in contrast to the market capitalization of Kuala Lumpur Stock Exchange of RM73.8 billion (Bank Negara1999). In May 1992, Bank Negara Malaysia included the credit rating requirement and that all private debt securities should be rated at least of an investment grade BBB(which was later reduce to BB) for long term papers and P3/Marc 3 for short term.

RAM rates presently on the following areas:

Corporate debt ratings: These ratings are done for long term and short term papers issued by the business units.

Financial institution rating: These ratings are undertaken as to the strength and performance of bank, stock brokerage houses, and non-bank financial institutions.

Islamic debt rating: This is one of the fastest growing debt instruments in the country mainly based on the murabaha and al-bai bithamin al-ajil concept.

Claims paying ability or CPA: These ratings involves insurance companies abilities to meet policyholders obligation as they come due.

Senior debt rating: These ratings cover all senior debt which have prior claims over all other debt of business unit.

Long term papers carry ratings AAA, AA, A, BBB,BB, B, C and D For rating AA until C suffixes 1,2, or 3 are given in descending order of importance.

RAM's rating process begins with a review of the information submitted to it by potential issuers. Following this, site visits and meetings with the senior management personnel are arranged. These meetings are thorough and all aspects of the business are explored. After the rating decision by RAM's committee is communicated to the client, they will have an option to accept the rating or appeal on the decision. Should the rating be accepted, it will be placed under continued surveillance until the debt issue matures. Rating appeals are reviewed by the internal review committee and presented to the Rating committee for consideration. Once this is done the circulars of each rating are faxed to Kuala Lumpur Stock Exchange and to the major newspapers.

All rating agencies will review the rating from time to time for changes that has taken place. Those factors, which may cause changes, could be favorable to the company or vice versa. At the moment the number of loan stock traded in Kuala Lumpur Stock Exchange is around 13 (The STAR).