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Faculty of Economics, Commerce and Management Sciences

Commerce Department

Module: English
Branch: Finance and International Trade
Level: First year Master

Lecture 03: Credit Rating

Learning Objectives

After teaching this Lecture the Students should be able to:

–Explain what credit ratings
– Provides an overview of different business models and methodologies used by different ratings agencies.
– Describes generally how S&P Global Ratings form ratings opinions about issuers and individual debt issues, monitors and adjusts its ratings.

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Credit ratings are crucial indicators that influence financial, economic, and investment decisions. Issued by specialized agencies, they assess the creditworthiness of countries and institutions, determining their ability to meet financial obligations and secure new loans. A high credit rating signals strong financial stability and crisis resilience, while a low rating suggests a higher risk of default, leading to stricter lending conditions such as higher interest rates or shorter repayment periods.

1-Meaning of Credit Rating

A credit rating is a quantified assessment of a borrower's creditworthiness, applicable to individuals, corporations, and governments. Individuals receive credit scores from bureaus like Experian and TransUnion using FICO scoring, while companies and governments are evaluated by agencies such as S&P, Moody’s, and Fitch. These agencies, funded by the entities seeking ratings, assess financial reliability for borrowing and debt issuance.

A credit rating evaluates the credit risk of a financial entity or instrument based on its financial history and stability. It reflects the entity’s borrowing and lending track record, assessing its ability to meet financial obligations.

A credit rating is a prospective assessment of the creditworthiness of an issuer, instrument, or obligation, determined through a structured ranking system. Scope Ratings evaluates creditworthiness based on the timely fulfillment of financial obligations or potential losses, following its specific credit rating methodology.

A credit rating is an independent assessment of a borrower's ability to meet debt obligations. Most ratings are publicly disclosed and play a key role in investment decisions, helping debt investors evaluate specific instruments while also providing creditors with insights into an entity's credit profile. For borrowers, credit ratings are often necessary for issuing public bonds or securing institutional loans, granting access to a broader range of lenders and financial products.

Additionally, credit references from agencies like Dun & Bradstreet and Experian serve trade creditors and other counterparties. While these scores influence certain regulatory calculations, such as the UK pension regulator's PPF levy, they are generally not used by debt investors and are not covered further in this guide.

2- Credit Rating Mechanism

A loan is a debt—essentially a promise, often contractual, and a credit rating determines the likelihood that the borrower will be able and willing to pay back a loan within the confines of the loan agreement, without defaulting. A high credit rating indicates a high possibility of paying back the loan in its entirety without any issues; a poor credit rating suggests that the borrower has had trouble paying back loans in the past and might follow the same pattern in the future. The credit rating affects the entity's chances of being approved for a given loan or receiving favourable terms for said loan.

Credit ratings apply to businesses and government, while credit scores apply only to individuals. Credit scores are derived from the credit history maintained by creditreporting agencies such as Equifax, Experian, and TransUnion. An individual's credit score is reported as a number, generally ranging from 300 to 850. Similarly, sovereign credit ratings apply to national governments, while corporate credit ratings apply solely to corporations. (For related reading, see "Credit Rating vs. Credit Score: What's the Difference?") .A short-term credit rating reflects the likelihood of the borrower defaulting within the year. This type of credit rating has become the norm in recent years, whereas in the past, long-term credit ratings were more heavily considered. Long-term credit ratings predict the borrower's likelihood of defaulting at any given time in the extended future. Credit rating agencies typically assign letter grades to indicate ratings. Standard & Poor's, for instance, has a credit rating scale ranging from AAA (excellent) to C and D. A debt instrument with a rating below BB is considered to be a speculative grade or a junk bond, which means it is more likely to default on loans.

3-Key Features of Credit Rating

-Evaluation of Repayment Ability – It measures the issuer's capability to fulfill financial commitments, including paying interest and repaying the principal amount borrowed.

-Data-Driven Analysis – The credit rating agency evaluates the borrower's financial strength based on available financial data.

-Symbol-Based Representation – Ratings are denoted using standardized symbols, such as AAA or BBB, making them easy to interpret, even for non-experts.

-Conducted by Professionals – Credit ratings are assigned by specialists from well-established and accredited institutions.

-Investment Guidance, Not a Recommendation – Credit ratings serve as a tool to inform investors but do not constitute a direct recommendation to invest in any specific financial instrument.

4- Credit Ratings Users

- Investors

Investors most often use credit ratings to help assess credit risk and to compare different issuers and debt issues when making investment decisions and managing their portfolios. Individual investors, for example, may use credit ratings in evaluating the purchase of a municipal or corporate bond from a risk tolerance perspective. Institutional investors, including mutual funds, pension funds, banks, and insurance companies, often use credit ratings to supplement their own credit analysis of specific debt issues. In addition, institutional investors may use credit ratings to establish thresholds for credit risk and investment guidelines. A rating may be used as an indication of credit quality, but investors should consider a variety of factors, including their own analysis.

- Intermediaries

Investment bankers help to facilitate the flow of capital from investors to issuers. They may use credit ratings to benchmark the relative credit risk of different debt issues, as well as to set the initial pricing for individual debt issues they structure and to help determine the interest rate these issues will pay. Investment bankers may look to a rating agency's criteria when seeking to understand that rating agency's approach toward rating different debt issues or different tiers of debt. Investment bankers may also serve as arrangers of debt issues. In this capacity, they may establish special purpose entities that package assets, such as retail mortgages and student loans, into securities or structured finance instruments, which they then market to investors

- Issuers

Issuers, including corporations, financial institutions, national governments, states, cities and municipalities, use credit ratings to provide independent views of their creditworthiness and the credit quality of their debt issues. Issuers may also use credit ratings to help communicate the relative credit quality of debt issues, thereby expanding the universe of investors. In addition, credit ratings may help them anticipate the interest rate to be offered on their new debt issues. As a general rule, the more creditworthy an issuer or an issue is, the lower the interest rate the issuer would typically have to pay to attract investors. The reverse is also true: an issuer with lower creditworthiness will typically pay a higher interest rate to offset the greater credit risk assumed by investors.

- Businesses and Financial Institutions

Businesses and financial institutions, especially those involved in credit-sensitive transactions, may use credit ratings to assess counterparty risk, which is the potential risk that a party to an agreement may not fulfill its financial obligations. For example, in deciding whether to lend money to a particular organization or in selecting a company that will guarantee the repayment of a debt issue in the event of default, a business may wish to consider the counterparty risk. A credit rating agency's opinion of counterparty risk can therefore help businesses analyze their credit exposure to financial firms that have agreed to assume certain financial obligations and to evaluate the viability of potential partnerships and other business relationships.

5-Credit Rating Agency: Definition and Role

A **credit rating agency (CRA)** is a private entity that evaluates the creditworthiness of large-scale borrowers, such as corporations or governments. It essentially ranks borrowers based on their ability to repay debt.

A CRA (also known as a ratings service) assigns **credit ratings**, which assess a debtor's ability to meet financial obligations—making timely principal and interest payments—and the likelihood of default. These agencies evaluate the creditworthiness of debt issuers, financial instruments, and in some cases, debt servicers, but they do not rate individual consumers.

The financial instruments rated by CRAs include **government and corporate bonds, certificates of deposit (CDs), municipal bonds, preferred stock, and collateralized securities**, such as mortgagebacked securities and collateralized debt obligations (CDOs). Debt issuers can include **corporations, special purpose entities, government bodies, non-profits, or sovereign nations**.

Credit ratings play a crucial role in the **secondary market**, influencing the interest rates securities pay—**higher ratings typically result in lower interest rates**. Unlike credit rating agencies, **credit bureaus** (also known as consumer reporting agencies) assess individual consumers' creditworthiness by issuing **credit scores**.

The **reliability of credit ratings** has been widely debated. During the **2007–08 financial crisis**, numerous securities that were initially given top ratings were later downgraded to junk status. Similarly, **rating downgrades** were blamed for worsening the **European sovereign debt crisis (2010–12)**.

The credit rating industry is highly **concentrated**, with the **"Big Three" agencies controlling 95%** of the market. **Moody's Investors Service and Standard & Poor's (S&P) hold 80% of the global market share, while Fitch Ratings accounts for another 15%**.

6-Rating agency methodology

The rating agencies use broadly similar methodologies in arriving at their credit rating determination, although they operate independently of each other and so differences in approach and rating outcome may exist in certain instances