CREDIT RATING AGENCIES

WHO ARE THEY AND DO WE NEED THEM?

By ***Nimisha Naik, Fatima Bhoola and Jannie Rossouw***

Rossouw is head of the school of economic and business sciences. Naik and Bhoola are lecturers in the school of economic and business sciences, University of the Witwatersrand.

Nimisha Naik

Fatima Bhoola

Jannie Rossouw

For all the influence they have on determining a country's ability to borrow money, hardly anything is known about credit rating agencies. In this matter-of-fact article, the authors lay bare the ABC's of rating agencies, how they operate and what informs the (sometimes death) sentences they pass on countries.

A number of recent developments coupled with a failure to meet the necessary criteria to prevent a further downgrade, has ultimately culminated in two of the three main ratings agencies downgrading South Africa's credit rating from investment grade to the speculative or 'junk status´ grade. Standard and Poor's (S&P) lowered the long term foreign currency sovereign credit rating to the speculative grade of BB+ on 3 April 2017. Fitch soon followed with a similar downgrade (Fitch Report, 2017). Moody's has kept their ratings on Baa1 but on review for a possible downgrade.

The downgrade to speculative grade is likely to scare off potential investors (particularly international investors) and further damage South Africa's already fragile growth potential. The impending exit of General Motors from South Africa (Nicolaides, 2017), citing a fall in expected returns from investing in South Africa, as well as the failure of Transnet to secure the desired liquidity through a recent bond auction (Thompson, 2017), are just two market developments explicitly linked to the recent downgrade suggesting that investors are losing confidence in South Africa as an investment destination and are opting for other, safer options.

This article aims to shed some light on the importance of credit ratings to a country. More particularly, who are ratings agencies, what do they look for when they rate a country and how important is it to be rated?

WHAT ARE CREDIT RATINGS?

A credit rating refers to an opinion on the ability and willingness of an issuer of debt instruments to meet its financial obligations timely and in full. These institutions include companies, financial institutions, governments (referred to as the sovereign), etc. It is therefore a relative measure of the likelihood that a borrower will default on its obligations (Cantor and Packer, 1995).

Governments, like others seeking loanable funds, require access to international capital markets. This is particularly true for the

government agencies of developing countries who cannot acquire investment funds domestically owing to low savings levels or undeveloped capital markets thus relying on foreign investors to purchase their debt instruments. As such, they choose to be rated in order to provide a signal to potential investors on the relative riskiness of investing in the country (Cantor and Packer, 1995). The ratings are used by market participants as a signal to gauge the future relative creditworthiness of securities and the risk of default; thus providing a benchmark for investors to use when deciding where to invest and to rate the relative riskiness of such investment. Investments carrying more risk (i.e. a lower credit risk rating) attract a higher return (Afonso, et al, 2011, Cantor and Packer, 2016).

Sovereign debt is regarded as the least-risky debt and therefore has the lowest rate of interest since governments can repay interest and capital commitments on debt by curbing expenditure, increasing taxes or printing money (Cantor and Packer, 1995). It therefore acts as a benchmark for other issuers of debt of the same country in the same market (Moody's Rating Methodology, 2015); for instance state owned enterprises whose debt instruments might be underpinned by the government. Corporate debt is comprised of securities issued by private issuers such as large companies in private ownership. Governments of countries therefore have an incentive to be graded on both their foreign currency obligations as well as the domestic currency offerings to provide a benchmark for other borrowers (Cantor and Packer, 1995).

To repay debt that is denominated in a foreign currency, countries must obtain hard currency in exchange for their domestic currency.

WHY ARE CREDIT RATINGS IMPORTANT?

From an investor's perspective, the riskiness of making an investment is associated with the interest gained, the guarantee of capital repayment and the tradability of the securities purchased. A higher risk investment tends to have a higher rate of return. Cantor and Packer (1996) analyse the effect of ratings on sovereign yields and find that sovereign yields tend to rise as the ratings decline. With limited information on the issuer's credit quality and likelihood to default, foreign investors rely on credit ratings to provide them with a gauge to the risk attached to such an investment. A downgrade of a sovereign's credit rating increases the cost of raising funds which places further pressure on the economy.

By acquiring an improved rating, a country improves the potential of the sovereign, government agencies and private companies to acquire funds at attractive rates and on favourable conditions from investors. Maintaining a good credit rating also compels a country to have sound monetary and fiscal policies in place and constantly ensure that both the economic and political conditions are favourable for growth and development.

A good credit rating of a country signals to investors that their investments in the country are attached to a lower risk of default. Such a credit rating underpins the borrowing activities of all borrowers in such a country.

METHODOLOGY WHEN ASSIGNING A RATING

Only Moody's provide detailed information on the methodology followed to assess and provide sovereign credit risk ratings. Moody's obtains data from sources such as the International Monetary Fund (IMF), Organisation for Economic Cooperation and Development (OECD), European Commission (EC), the World Bank and the Bank for International Settlements (BIS). National statistics provided by countries are also used for assessment purposes. In its assessment of credit risk of sovereigns, Moody's considers the following aspects:

Economic Strength

A sovereign's ability to generate revenue and service its debt in the medium run relies on fostering economic growth and prosperity. Several indicators such as its growth dynamic, the scale of the economy and its National Income (GDP) are some of the main determinants of the economic strength of a country.

Institutional Strength

The second consideration is whether a country's institutional structures can support the sovereign's ability and willingness to repay its debt. Specifically, the government's capacity to implement sound economic policies that will contribute to sustained economic growth. To this end, ratings agencies assess the following: the effectiveness of the country's institutional framework encompassing the quality of government bureaucracy and administration; the rule of law that measures contract enforcement; property rights; independence of judiciary and trust in the judicial system; and the transparency and accountability of the public sector. These indicators measure the extent to which public power is abused for

private gain, as well as the capture of the economy by elites or special interests.

Fiscal Strength

This aspect captures the overall health of government finances and includes indicators such as the debt burden and its affordability. Specifically, its interest payments-to-revenue ratio is indicative of the degree to which its debt service burden is within revenue-generation capacity.

Susceptibility to event risk

This factor looks at the risk of a sudden extreme event occurring. An event such as this can result in a severe strain in public finances that increases the sovereign's probability of default. Susceptibility to an event risk can arise from risks relating to political instability, government liquidity, the banking sector risk or external vulnerability. To repay debt that is denominated in a foreign currency, countries must obtain hard currency in exchange for their domestic currency. A shortage of hard currencies arises due to a current account deficit or net capital outflow. This is reflected in the depreciation of the currency and diminishing official foreign reserves.

For South Africa, the negative implication of a lower rating is evident, namely an increase in borrowing rates.

WHAT WENT WRONG IN SOUTH AFRICA?

The downgrade to junk status by Fitch and S&P was largely triggered after the sudden reshuffle of Cabinet ministers by the president of South Africa. The dismissal of the finance minister, Mr. Pravin Gordhan, was seen as a weakening of governance and public finances. The change of leadership in key government institutions namely finance and energy has led to the increase in a perceived political risk.

Source: http://top10companiesinindia.net/top-credit-rating-agencies-in-india/

The continued in-fighting within the ANC raises the issue of whether there is a commitment to sustain fiscal consolidation and maintain prudent governance of state - owned enterprises. The newly appointed energy minister may accelerate the nuclear programme; this will only compound an already large liability on the state. All three agencies have noted that the continued political noise and recent political events have distracted policymakers from growth-enhancing reforms.

State owned enterprises (SOEs) have placed a large burden on government finances. The debt of the major SOEs amounted to approximately 18.2% of GDP as at March 2016 (Fitch Report, 2016), of which over 36% was subject to government guarantees. The recent downgrade to junk status has placed further pressure on acquiring funds. Transnet attempted to issue R200 million in long-term bonds, only two bids worth R40 million were received. Transnet agreed to only issue bonds for R10 million (Thompson, 2017). This reflects the lowered confidence that investors have in long-term investments in South Africa.

Overall, all three agencies have highlighted a persistent low trend in the GDP growth. The expected growth rate of GDP remains low for 2017. High debt levels and significant fiscal and current account deficits have contributed to the negative outlook. General government debt is expected to be 53.3% of GDP during 2017 (Fitch Report, 2016). The current account deficit was at 4.3% of GDP during 2015 and the government's net

external debt was estimated to be at 8.7% of GDP during 2015. The inflation rate is also above its peer countries but there is confidence that the South African Reserve Bank is independent and committed to controlling inflation.

Moody's has an expectation that economic growth will strengthen after the supply-side shocks will recede. These include the ending of the drought, the reduction in the shortage of electricity supply and the decrease in the number of work days lost due to strikes (Moody's Report, 2016). The political and institutional uncertainty remains a challenge in providing greater confidence on the economy.

The importance of credit rating agencies came about due to asymmetric information regarding investments and the risk attached to it. Potential investors rely on these ratings in order to make more informed decisions on investment opportunities and risk. In turn, entities both from individual companies to the sovereign have relied on the ratings to attract more investment.

These companies have stated that their ratings are just 'opinions', yet these opinions have had large impacts on firms and countries. This is especially the case when there is a downgrade in the ratings (Afonso, et al, 2011, Cantor and Packer, 2016).

Credit rating agencies are meant to be credible. They are assumed to be fair with sound methodologies but this has at times been questioned. Nevertheless they play an integral part in determining risk and investment potential. The question is therefore not whether South Africa likes credit rating agencies. South Africa, along with every other country, needs these agencies to attract investment capital and improve economic growth and development.

NOTE FROM THE EDITOR

The last paragraph indicates some concern about the credibility of the ratings agencies. In our judgment this understates the problem. During the financial crisis of 2008 there were strong allegations of misconduct by the same agencies which were never properly refuted.

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