

Credit rating & Rating agencies



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Credit rating

Credit rating

- an evaluation of the credit worthiness of a debtor, especially a state, business (company) or a government. Or in other words, an estimate of the ability of a person or organization to fulfill their financial commitments, based on previous dealings. The evaluation is made by a credit rating agency of the debtor's ability to pay back the debt and the likelihood of default.



Credit rating

- The real role of credit ratings in the financial system is to improve the functioning of markets by reducing information asymmetry between issuers and borrowers who need funding and the investors and lenders who can provide it.
- By serving as information intermediaries, CRAs (Community Reinvestment Act) theoretically reduce information costs, increase the pool of potential borrowers, and promote liquid markets. These functions may increase the supply of available risk capital in the market and promote economic growth.



Credit rating



A credit rating can be assigned to any entity that seeks to borrow money – a corporation, state or provincial authority, or sovereign government.



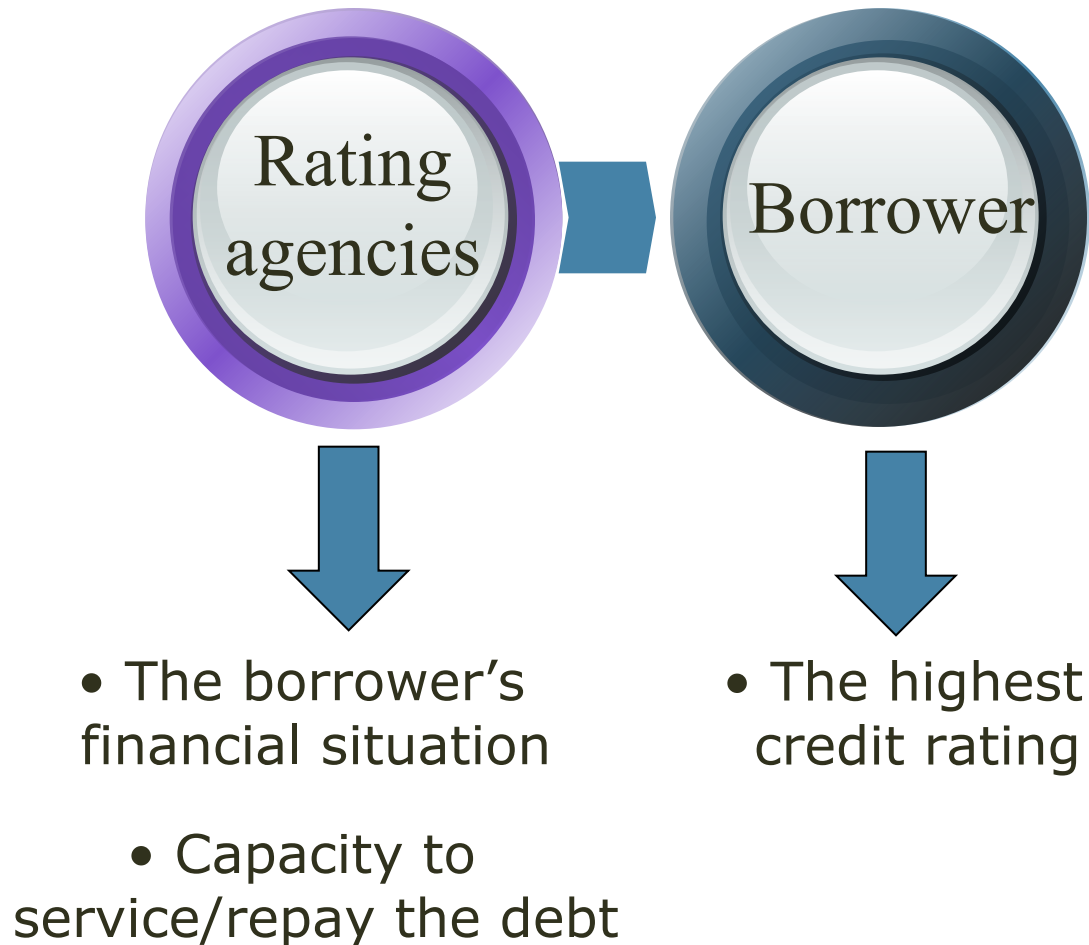
Credit rating



- ❑ Credit ratings are not based on mathematical formulas.
- ❑ Credit ratings for borrowers are based on substantial due diligence conducted by the rating agencies.



Credit rating



The most internationally recognized independent credit rating agencies

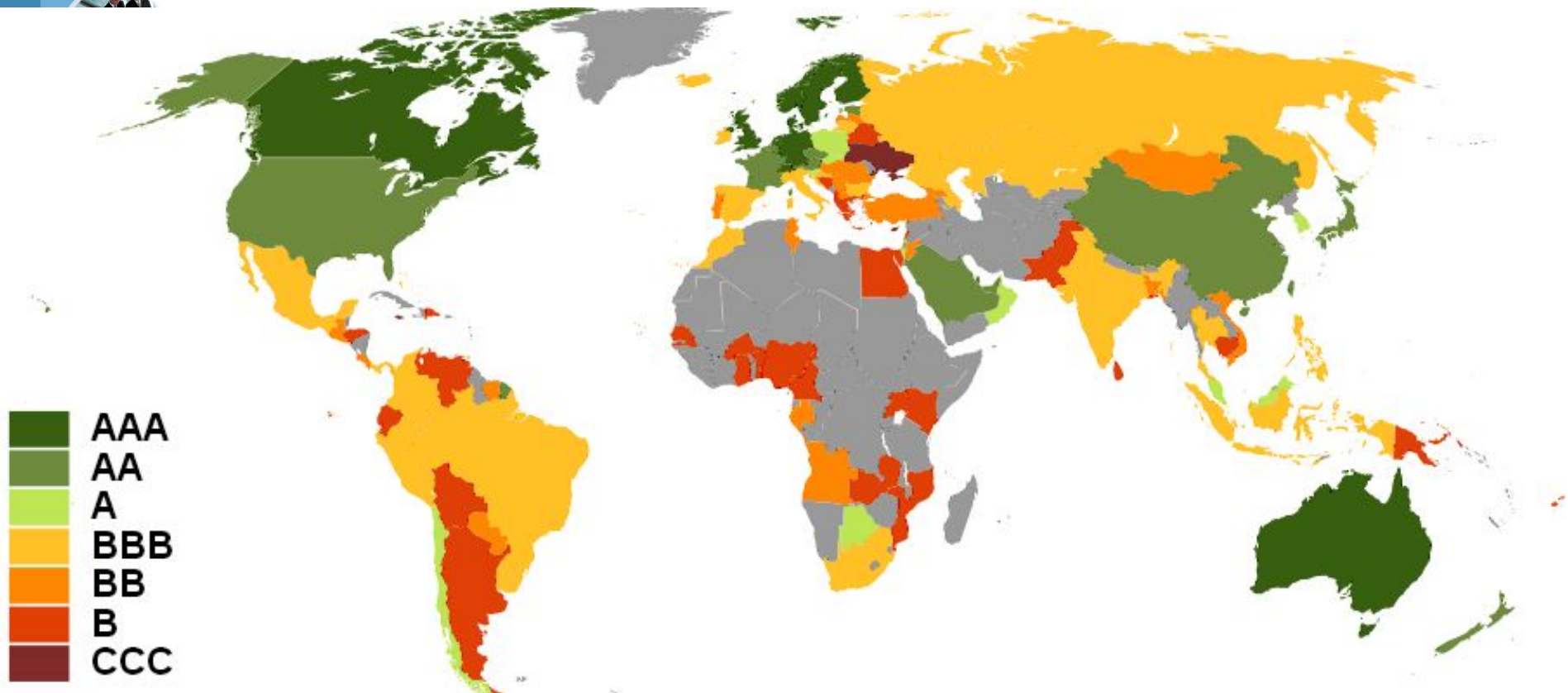




Moody's		S&P		Fitch		
Long-term	Short-term	Long-term	Short-term	Long-term	Short-term	
Aaa	P-1	AAA	A-1+	AAA	F1+	Prime
Aa1		AA+		AA+		High grade
Aa2		AA		AA		
Aa3		AA-		AA-		
A1		A+	A-1	A+	F1	Upper medium grade
A2	A			A		
A3	P-2	A-2	A-	F2	Lower medium grade	
Baa1			BBB+			BBB+
Baa2	P-3	A-3	BBB	F3		Non-investment grade speculative
Baa3			BBB-		BBB-	
Ba1	Not prime	BB+	B	BB+	B	
Ba2		BB		BB		
Ba3		BB-		BB-		
B1		B+		B+		
B2		B		B		
B3		B-		B-		
Caa1		CCC+	C	CCC	C	Substantial risks
Caa2		CCC				Extremely speculative
Caa3		CCC-				In default with little prospect for recovery
Ca		CC				
		C				
C	D	/	DDD	/	In default	
/			DD			
/			D			



World countries by Standard & Poor's Foreign Rating





Credit Worthiness

Credit Worthiness

- an assessment of the likelihood / risk that a borrower will default on any type of debt by failing to make required payments.

It is based upon factors, such as their history of repayment and their credit score. Lending institutions also consider the availability of assets and extent of liabilities to determine the probability of default.



Credit Worthiness



The loss may be complete or partial and can arise in a number of circumstances. For example:

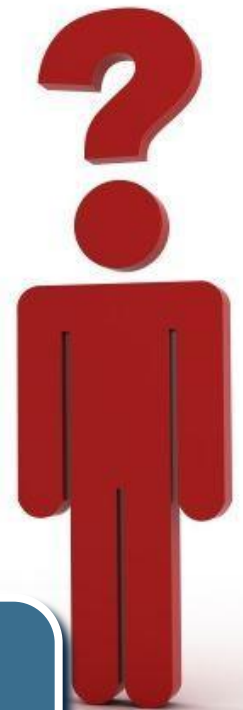


- A consumer may fail to make a payment due on a mortgage loan, credit card, line of credit, or other loan
- A company is unable to repay asset-secured fixed or floating charge debt
- A business does not pay an employee's earned wages
- A business or government bond issuer does not make a payment on a coupon or principal payment
- An insolvent insurance company does not pay a policy obligation
- An insolvent bank won't return funds to a depositor
- A government grants bankruptcy protection to an insolvent consumer or business

In general, the higher the risk, the higher will be the interest rate that the debtor will be asked to pay on the debt.



Types of credit risk



**Credit default
risk**

**Concentration
risk**

Country risk





Credit Worthiness

- **Credit ratings are NOT indications of investment merit.**
- **The ratings are not buy, sell, or hold recommendations, or a measure of asset value.**
- **Nor are they intended to signal the suitability of an investment.**



Why do Credit Ratings change?

The reasons for ratings adjustments vary, and may be broadly related to overall shifts in the economy or business environment or more narrowly focused on circumstances affecting a specific industry, entity, or individual debt issue.





Are Credit Ratings absolute measures of default probability?

Ratings express relative opinions about the creditworthiness of an issuer or credit quality of an individual debt issue, from strongest to weakest, within a universe of credit risk. The likelihood of default is the single most important factor in our assessment of creditworthiness



Why credit ratings are useful?

- **Investors purchase these debt securities, such as municipal bonds, expecting to receive interest plus the return of their principal, either when the bond matures or as periodic payments.**
- **Investors and other market participants may use the ratings as a screening device to match the relative credit risk of an issuer or individual debt issue with their own risk tolerance or credit risk guidelines in making investment and business decisions.**
- **At the same time, credit ratings may be used by corporations to help them raise money for expansion and/or research and development, as well as help states, cities, and other municipalities to fund public projects.**

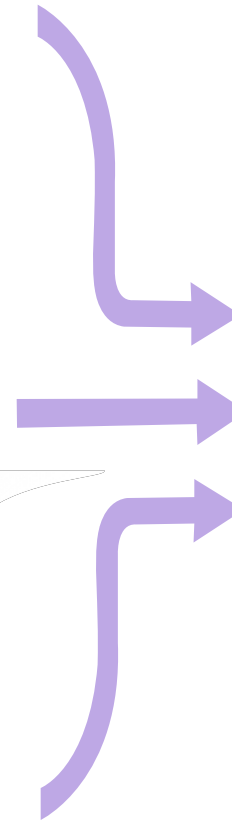
Factors used for assessing corporate credit ratings



- Country risk
- Industry risk
- Competitive position

- Cash Flow / Leverage
- Group or Government Influence

- Diversification / Portfolio Effect
 - Capital Structure
 - Financial Policy
 - Liquidity
- Management / Governance
- Comparable Rating Analysis



Rating methodologies



Model driven ratings

- focus almost exclusively on quantitative data, which they incorporate into a mathematical model

Analyst driven ratings

- generally assign an analyst, often in conjunction with a team of specialists, to take the lead in evaluating the entity's creditworthiness



Analyst driven ratings

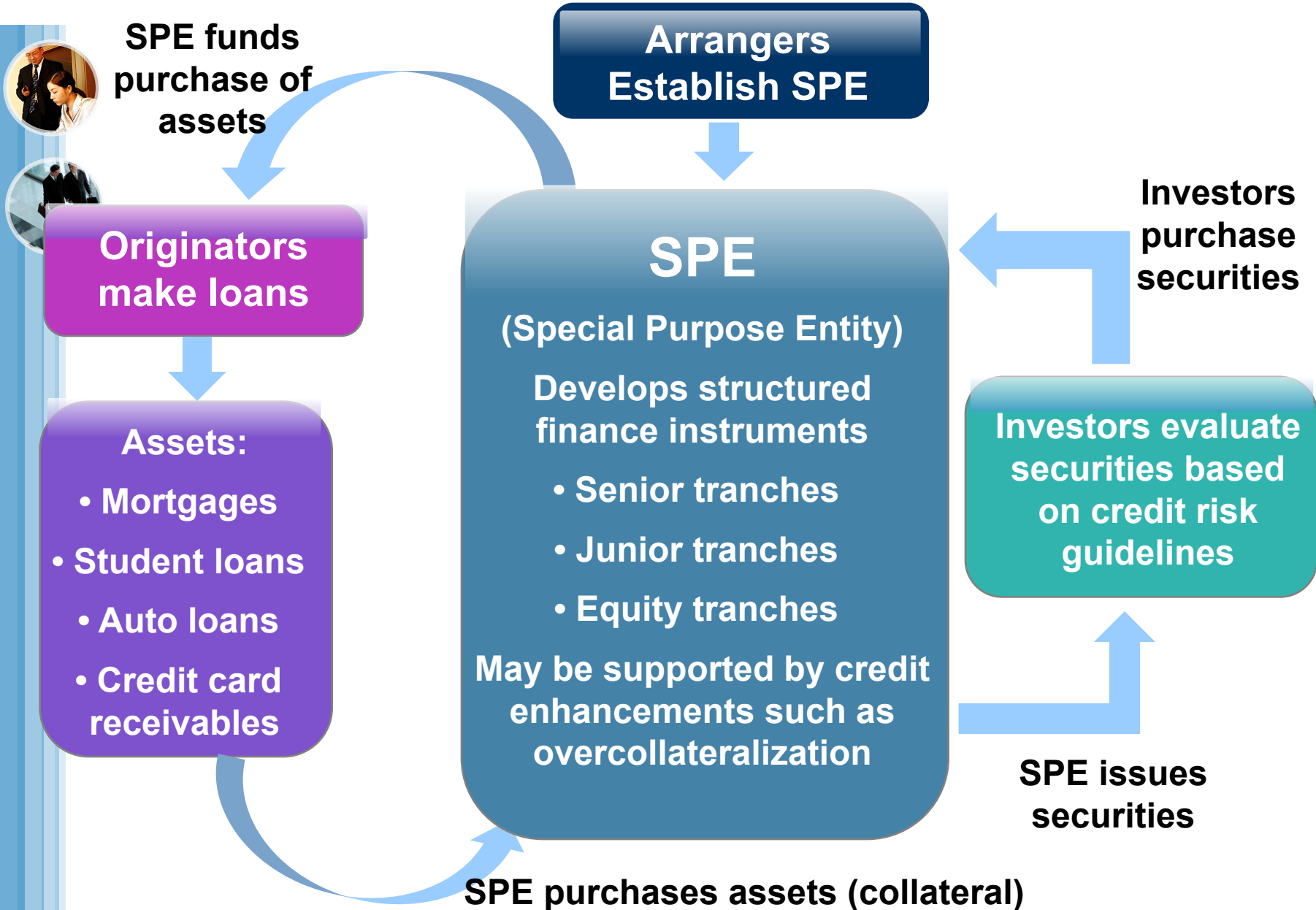


Recovery of investment after default



- **Credit rating agencies may also assess recovery, which is the likelihood that investors will recoup the unpaid portion of their principal in the event of default. Some agencies incorporate recovery as a rating factor in evaluating the credit quality of an issue, particularly in the case of non-investment grade debt.**
- **Other agencies, such as Standard & Poor's, issue recovery ratings in addition to rating specific debt issues. Standard & Poor's may also consider recovery ratings in adjusting the credit rating of a debt issue up or down in relation to the credit rating assigned to the issuer.**

Rating structured finance instruments



Tranching



- **Stratifying a pool of undifferentiated risk into multiple classes of bonds with varying levels of seniority is called “tranching”.**
- **Investors who purchase the senior tranche, which generally has the highest quality debt from a credit perspective and the lowest interest rate, are the first to be repaid from the cash flow of the underlying assets.**
- **Investors who purchase the lowest tranche generally have the potential to earn the highest interest rate, but they also tend to assume the highest risk.**

Surveillance:

Tracking credit quality

- The frequency and extent of surveillance typically depends on specific risk considerations for an individual issuer or issue, or an entire group of rated entities or debt issues.
- Agencies typically track developments that might affect the credit risk of an issuer or individual debt issue for which an agency has provided a ratings opinion.
- As a result of its surveillance analysis, an agency may adjust the credit rating of an issuer or issue to signify its view of a higher or lower level of relative credit risk.





International Monetary Fund

- Specialized agency of the United Nations system.
- Was conceived at the Bretton Woods Conference (1944)
- Officially founded in 1945 by 29 member countries
- More than 180 countries are members of the IMF
- Principal functions: stabilizing currency-exchange rates, financing the short-term balance-of-payments deficits of member countries, and providing advice and technical assistance to borrowing countries.
- Members contribute operating funds and receive voting rights
- The U.S. holds in excess of one-sixth of the voting rights,



International Monetary Fund



- Supports worldwide economic growth by granting loans and technical assistance to countries in need
- Has no coercive power over members
- Can refuse to lend money to members that do not agree to adhere to its policies
- Growing number of dollars in their central bank reserves, especially after 1958, stimulated worldwide inflation.
- The gold exchange standard broke down in 1968–1971
- Collapse of fixed exchange rates in 1973
- Provides information to the public, and technical assistance to governments of developing countries.



World Bank Group

- Specialized agency of the United Nations system
 - Established at the Bretton Woods Conference for postwar reconstruction.
- It is the principal international development institution.



World Bank Group

The International Bank
for
Reconstruction and
Development (IBRD)

The International Center
for Settlement of
Investment Disputes
(ICSID)

The International
Development Association
(IDA)

The Multilateral
Investment
Guarantee Agency
(MIGA)

Divisions

The International
Finance Corporation
(IFC)



Complementary ways in achieving objectives

First way

The World Bank is the single largest source of HNP financing for developing countries. From 1970 through 2000, the bank has offered \$16 billion in loans to more than one hundred countries.



Second way

The World Bank provides technical and policy advice on a wide range of topics in HNP. It also supports governments in the formulation of poverty-reduction strategies



Third way

The bank mobilizes and maintains partnerships with countries, nongovernmental organizations (NGOs), private enterprises, bilateral donors, foundations, and other agencies.

Fourth way

Knowledge management and sharing, including dissemination of the bank's analytical work, are also critical.



Thank You!



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