

Present Scenario of Credit Rating – To Confuse or Guide Investors

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Abstract

We have conducted a study to know whether credit rating issued to the corporate guide the investors or to confuse them. In the past credit rating is a tool of value measurement. We have conducted a survey to know about the credit rating trustworthiness in present scenario. Companies are entering into agreements with few of the credit rating agencies and obtaining ratings.. The audit results are misrepresented sometimes. Mal practices in accounting are done by the companies in order to grab a better rating. So some of the investors are losing money in making a wrong selection of the potential company. These agencies must also ensure that proper and fair inspection of the company should be done by considering in the investor perspective. Credit raters must be

ethical in order to increase the faith on the rating system.

Keywords; credit rating agencies, value measurement, unethical practices, misrepresentation.

INTRODUCTION

A **credit rating agency (CRA)**, also called a **ratings service**) is a company that assigns credit ratings, which rate a debtor's ability to pay back debt by making timely interest payments and the likelihood of default. An agency may rate the creditworthiness of issuers of debt obligations, of debt instruments, and in some cases, of the servicers of the underlying debt, but not of individual consumers. The debt instruments rated by CRAs include government bonds, corporate

bonds, CDs, municipal bonds, preferred stock, and collateralized securities, such as mortgage-backed securities and collateralized debt obligations.

OBJECTIVES OF STUDY

- ❖ To study about benefits of credit rating
- ❖ To study whether investors are trusting credit rating
- ❖ To study about ethnicity of corporate for gaining rating .
- ❖ To study about ethnicity of credit rating agencies.
- ❖ To study corrective measures to improve rating by the companies.

METHODOLOGY OF STUDY

We have conducted a study to know whether credit rating issued to the corporate guide the investors or to confuse them. In the past credit rating is a tool of value measurement. We have conducted a survey to know about the credit rating trustworthiness in present scenario. We have obtained results which contradict general public opinion. Most of our opinion was collected from educated students. We have selected a sample of 100 respondents. Our study was performed with random sampling and is limited to Kakinada city.

ANALYSIS AND INTERPRETATION

- ❖ whether investors are trusting credit rating

S.NO	ATTRIBUTE	PERCENTAGE OF RESPONDENTS
1.	Yes, completely	22
2.	No	44
3.	To some extent	34
	TOTAL	100

Interpretation; Most of them are of opinion that investors are slowly losing faith in credit rating. But still there are certain investors who still trust the international credit rating agencies.

- ❖ Ethnicity of corporate for gaining rating.

S.NO	ATTRIBUTE	PERCENTAGE OF RESPONDENTS
1.	Ethical	90
2.	unethical	10
	TOTAL	100

Interpretation; Most of the corporate are adopting unethical measures in order to get a better rating. They are bribing the raters to grab a good rating. They are misrepresenting the accounts and showing faulty audit reports.

- ❖ Ethnicity of credit rating agencies.

S.NO	ATTRIBUTE	PERCENTAGE OF RESPONDENTS
1.	Ethical	34
2.	unethical	66
	Total	100

Interpretation; Most of the domestic raters are giving good rating to the companies for business. They are unethical on this ground. They are unethical in nature. This results in loss of investor faith.

- ❖ Reason for mal practices for better rating by corporate

S.NO	ATTRIBUTE	PERCENTAGE OF RESPONDENTS
1.	Gain goodwill	05
2.	Profits and existence	12
3.	Face the competition	07
4.	Attract investors	08
5.	All of the above	68
	Total	100

Interpretation. Some of the corporate are getting ratings through bribing in order to gain the goodwill and attract the investors. They want to gain competitive advantage.

- ❖ Reason for mal practices by credit rating agencies

S.NO	ATTRIBUTE	PERCENTAGE OF RESPONDENTS
1.	Profits and existence	05
2.	Face the competition	07
3.	All of above	88
	Total	100

Interpretation; The reason for unethical practices of credit rating agencies is to increase the profit and business. But some of the raters are still ethical and standardized

- ❖ Necessity of corrective measures to improve rating by the companies.

S.NO	ATTRIBUTE	PERCENTAGE OF RESPONDENTS
1.	Yes	79
2.	no	21
	TOTAL	100

Interpretation; There must be a government initiative to take actions on the raters who involve in unethical practices. This would help the investors to get a proper guidance regarding choice of right investment avenue.

REVIEW OF LITERATURE

The performance of credit rating agencies has fallen far short of an adequate level in protecting investors as witnessed by the following failures:

- Enron was rated investment grade by the NRSRO's four days before bankruptcy;
- The California utilities were rated "A-" two weeks before defaulting;
- WorldCom was rated investment grade three months before filing for bankruptcy;
- Global Crossing was rated investment grade in March 2002 and defaulted on loans in July 2002;
- AT&T Canada was rated investment grade in early February 2002 and defaulted in September 2002; and
- ABB was rated "A2" by Moody's as of March 14th 2002 and was rated "Ba2", negative watch as of October 31, 2002. Similarly, S&P rated ABB at "A+" as of March 14th, 2002 and "BBB-", negative watch as of November 5th 2002.

An additional indication of the failure of the NRSRO's was a survey by H. Kent Baker and Sattar A. Mansi published in Table 9 of their June 18, 2001 article *Assessing Credit Rating Agencies by Bond Issuers and Institutional Investors* which indicated that only 29% of

bond fund managers believe the NRSRO's updated their ratings in a timely manner. Since other firms succeeded in providing investors with warning, we believe the failures can be attributed to (i) a conflict in interest, and (ii) the lack of competition.

Regarding conflicts, we note a pattern similar to the Wall Street equity analysts since the current NRSRO's are supported mainly by the issuers (according to Moody's 10K, it obtains 87% of its compensation from issuers) and therefore have substantial conflicts of interests with investors. The adage "one cannot serve two masters" applies to the ratings field; a firm can either support issuers or investors. The conflict appears to be particularly acute for large important issues such as the California utilities, Enron, WorldCom, and currently, the auto firms. In these cases investors desperately need guidance from credit rating firms, but often do not get it because of pressure from issuers, investment banks, commercial banks and in some cases, security exchange officials (see the October 8, 2002 Report of the Staff to the Senate Committee on Governmental Affairs, *Financial Oversight of Enron: the SEC and Private-Sector Watchdogs*, page 113). Although argument can be made that any one issue represents a relatively small share of the rating firm's revenue base, the reality is that investors have not been protected. Revenues

produced by Jack Grubman and Henry Blodget were likewise only a small portion of CitiGroup's and Merrill's revenues.

Regarding the lack of competition, the number of NRSRO's has declined from six three years ago to three currently. In the case of most US corporate ratings and an increasing number of structured finance transactions, S&P and Moody's are the only firms used. The industry could more accurately be described as a "partner monopoly", a term used by U.S. Department of Justice personnel. A partner monopoly differs from an oligopoly in the sense that the two firms share the market whereby the gain in revenues by one firm does not reduce the revenues of the second firm. Since two ratings are normally needed for the issuance of bonds, the gains of Moody's do not come at the expense of S&P and vice versa.

The problems associated with the lack of competition and conflicts of interest go beyond the Enron, Global Crossing and California utility failures. A letter (available upon request) from a senior executive at a brokerage firm whose clients were defrauded by Allied Signal which requested that the rating firms withdraw their rating of an issue of Grimes, an Allied subsidiary, so that investors holding the bonds would be forced to sell (because of the lack of a credit rating), thereby enabling Allied Signal to repurchase the bonds at a lower price. The

response given by the rating firms for not rating the bonds was "an official of Allied ... told them they [Allied] would be very unhappy if that agency rated Grimes. That rating agency said candidly that Allied was a source of rating income and that they would not jeopardize the relationship". In another variation of the abuses of the NRSRO designation and anti-competitive practices, Moody's in the 1990's assigned an intentionally low rating to some municipal issues which refused to retain Moody's for its ratings services. In these and most other cases, Moody's successfully used the First Amendment protection, arguing that its ratings were merely its opinions and that it was exercising its freedom of speech. Individuals have the right to free speech, but when monopoly firm employs anti-competitive practices to extend its monopoly, the SEC needs to revoke its NRSRO designation. Because of the dominance of S&P and Moody's it is rare to find parties willing to file a public complaint against them.

FINDINGS OF STUDY

- ❖ In the past credit rating is a tool of value measurement.
- ❖ The companies which are having good credit rating are blindly selected for investment because rating institutions are few and genuine.

- ❖ Now a day credit rating is purely biased and a malpractice. Companies are entering into agreements with few of the credit rating agencies and obtaining ratings. The inspection of these agencies is just for a formality and nominal.
- ❖ The rating is in fact purchased by some of them. The audit results are misrepresented sometimes. Mal practices in accounting are done by the companies in order to grab a better rating. So some of the investors are losing money in making a wrong selection of the potential company.
- ❖ Now the companies are more, rating agencies are more.
- ❖ Credit rating became a business at corporate level. So we feel that there must be someone to prevent unethical practices in credit rating agencies.
- ❖ These agencies must also ensure that proper and fair inspection of the company should be done by considering in the investor perspective.
- ❖ Credit raters must be ethical in order to increase the faith on the rating system.

CONCLUSION :

In spite of unethical practices in rating corporate, yet investors have trust on ratings

given by international credit rating agencies. The government must prepare by laws to regulate few unethical practices in rating corporates. This will be helpful for the investors.

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