Summit has a positive view on the country, its people, and outlook. While we concur with the economists that interest will rise and there will be an impact, we do not believe it will stop the growing drive for change, entrepreneurship and transformation.

Demystifying Rating Agencies

Over the course of a three-part series, we are going to explore the *impact* of South Africa's recent credit ratings downgrade on the investment landscape and its bearing on the *future* of South Africa's Retirement Fund Industry. The burning question of course is how does *South Africa* rise out of this rating downgrade and is it possible for Alternative Asset Classes such as Private Equity and Unlisted Property to keep investment portfolios *in the black* in the current investment climate?

In this issue we tackle the question of why a credit rating agency's opinion is relevant to South Africa and how and why credit rating agencies came to wield such authority within the financial community.

- Why is a credit agency's opinion relevant to South Africa?
- How did credit rating agencies become so powerful?
- A brief history of the Big Three credit ratings agencies
- Their business model
- How do ratings work?
- Are credit agencies reliable?
- The challenges

Uderstanding What a Credit Rating Agency (CRA) is and its Relevance to South Africa

A Credit Rating Agency is in essence *a grading system* that scores how likely a borrower is able to pay back their debt and also affects the cost of that debt. Sovereign credit ratings inform investors of the level of investment and political risk a country carries. Countries with a low sovereign debt credit rating of **BB or lower** by Standard & Poors (refer to table below) OR **Ba or lower** by Moody are considered non investment grade or junk bond status.

Junk bonds are considered dicey investments as they are judged a greater threat to default on capital & interest repayments which is *why investors demand higher interests on capital* borrowed in compensation for the risk of investing in them. The consequence of the higher priced capital ultimately trickles down to consumers as money moving through the economy becomes more expensive and harder to come by.

Pension funds, and other savings (as well as individuals) could lose value as higher interest rates do have an impact on the economic conditions which in turn impacts a company's ability to generate profits. Ratings have in the past and will continue to have a significant *impact on markets and economy.* Basically, if one of the Big Three credit rating agencies sneezes in your direction, the rest of the world reacts.

How did Credit Rating Agencies get to be so powerful?

The *Big Three* credit ratings agencies are Standard & Poors Inc (S&P), Moody's Investors Service Inc (Moody's), and Fitch Inc (Fitch) having a market share between the three of them of approximately 95%. S&P and Moody's hold around 40% each and Fitch around 15%.

In 1975, the US financial watchdog, the Securities and Exchange Commission (SEC) began to specifically reference credit rating requirements done by Nationally Recognised Statistical Ratings Organizations (NRSRO) and as such acknowledged S&P, Moody's and Fitch as the first of these NRSRO's who became known as the 'Big Three'. Ratings provided by these companies are used by investors to *assess investment risk* and as benchmarks by federal and government agencies. Further credence comes from the fact that some regulated investment funds are mandated to only hold bonds and investments that have a high rating from an *accredited* rating agency meaning that in the event of a downgrade in ratings, regulated funds would have to sell.

In the current environment where the global value of sovereign bonds in issue is well in excess of USD 15 trillion, the influence of the Big Three credit rating agencies cannot and should not be underestimated.

A Brief History of the Big Three

As with most development in the US, it all started with the railroads. In the early 1900s, ratings began to be applied to securities, specifically those related to the railroad bond market.

In the U.S, the construction of the extensive railroad network led to the issuances of bonds to finance them, and a *bond market* several times larger than in other countries.

S&P is the oldest of the Big Three and began in 1860 when Henry Poor wrote and published an *investor's guide* to the U.S railroad industry, recording financial data about the railroad and canal industries. In 1923 the Standard Statistics Co. began rating mortgage bonds providing investors with *essential information* on the bond market; and in 1941, Poor's Publishing Company merged with Standard Statistics Company to form Standard & Poor's.

In 1907, following a *financial crisis* which drove the demand for independent market information and analysis of bond creditworthiness, financial analyst, John Moody issued a publication in 1909 focused solely on railroad bonds. His ratings became the first to be published widely in an accessible format, and his company was the first to charge subscription fees to investors. In 1913, the ratings publication by Moody's underwent two significant changes: it expanded its focus to include industrial firms and utilities, and it began to use a *letter-rating system*. For the first time, public securities were rated using a system borrowed from the mercantile credit rating agencies, using letters to indicate their creditworthiness.

The smallest of the Big Three, Fitch Inc. was founded by John Knowles Fitch December 24, 1914 in New York as the Fitch Publishing Company. He published the Fitch Bond Book, the Fitch Stock and Bond Manual, and other services furnishing daily and weekly *statistics* on the New York Stock Exchange and the American and Canadian corporate security field.

Over the next few years, antecedents of the "Big Three" credit rating agencies were established. Poor's Publishing Company began issuing ratings in 1916, Standard Statistics Company in 1922, and the Fitch Publishing Company in 1924.

From 1936 US banks were permitted to hold only *"investment grade"* bonds, and it was the ratings of Fitch, Moody's, Standard, and Poor's that legally determined which bonds were investment grade.

Their Business Model

Today, the Big Three are hugely *successful* agencies generating income in the upper Hundred Million Dollars. So, how do they do it?

Most agencies operate under one or a combination of business models, the *subscription model*, started by John Moody in 1909, and the *debt issuer-pays model*. However, credit rating agencies do offer additional services using a combination of business models.

Under the *subscription model,* a credit rating agency does not make its ratings freely available to the market with investors paying a subscription fee for access to ratings. Under the *issuer-pays model* a credit rating agency will charge the issuer of a debt-security (borrower) a fee for providing a credit rating assessment of the issuer (borrower) or in relation to particular debt security issued by the issuer (borrower). In the instance where the issuer pays the credit rating agencies, the agencies make their ratings freely available to the broader market, especially via the Internet.

In 2009 a World Bank report proposed a *"hybrid" approach* in which issuers (borrowers) who pay for ratings from credit rating agencies are required to source additional credit rating scores from other credit rating providers and where those providers only release the credit rating information to paying subscribers.

How Do Ratings Work?

Credit rating agencies are distinguished predominantly by their analytical approach in terms of assessing a credit risk. How exactly did S&P determine South Africa's credit rating downgrade following the recent cabinet reshuffle?

When analysing the credit risk of a country, S&P has a 5-8-member team that analyses the following aspects to make a determination on the credit rating of a country:

- **Political Risk** - are there any issues from a political standpoint that impede the country from paying or servicing its debts? A country in turmoil or at war is unlikely to pay back anything.
- **Regulatory risk** - do the policies and regulations make sense for the environment and for investors? Are the custodians of such policies and regulations adequately experienced and committed to these policies and regulations?
- **External risk** - is there a threat of war or trade sanctions, termination of trade agreements or concessions?
- **Fiscal risk** - is the government borrowing too much and does it spend too much on non-productive expenditure?
- **Economic risk** - Is the productivity of the country decelerating and the GDP growth slowing? If the economy is in turmoil, the government can collect less revenue from companies and individuals.

When it comes to assessing businesses, S&P considers the following list of indicators:

- **The quality of the assets** – this entails an assessment of the quality and value of the assets against which the institution is borrowing, making sure that there is enough coverage of the debt by the assets so that the lender could take these as collateral if borrower fails to repay.
- **Quality of the management team** - the calibre of management and their ability to drive the business in a growth trajectory if the business takes up a debt position as well as their aversion to overly exposing the business to risk.
- **Quality of the business** - this takes into account the performance of the business and whether or not it is growing and also if there are any external market, political or economic risks it faces.
- **Financial Balance Sheet** - does the business have any existing debt and are they in a position to service this and take on more debt and continue to repay this additional debt?

The S&P ratings range from AAA* to D (fail grade). In the international bond markets, most countries and businesses are rated this way.

S&P apply the following scale

AAA Highest Safety	Instruments with this rating are considered to have the highest degree of safety regarding timely servicing of financial obligations. Such instruments carry lowest credit risk.
AA High Safety	Instruments with this rating are considered to have high degree of safety regarding timely servicing of financial obligations. Such instruments carry very low credit risk.
A Adequate Safety	Instruments with this rating are considered to have adequate degree of safety regarding timely servicing of financial obligations. Such instruments carry low credit risk.
BBB Moderate Safety	Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.
BB Moderate Risk	Instruments with this rating are considered to have moderate risk of default regarding timely servicing of financial obligations.
B High Risk	Instruments with this rating are considered to have high risk of default regarding timely servicing of financial obligations.
C Very High Risk	Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.
D Default	Instruments with this rating are in default or are expected to be in default soon.

Source: https://www.crisil.com/ratings/credit-rating-scale.html

Are Credit Agencies Reliable?

Do credit rating agencies always just *'tell it like it is'* or are they also accountable for having made some serious mistakes? In performing a balanced overview of credit rating agencies it is essential to understand that like any enterprise or independent professional services company such as Audit Firms, credit ratings agencies are not infallible and history has shown that misjudgments can occur.

How is it that the credit rating agencies did not pick up the flaws in various debt-linked securities that triggered the Subprime crisis and where credit rating agencies continued to rate mortgage backed bonds as investment grade right up until the crisis occurred?

Similarly credit rating agencies rated Enron as Investment grade until 4 days before its collapse while the share price had been dropping for a considerable time before that. Popular reference is also made to Enron's Auditor at the time, Arthur Anderson, who were found guilty in relation to their handling of the auditing of Enron.

Credit rating agencies and others have put a number of explanations forward as to why inaccurate ratings and forecasts have occurred in the past. The reasons given at the time are summarised from an article published by the Wall Street Journal:

- The methodologies employed by agencies to rate and monitor securities may be inherently flawed where they rely on inaccurate historical data. For instance, a 2008 report by the Financial Stability Forum singled out methodological shortcomings—especially inadequate historical data—as a contributing cause in the underestimating of the risk in structured finance products before the subprime mortgage crisis.
- The ratings process relies on subjective judgments. This means that governments, for example, that are being rated can inform and influence credit rating analysts during the review process.
- The credit rating agencies' have an inherent conflict of interest to please the issuers (borrowers) of securities, who are their paying customers and who benefit from high ratings. Issuers (borrowers) stand to benefit from higher ratings in that many of their customers—retail banks, pension funds, money market funds, insurance companies—are prohibited by law or otherwise restrained from buying securities below a certain rating.
- The credit rating agencies may be significantly understaffed and thus unable to properly assess every debt instrument.
- Credit rating agency analysts may be underpaid relative to similar positions at investment banks, resulting in a migration of credit rating analysts and the analysts' inside knowledge of rating procedures to higher-paying jobs at the banks and firms that issue the securities being rated, and thereby facilitating the manipulation of ratings by issuers.
- The functional use of ratings as regulatory mechanisms may inflate their reputation for accuracy.

The Challenges

In all fairness, these challenges are equally applicable to all independent professional practitioners that engage and express an opinion on a company, issuer or security.
Whilst not completely fail proof the role of credit rating agencies is widely accepted as indispensable to both issuers and investors. Their quantifying of risk and predicting uncertainty does provide an easier and more efficient approach to investing in a Global market.

Keep abreast with our next issue as we highlight how Alternative Asset Classes such as Private Equity and Unlisted Property can offset the blow of the ratings downgrade and its impact on Retirement Funds.

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For the Clients and Partners of Summit Africa.

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