ROLE OF CREDIT RATING AGENCIES IN ANALYZING BANKS CREDIT RISK MANAGEMENT: ADVANTAGES AND DISADVANTAGES

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ABSTRACT

A credit rating agency 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. The debt instruments rated by CRA's include government bonds, corporate bonds, CD's, municipal bonds, preferred stock, and collateralized securities, such as mortgage-backed securities and collateralized debt obligations. The objective of the study is to analyze the major role played by credit rating agencies in decreasing credit risk of banks. The study analyzed both the advantages as well as disadvantages of credit rating. Both Analytical and descriptive type of research is used for the study. Data has been gathered from both primary and secondary sources i.e., through the websites of banks and credit rating agencies. The study briefly explains the advantages and disadvantages of CRA's towards banks. This helps banks to know how CRA's help them in choosing the worthy and credit repayable customers. The study describes the major role played by CRA's in banks credit risk management.

***Key Words**: Credit Rating, Credit Rating Agencies, Banks, Credit Risk Management, Customers, Investors.*

Introduction

Credit rating represents an opinion of a rating agency that evaluates the fundamental credit strength of an issuer and his ability to fully and punctually meet his debt obligations. Credit Rating indicates the credit worthiness of the borrowers and the probability that the borrowers will repay the interest and principal on due dates. Credit risk refers to the negative losses that are, if a borrower fails to repay debt of any kind. Credit risk management is a way of improving efficiency, capability and attaining a competitive edge. Banks are the main source of funds. They play a major role to all sectors of people by providing loans and finance. It is a financial institution which accepts deposits and provides loans for different purposes. Banks are managed and controlled by Reserve Bank of India (RBI).

Origin of Credit Rating and Credit Rating Agencies:

The Credit Rating Agency was first established in 1841 by Lewis Tappan in New York City. It was later taken by Robert Dun, who made available its first ratings guide in 1859. Another early agency, John Bradstreet, formed in 1849 and published a ratings guide in 1857.

Credit rating agencies originated in the United States in the early 1900s, when ratings began to be applied to securities, specifically those related to the railroad bond market. The bond markets in the Netherlands and Britain had been established longer but tended to be small, and revolved around sovereign governments that were trusted to honor their debts. Credit rating agencies provided investors with financial information on different industries. Later, they started emerging as a huge spectrum of information about different industries. In 1909, John Moody published solely on railroad bonds which became the first to be published worldwide in reachable format and his company was the first company who charged subscription fees to investors.

REVIEW OF LITRATURE:

1. **Robert and Gary (1994)** state that the most obvious characteristics of failed banks is not poor operating efficiency, however, but an increased volume of non-performing loans. Non-performing loans in unsuccessful banks have usually been connected with local macroeconomic troubles.
2. **DeYoung and Whalen (1994)** observed that the US Office of the Comptroller of the Currency found the difference between the failed banks and those that remained healthy or recovered from problems was the caliber of management. Superior mangers not only run their banks in a cost efficient fashion, and thus generate large profits relative to their peers, but also impose better loan underwriting and monitoring standards than their peers which result to better credit quality.
3. **Owojori et al (2011)** highlighted that available statistics from the liquidated banks clearly showed that inability to collect loans and advances extended to customers and directors or companies related to directors and managers was a most important provider to the suffering of the liquidated banks.
4. **Herwig; Patricia Langohr (2010)**Credit rating agencies play a critical role in capital markets, guiding the asset allocation of institutional investors as private capital moves freely around the world in investigating for the best trade-off connecting risk and return. However, they have also been strongly criticized for failing to spot the Asian crisis in the early 1990s.

   After analyzing various research papers and articles, besides the above mentioned, the following important observations with regard to credit rating and credit risk can be made:

OBJECTIVES OF THE STUDY:

1. The main objective of the study is to analyze the role played by credit rating agencies in banks credit risk management.
2. The study helps banks in analyzing the credit worthiness of their customers.
3. To analyze the causes of credit risk in Banks
4. To study the advantages and disadvantages of CRA’s towards banks.

NEED AND IMPORTANCE OF THE STUDY:

1. To know the role of credit rating agencies in banks credit risk management.
2. Their primary role is to reduce information asymmetry in credit markets by providing investors an opinion on the ability of an instrument to meet its obligations.

3. Banks need to select best credit rating agency to get accurate information about customers.
4. It also helps the issuers of the debt instruments to price their issues correctly and to reach out to new investors.

SCOPE OF THE STUDY:

The scope of the study is limited to banks which are failed in performing better. Worldwide data has been gathered to know whether there is any change with the compliance of credit rating agencies. The study is confined to analytical research and descriptive research. Secondary data is used for evaluation of banks, which are failed due to credit risk. Primary data gave the idea of credit rating agencies and their methodologies followed.

ROLE OF CREDIT RATING AGENCIES:

1. Credit rating agencies assess the relative credit risk of specific debt securities or structured finance instruments and borrowing entities, and in some case the creditworthiness of governments and their securities.
2. Credit rating establishes a link between risk and return. They have become a benchmark in measuring the risk for any instrument.
3. An investor uses the ratings to assess the risk level and compares the offered rate of return with this expected rate of return for the particular level of risk to optimize his risk-return trade-off.
4. The risk perception of a common investor, in the absence of a credit rating system, largely depends on his familiarity with the names of the promoters or the collaborators.
5. It is not feasible for the corporate issuer of a debt instrument to offer every prospective investor the opportunity to undertake a detailed risk evaluation.

ADVANTAGES OF CREDIT RATING:

- Lower cost of borrowing
- Wider audience for borrowing
- Rating as marketing tool
- Reduction of cost in public issues
- Motivation for growth
- Unknown issuer
- Benefits to brokers and financial intermediaries

This enables us for the best credit card offers, including many services like low interest rates and cards that give us gifts, points, airline miles or monetary rewards. We will even get low interest rates on all types of loans, and our applications will be approved quickly. We will be eligible for insurance at ideal rates.

DISADVANTAGES OF CREDIT RATING:

- Biased rating and misrepresentations
- Static study
- Concealment of material information
- Rating is no guarantee for soundness of company
- Human bias
- Reflection of temporary adverse conditions
- Difference in rating of two agencies

Our credit rating would upset us even more when you are previously having financial troubles. The rating would go down if we lose our job or have a medical emergency or fail in our bills for some or the other reason. This would remain you from receiving credit at a time when you might badly need it. Your credit rating can lock you into a subprime group. You will pay extremely high interest rates for any loans you manage to get because your rating marks you as a high-risk borrower. We might have difficulty in making payments on-time because the loan is so costly, which would keep us from improving our rating and thus thronging you into a negative cycle.

RESEARCH METHODOLOGY:

Both analytical research and descriptive research were used in accomplishing the objective of the study.

As analytical research, the researcher has to use the already available facts or information to make a critical evaluation.

Descriptive research is related to the state of relationships as it exists at the time of study.

In this study the researcher gathered the data from websites and made conclusions from it.

SOURCES OF DATA:

Primary data: Data has been gathered from personal communication with the employees of credit rating agencies.

Secondary data: Data from websites, journals, books, credit rating agencies is used for the study.

Main causes of credit risk in Banks:

1. Inadequate supervision by the central bank
2. Government interference
3. Poor lending practices
4. Laxity in credit assessment
5. Poor loan underwriting
6. Poor credit assessment
7. Reckless lending

8. Massive licensing of banks
9. Directed lending
10. Low capital and liquidity levels
11. Volatile interest rates
12. Inappropriate credit policies
13. Limited institutional capacity
14. Inappropriate laws

List of banks which failed worldwide from 2009 to 2016:

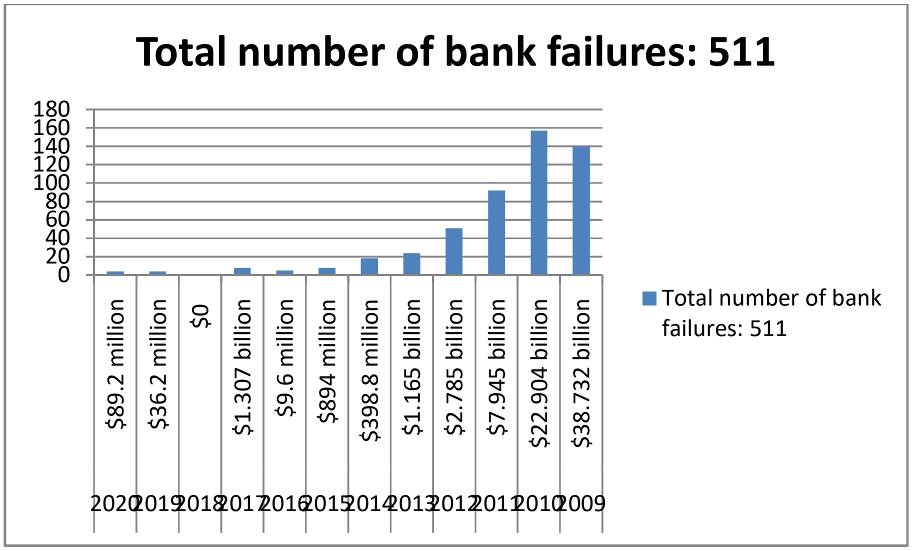
The estimated cost to the DIF is the amount of money paid out of the FDIC‘s Deposit Insurance Fund to depositors that likely won’t be recouped by the sale of the bank’s assets.

Table representing the list of banks which failed worldwide from 2009 to 2020

Year	Bank failure cost to Deposit Insurance Fund (DIF)	Total number of bank failures: 511
2020 (estimated)	$89.2 million	4
2019 (estimated)	$36.2 million	4
2018 (estimated)	$0	0
2017 (estimated)	$1.307 billion	8
2016 (estimated)	$9.6 million	5
2015 (estimated)	$894 million	8
2014 (estimated)	$398.8 million	18
2013 (estimated)	$1.165 billion	24
2012 (estimated)	$2.785 billion	51
2011 (official)	$7.945 billion	92
2010 (official)	$22.904 billion	157

2009 (official)	**$38.732 billion**	**140**

Graph representing the list of banks worldwide failed from 2009 to 2020



INTERPRETATION:

The graph represents the gradual decrease of bank failures from 2009-2016 which were 140 in 2009 and decreased to 1 in 2016. But again it increased from 2016 to 2017 and gradually decreased and became zero in 2018 and increased in 2019 and 2020. In 2010 we can see increase but slowly it started decreasing year by year. The role of credit rating agencies in banks credit risk management is very high. It was estimated from 2012 to 2020 and official from 2009 to 2011.

LIMITATIONS OF THE STUDY:

1. The existing manual credit risk management systems are quite expensive and very difficult to maintain.
2. The cost involved in keeping the qualified, experienced and trained credit rating executives is very high.
3. It is very uncommon for different classes of investors to arrive at some uniform conclusion as to the relative quality of the instrument. Moreover they do not possess the requisite skills of credit evaluation.

FINDINGS:

1. Credit rating agencies play a major role in credit risk management of banks
2. From the data we can find that banks are depending on credit rating agencies to know their customer's creditworthiness and credit repay ability.

3. Banks which are depending on credit rating agencies for customer information are able to withstand in the market.
4. Other banks without the proper information about customers start declining gradually.

SUGGESSIONS:

1. Banks should get customer information before granting loans to manage credit risk.
2. They should periodically recall customers about the credit repayment.
3. When banks are able to collect their loan amount on time then the problem of risk does not exist.
4. Banks need to select credit rating agency which give accurate and correct information about customers.

CONCLUSIONS:

1. With the involvement of credit rating agencies the number of banks failed, gradually decreased.
2. Credit rating agencies plays major role in controlling the credit risk and managing it.
3. It totally depends on getting the correct data from credit rating agencies.
4. If the data is incorrect then the results goes wrong, which leads the banks to close.
5. The need for credit rating in today's world cannot be overemphasized. It's of greater support in making investment decisions to the investors.

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