Risky Business

Credit rating agencies have been in the news for all the wrong reasons lately. Some institutions and countries have even blamed them for causing the current financial crisis in Europe and North America, prompting the EU to propose regulation in order to cut reliance on the big three rating agencies.

Historically, investors have relied on these rating agencies to provide them with information and assessments of companies and countries in order for them to analyse the risk before making investments.

Investment opportunities are increasingly global and diverse, making it difficult to decide which companies and which countries are good value. There are advantages to investing in foreign markets but the risks associated with sending money abroad are considerably higher than those associated with investing in a domestic market. It is important to gain an insight into different investment environments and also to understand the risks and the advantages that these environments pose.

Credit ratings, which measure the ability and willingness of an entity – whether a person, corporation or a country – to honour its financial commitments and debts, are crucially important when making investment decisions.

There are three primary agencies that deal in credit ratings for the investment world – Moody's, Standard & Poor's and Fitch. Each of these agencies aims to provide a rating system to help investors determine the risks associated with investing in a specific firm, instrument or market.

Ratings can be assigned to short-term and long-term debt obligations, as well as securities, loans, preferred stock and insurance companies. Long-term credit ratings tend to be more indicative of a country's investment surroundings and/or a company's ability to honour its debt responsibilities.

For a government or company, it is sometimes easier to pay back local currency obligations than it is to pay foreign currency obligations. Therefore, the ratings assess an entity's ability to pay debts in both foreign and local currencies. For example, a lack of foreign reserves may warrant a lower rating for those obligations that a country has made in foreign currency.

Clearing the junk

It is important to note that ratings are not the same as buy, sell or hold recommendations. Ratings are rather a measure of an entity's ability and willingness to repay debt.

Ratings lie on a spectrum ranging between highest credit quality on one end and default or "junk" on the other. Long-term credit ratings are denoted with a letter: a triple A (AAA) is the highest credit quality and C or D (depending on the agency issuing the rating) is the lowest or junk quality. Within this spectrum there are different degrees of each rating, which are, depending on the agency, sometimes denoted by a '+' or '–' or a number.

For example, when Fitch award a AAA rating, this signifies the highest investment grade and means that there is very low credit risk. AA represents very high credit quality, A means high credit quality and BBB is good credit quality. These ratings are considered to be investment grade, which means that the security or the entity being rated carries a level of quality that many institutions require when considering overseas investments.

Ratings that fall under BBB are considered to be speculative or junk. Thus for Moody's, a Ba2 would be a speculative grade rating, while for Standard & Poor's, a D denotes default or junk bond status. The chart gives us an overview of the different ratings symbols that Moody's and Standard & Poor's issue.

BOND RATING

Moody’s	Standard & Poors	Grade	Risk
Aaa	AAA	Investment	Lowest Risk
Aa	AA	Investment	Low Risk
A	A	Investment	Low Risk
Baa	BBB	Investment	Medium Risk
Ba, B	BB, B	Junk	High Risk
Caa/Ca/C	CCC/CC/C	Junk	Highest Risk
C	D	Junk	In Default

A rating can refer to an entity’s specific financial obligation or to its general credit worthiness. A sovereign credit rating provides the latter as it signifies a country’s overall ability to provide a secure investment environment.

This rating reflects factors such as a country’s economic status, transparency in the capital markets, level of public and private investment flows, foreign direct investment, foreign currency reserves, political stability or the ability for a country’s economy to remain stable, despite political change.

Doorway to understanding

Because it is the doorway into a country’s investment atmosphere, the sovereign rating is the first thing most institutional investors will look at when making a decision to invest money abroad. This rating gives the investor an immediate understanding of the level of risk associated with investing in the country. Therefore, a country with a sovereign rating will get more attention than one without. To attract foreign investment, most countries will strive to obtain a sovereign rating and they will strive even further to reach investment grade. In most circumstances, a country’s sovereign credit rating will be its upper limit of credit ratings.

Getting “rated” is a relatively new phenomenon in the GCC, becoming fashionable over the past few years, making GCC countries and entities attractive to foreign investors and lenders alike.

Emaar properties obtained its first rating in 2007, Moody’s giving it A3 and Standard & Poor’s giving it A-. Like many others, Emaar suffered in the property market collapse that followed and in 2011, its rating was BB but the outlook was revised from negative to stable.
“A credit rating is useful, not only for investors, but also for entities looking for investors. An investment grade rating can … boost a nation’s economy.”

Moody’s gave the GCC countries the following ratings and outlooks for 2011:

- Bahrain – Baa1 Negative
- Kuwait – Aa2 Stable
- Oman – A1 Stable
- Qatar – Aa2 Stable
- Saudi Arabia – Aa3 Stable
- UAE Abu Dhabi – Aa2 Stable

Abu Dhabi, the largest emirate in the UAE and the world’s sixth largest oil exporter, received its first credit ratings in July 2007 – “AA” from Fitch and Standard & Poor’s with a stable outlook – and became the first emirate to sell government bonds (US$ 1 Billion five year bond in July 2007). The Emirate of Ras AL

Khaimah received a credit rating in July 2011, “A” from Standard & Poor’s.

Surprisingly, Dubai does not yet have a credit rating, although it is actively seeking one.

A credit rating is useful, not only for foreign investors but also for entities looking for investors. An investment grade rating can put a company or country on the global radar, attracting money and boosting a nation’s economy.

Indeed for emerging market economies, a credit rating is key to attracting investment from foreign investors and, because a credit rating acts to facilitate investments, many countries and companies will strive to maintain and improve their credit ratings, hence ensuring a stable political environment and a more transparent capital market.