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Credit rating agency performance in terms of profit

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Abstract

This article aims to answer to certain issues of great interest: how profitable are rating agencies, that are their operating incomes, how a credit rating is assigned, who pays credit rating. This study follows the evolution of the three major agencies rating, Standard & Poor's, Moody's, Fitch, during 2003-2012, data were collected from official websites of the agencies published from annual reports.

Article is structure on two parts. The first part describes the agencies, their role in the market, what is their purpose. The second part presents the performance indicators and their evolution, and then presents the main strategies of agencies achieved through product diversification, increasing the quality agencies, etc.

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1. Introduction

Credit rating agencies are considered intermediaries of information as pursuing long-term evolution of a debt. Mostly, the rating agencies do not supervise short-term market and thus they do not respond to them in a short period fluctuations. Credit rating agencies are known as independent providers of credit opinions and play an important role in the market. Credit ratings agencies provide an assessment of the creditworthiness of issuers, which is essentially an assessment they made timely payment of debt, loans in general (Rousseau, 2009).

All the credit rating agencies listed below appear registered or certified in accordance with Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies on the ESMA official web site (European Securities and Markets Authority).

Table 1.List of registered and certified CRAs

Name of CRA	Country of residence	Status	Effective date
Euler Hermes Rating GmbH	Germany	Registered	16 November2010
Japan Credit Rating Agency Ltd	Japan	Certified	6 January 2011
Feri EuroRating Services AG	Germany	Registered	14 April 2011
BCRA-Credit Rating Agency AD	Bulgaria	Registered	6 April 2011
Creditreform Rating AG	Germany	Registered	18 May 2011
Scope Ratings AG (previously PSR Rating GmbH)	Germany	Registered	24 May 2011
ICAP Group SA	Greece	Registered	7 July 2011
GBB-Rating Gesellschaft für Bonitätsbeurteilung GmbH	Germany	Registered	28 July 2011
ASSEKURATA Assekuranz Rating-Agentur GmbH	Germany	Registered	18 August 2011
ARC Ratings, S.A. (previously Companhia Portuguesa de Rating, S.A)	Portugal	Registered	26 August 2011
AM Best Europe-Rating Services Ltd. (AMBERS)	UK	Registered	8 September 2011
DBRS Ratings Limited	UK	Registered	31 October 2011
Fitch France S.A.S.	France	Registered	31 October 2011
Fitch Deutschland GmbH	Germany	Registered	31 October 2011
Fitch Italia S.p.A.	Italy	Registered	31 October 2011
Fitch Polska S.A.	Poland	Registered	31 October 2011
Fitch Ratings España S.A.U.	Spain	Registered	31 October 2011
Fitch Ratings Limited	UK	Registered	31 October 2011
Fitch Ratings CIS Limited	UK	Registered	31 October 2011
Moody's Investors Service Cyprus Ltd	Cyprus	Registered	31 October 2011
Moody's France S.A.S.	France	Registered	31 October 2011
Moody's Deutschland GmbH	Germany	Registered	31 October 2011
Moody's Italia S.r.l.	Italy	Registered	31 October 2011
Moody's Investors Service España S.A.	Spain	Registered	31 October 2011
Moody's Investors Service Ltd	UK	Registered	31 October 2011

Standard & Poor's Credit Market Services France S.A.S.	France	Registered	31 October 2011
Standard & Poor's Credit Market Services Italy S.r.l.	Italy	Registered	31 October 2011
Standard & Poor's Credit Market Services Europe Limited	UK	Registered	31 October 2011
CRIF S.p.A.	Italy	Registered	22 December 2011
Capital Intelligence (Cyprus) Ltd	Cyprus	Registered	8 May 2012
European Rating Agency, a.s.	Slovakia	Registered	30 July 2012
Axesor SA	Spain	Registered	1 October 2012
Cerved Rating Agency S.p.A. (previoulsy CERVED Group S.p.A.)	Italy	Registered	20 December 2012
Kroll Bond Rating Agency	USA	Certified	20 March 2013
The Economist Intelligence Unit Ltd	UK	Registered	3 June 2013
Dagong Europe Credit Rating Srl (Dagong Europe)	Italy	Registered	13 June 2013
Spread Research	France	Registered	1 July 2013
EuroRating Sp. z o.o.	Poland	Registered	7 May 2014
HR Ratings de México, S.A. de C.V. (HR Ratings)	Mexico	Certified	7 November 2014
Moody's Investors Service EMEA Ltd	UK	Registered	24 November 2014
Egan-Jones Ratings Co. (EJR)	USA	Certified	12 December 2014

Source: http://www.esma.europa.eu (update: 12 December 2014)

The market for fundamental credit ratings cannot sustain a large number of agencies. The market will remain an oligopoly where CRAs tend to compete for the market (to become a standard) rather than in the market. However, competitive dynamics amongst even a small number of CRAs can be based on building a reputation for rating quality.

The credit rating industry is a global business, but controlled by only a few players. Two of US parentage (Moody"s and Standard & Poor"s) control over 80% of the market. Fitch was the third entrant into the market, and its ultimate owner is headquartered in Paris so in principle European. With Fitch, the three leading players control over 94% of the global market. Since 2007 all three groups suffered a serious decline in revenue and profits. However it was Fitch which suffered the most, suggesting that more competition may not be the answer to improving the status of the market.

Table 2. Structure of rating agencies

McGraw Hill Financial	Moody's Corporation	Fitch Group (until 2005 Fitch Ratings)
S&P Ratings Services	**Moody's Investors Service**	**Fitch Ratings**
S&P Dow Jones Indices	Moody's Analytics	Fitch Learning
S&P Capital IQ		Fitch Solutions

Besides these three agencies, a very small part of the market is occupied by small specialized companies, most organized nationally. Basel Committee on Banking Supervision has estimated that it would be around 130 agencies worldwide.

There are 10 agencies NRSRO according to the organization's annual report of 13 dec.2013: AM Best Company Inc., registered on 24 September. 2007; DBRS Inc., registered in 24 Sept.2007; Egan-Jones Rating Company, registered on 21 Dec.2007,; Fitch Rating Inc., registered in 24 Sept.2007; Japan Credit Rating Agency Ltd, registered on 24 Sept.2007; Moody's Investors Service Inc., registered on 24 September. 2007 Morningstar Credit Rating LLC, registered on 23 June 2008, Kroll Bond Rating Agency Inc., registered on 11 Febr. 2008, S & P Ratings Services, filed 24 Sept.2007; hr Ratings de Mexico SA The C.V., registered on 5 nov.2012. Most have as headquarters US, excluding Japan Credit Rating Agency Ltd, with headquarters in Japan and HR Ratings de Mexico SA The C.V, with headquarters in Mexico.

Nationally Recognized Statistical Rating Organization (NRSRO) nationally recognized statistical rating organization is a credit rating agency which issues credit ratings certified by qualified institutional buyers on: (I) financial institutions, brokers, dealers or; (ii) insurance companies; (iii) corporate issuers; (iv) issuers of asset-backed securities; (v) issuers of government securities, municipal securities, or securities issued by a foreign government; (vi) a combination of one or more categories of borrowers described in any of clauses (i) through (v) above.

The first credit ratings (1909) occurred after the panic of 1907 in the US, who trained alteration of investor confidence in financial markets and the regulation of it and the emergence need to provide impartial information by neutral entity, the financial creditworthiness of borrowers. Rating activity has grown tremendously since the '80s, with the development of international financial markets and the increasing complexity of loan products.

Table 3. Number of Outstanding Credit Ratings by Category of Credit Rating

NRSRO	Financial Institutions	Insurance Companies	Corporate Issuers	Asset-Backed Securities	Government Securities	Total Ratings
A.M. Best	N/R	4,610	1,787	55	N/R	6,452
DBRS	16,222	148	3,736	10,054	15,952	46,112
EJR	109	48	1,004	N/R	N/R	1,161
Fitch	51,718	3,786	15,367	56,311	223,188	350,370
HR Ratings	N/R	N/R	N/R	N/R	184	184
JCR	159	27	472	N/R	56	714
KBRA	15,646	50	1,000	352	1,945	18,993
Moody's	50,795	3,639	32,510	82,357	754,062	923,363
Morningstar	N/R	N/R	N/R	13,935	N/R	13,935
S&P	60,300	7,600	47,400	97,500	930,500	1,143,300
Total	194,949	19,908	103,276	260,564	1,925,887	2,504,584

Source: NRSRO Annual Report 2013

Of the total of 2,504,584 issued ratings, S & P holds 45, 6%, ie 1,143,300 issued ratings, most ratings of government securities being issued, 930500. On the second place is Moody's by having 923,363 ratings issued, where 754,062

were issued for government securities and 82,357 were asset-backed securities. The third place is occupied by Fitch, 14% of all ratings issued, most of them 223,188 are goverment securities.
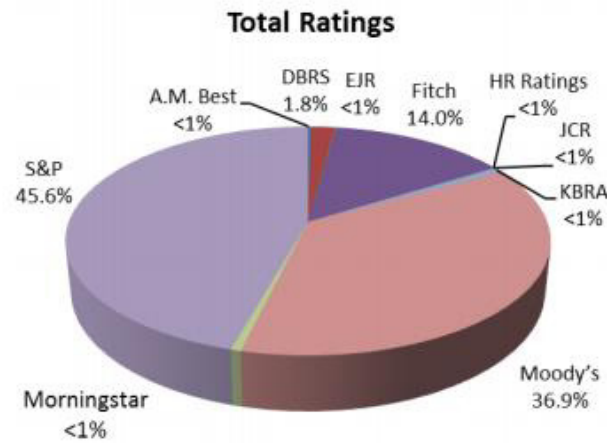
Total Ratings

Chart 1. The percent of the credit ratings in total for all NRSRO agencies

The pie charts above show that, S&P and Moody's continue to be the two NRSROs with the highest number of ratings reported to be outstanding as of December 31, 2012, accounting for about 45.6% and 36.9%, respectively, of all outstanding ratings. Fitch reported having the third highest number of outstanding ratings, accounting for about 14.0% of all outstanding ratings. In total, these three NRSROs issued about 96.5% of all the ratings that were reported to be outstanding as of December 31, 2012. This is the lowest percentage of outstanding ratings issued in the aggregate by such NRSROs since 2007, which is the year when NRSROs began reporting outstanding ratings on Form NRSRO. As of the 2007 year end, these three NRSROs accounted for about 98.8% of all outstanding ratings.

Credit rating agencies have a similar **role** of external auditors. Therefore, the rating can be used as a tool in transactions with companies (mergers and acquisitions), strengthens contracts, reduce transaction costs and monitoring.

Role of rating agencies is to assess objectively and independently the risk of bankruptcy or default of an economic actor issuer of debt securities or bonds. Agencies inform investors about the risks they are subject when borrowing a company or state.

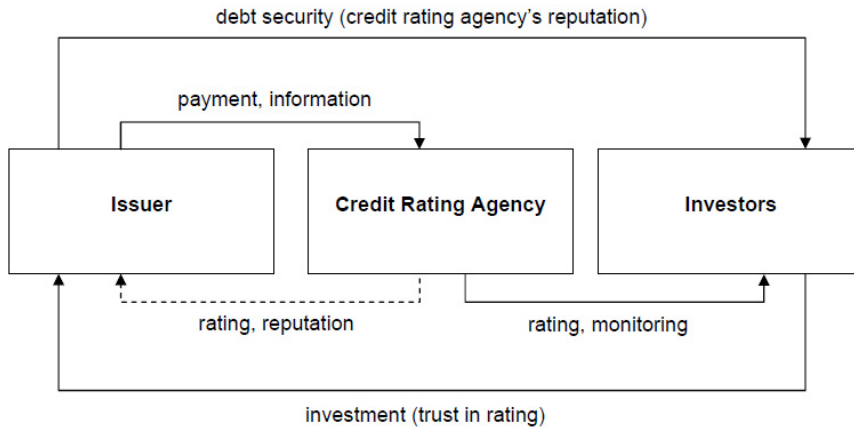The relationship between rating and reputation of rating agencies is shown in the following figure.

Fig. 1. Information intermediation

Source: Dittrich, 2007, p.10

Through the credit rating debtor's companies benefit from the credibility of rating agencies. Transfer of credibility is ensured by the main service offered by agencies: indicator services (Dittrich, 2007).

The role of rating agencies is to objectively and independently assess the risk of bankruptcy or default of an economic actor issuing debt securities or bonds. These inform investors about the risks they are subject when borrowing a company or state.

Another important role of agencies is to facilitate contracting because letters / rating scale are effective criteria for assessing credit quality. The private contracting of basic restrictions ratings appear in contracts for loans, payment commitments and other financial instruments.

Rating agencies were those that made possible the existence and development of structured finance securities market, according to Utzig (2010, p. 1), because ratings have guaranteed the interpretation of new products for investors safety. The rating has become an referential for active package structuring and rating agencies have provided support services to issuers (paying rating) to this effect, which opened the way the manifestation of conflicts of interest.

2. Performance indicators

Table 4. CRA market share on 2013

Registered Credit Rating Agency	Market share %
AM Best Europe-Rating Services Ltd. (AMBERS)	0.72
ARC Ratings, S.A.	0.03
ASSEKURATA Assekuranz Rating-Agentur GmbH	0.26
Axesor S.A.	0.58
BCRA-Credit Rating Agency AD	0.03
Capital Intelligence (Cyprus) Ltd	0.13
CERVED Group S.p.A.	2.19
Creditreform Rating AG	0.53
CRIF S.p.A.	0.76
Dagong Europe Credit Rating Srl (Dagong Europe)	<0.01
DBRS Ratings Limited	1.27
Euler Hermes Rating GmbH	0.24
European Rating Agency, a.s.	<0.01
EuroRating Sp. Zo.o.	<0.01
Feri EuroRating Services AG	0.67
Fitch Group	16.22
GBB-Rating Gesellschaft für Bonitätsbeurteilung mbH	0.33
ICAP Group SA	0.75
Moody's Group	34.53
Scope Credit Rating GmbH	0.14
Spread Research SAS	0.09
Standard & Poor's Group	39.69
The Economist Intelligence Unit Ltd	0.83
TOTAL	100

Source : http://www.esma.europa.eu

In generally we measure *industry concentration*, which indicates the competitiveness of an industry, by using the Herfindahl-Hirschman Index ("HHI").

The inverse of the HHI ("HHI Inverse") can be used to represent the number of equally sized firms necessary to replicate the degree of concentration in a particular industry. The HHI Inverse is calculated by dividing 10,000 by the HHI. In other words, an industry with an HHI Inverse of 3.0 would have a concentration that is equal to an industry where the entire market is evenly divided among three firms.

Calculations of the HHI and HHI Inverse confirm the results included in table 3 of this article. Based on the number of outstanding ratings included there, the HHI indicates that the NRSRO industry constitutes a "concentrated" market, and is the equivalent concentration of an industry with approximately 2.75 equally sized firms.

Table 5. HHI Inverse for each rating category from 2008 to 2012

Year	Financial Institutions	Insurance Companies	Corporate Issuers	Asset-Backed Securities	Government Securities	Total (all rating categories)	Total Excluding Government Securities
2008	3.72	4.05	3.79	2.82	2.83	2.99	3.56
2009	3.85	3.84	3.18	3.18	2.65	2.86	3.58
2010	3.99	3.37	3.17	3.20	2.69	2.88	3.55
2011	4.16	3.76	3.02	3.38	2.47	2.74	3.70
2012	4.02	3.72	3.00	3.44	2.50	2.75	3.68

Source: NRSRO Annual Report 2013

The table shows that since 2008, the HHI Inverse for all rating categories in total and the rating categories of insurance, corporate and government securities has declined, indicating that NRSRO industry concentration has increased in those rating categories. Since 2008, the HHI Inverse for financial institutions and asset-backed securities has increased, indicating that NRSRO industry concentration has declined for those rating categories.

The government securities rating category (which includes sovereigns, U.S. public finance, and international public finance) is the largest class of ratings (comprising approximately 77% of all ratings outstanding as of December 31, 2012) and is dominated by S&P and Moody's (which together issued 87.5% of all outstanding government ratings as of December 31, 2012). The size of the ratings class relates to the large number of municipalities which issue rated securities, often several times a year. Thus, the table shows that the HHI Inverse for all rating categories excluding government securities increased slightly between 2008 and 2012, indicating a slight decline in concentration. While the aggregation of all five rating categories shows that industry concentration has increased since 2008, if the government securities rating category is excluded, industry concentration will be seen to have declined slightly.

The performance of rating agencies is seen from two perspectives: in terms of profit and performance in terms of accuracy.

This article presents the performance of CRA in terms of profit, making an analysis of the following indicators listed below: net turnover, net income, number of employees and I have calculated for all three agencies net margin and labor productivity. Net margin is a financial indicator of profitability, which shows how profitable is a company's of total activity. The higher the percentage is, the company in terms of profitability is more stable and suggests it has a good situation. Labour productivity measures efficiency use of human factor, must be in continuous increase.

Net margin = net income/net turnover*100 (1)
Labor productivity=net turnover/employees   (2)

Tabel 6. Main performance indicators of Moodys agency during 2012-2003 (thousand dollars).

MOODYS	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003
NET INCOME	690.000	571.400	507.800	402.000	457.600	701.500	753.900	560.800	425.100	363.900
NET TURNOVER	2.730.300	2.280.700	2.032.000	1.797.200	1.755.400	2.259.000	2.037.100	1.731.600	1.438.300	1.246.600
NUMBER OF EMPLOYEES	6800	6100	4500	4000	3900	3600	3400	2900	2500	2300
NET MARGIN	25,2719481	25,05371	24,99015748	22,3681282	26,06813	31,05356	37,00849	32,38623	29,55573	29,1914
LABOR PRODUCTIVITY	401,514706	373,8852	451,5555556	449,3	450,1026	627,5	599,1471	597,1034	575,32	542

Source: www.moodys.com

From the tabel above we can see that the number of employees have increased, but regarding net turnover and net income we see that starting with 2008 they both decreased, and that the financial economic crises started in 2008 influenced the profitability of the company.
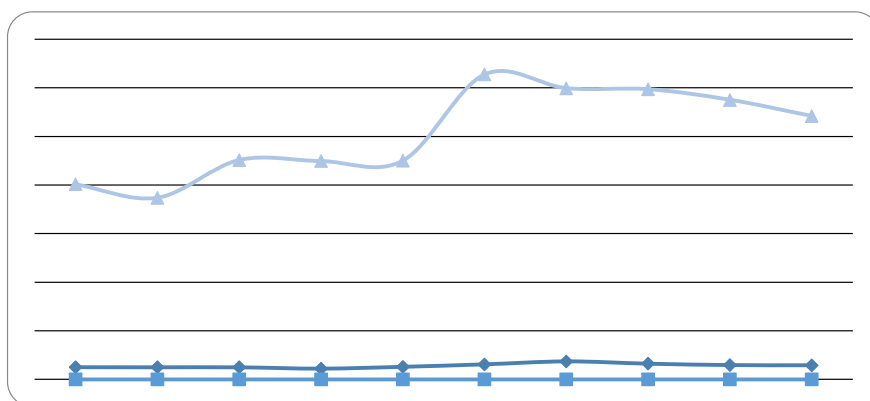
Chart 2. The evolution of labor productivity and net margin of Moodys agency during 2012-2003

Even though the number of employees increased labor productivity has fluctuated various because the net turnover recorded different values during the analised period. In period 2003-2007 labor productivity increased, but starting with 2008, has decreased. However registered a slight stagnation in 2008-2009-2010. Regarding net margin, the biggest value was in 2006, 37%, and the lowest value eas in 2009, 22.36%.

Tabel 7. Main performance indicators of Standard&Poors agency during 2012-2003 (thousand dollars).

S&P M C Graw Hill	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003
NET INCOME	437.000	911.00 0	828.000	731.000	799.49 1	1.013.5 59	882.23 1	844.30 6	755.82 3	687.65 0
NET TURNOVER	4.450.00 0	3.954.0 00	3.639.000	5.870.000	6.355.0 55	6.772.2 81	6.255.1 38	6.003.6 42	5.250.5 38	4.890.3 20
NUMBER OF EMPLOYEES	21687	22660	20755	21077	21649	21171	20214	19600	17253	16068
NET MARGIN	9,820224 72	23,039 96	22,75350 371	12,45315 162	12,580 39	14,966 29	14,104 1	14,063 23	14,395 15	14,061 45
LABOR PRODUCTIV ITY	205,1920 51	174,49 25	175,3312 455	278,5026 332	293,54 96	319,88 48	309,44 58	306,30 83	304,32 61	304,35 15

Source: www.standard&poors.com

Regarding net turnover we see that S&P is the largest agency from all three. Is the largest also regarding the number of employees and from, the table we see it also was in continuous growing.

Tabel 8. Main performance indicators of Fitch agency during 2012-2003 (thousand dollars).

Fitch	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003
NET INCOME	77.718	53.390	42.386	42.574	38.996	32.766	17.725	21.544	15.944	17.278
NET TURNOVER	349.997	258.746	227.197	214.957	199.491	191.765	106.506	127.495	104.668	97.561
NUMBER OF EMPLOYEES	1466	1426	1367	1384	1404	1215	1002	859	733	667
NET MARGIN	22,2053332	20,63414	18,6560562	19,80582163	19,54775	17,08654	16,64225	16,89792	15,23293	17,70995
LABOR PRODUCTIVITY	238,742838	181,4488	166,2011704	155,3157514	142,0876	157,8313	106,2934	148,4226	142,794	146,2684

Source: www. fitch.com

From the table above we can see that number of employees was in continuous growing but comparing to S&P was much lower. Regarding net income we can see that comparing 2011 with 2003 has tripled and the net turnover in generally has increased, a a slight decrease was recorded in 2006.
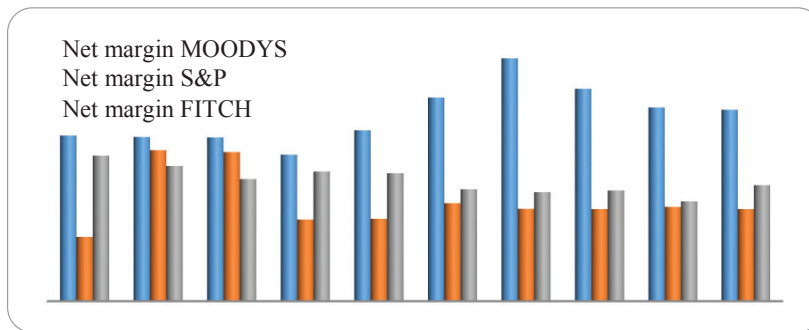

Chart 3. Evolution of net margin of the three major agencies.

A net margin spectacular evolution is recorded by Moodys Agency in 2006. An increasing trend can be observed at Fitch agency for 2009-2012 perioud and for S & P a spectacular decline was recorded in 2012 compared to 2010-2011.
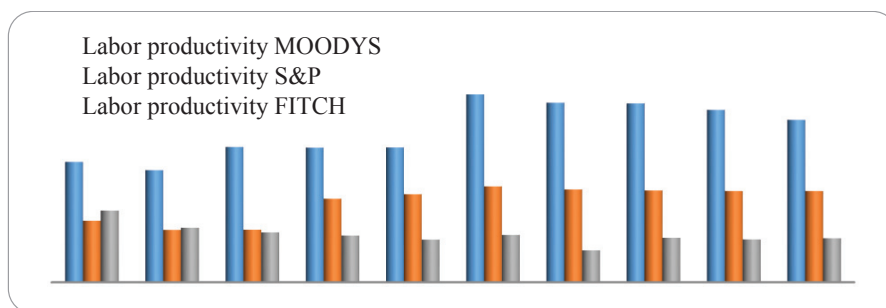

Chart 4. Evolution of the labor productivity of the three major agencies.

From the chart done it appears that in the period 2003-2007, labor productivity is still growing for Moodys, company because the number of agency staff has been growing even registered a double of the number of employees in 2010 compared 2003.

Regarding the S & P there is an increase in labor productivity for the years 2003-2007, a slight decrease, 2008-2009, the year 2010 was marked by a sharp decline.

For Fitch, low productivity was recorded in 2006, and after 2009 has seen an ascending evolution until 2012.

3. Conclusion

Although there is possibility of theoretical conflicts and intuitive, there are no empirical studies to support their materialization in practice. As financial products were new, the rating agencies had the experience, theoretical knowledge and poor historical data about them, which affected negative the technical side rating (models and qualitative assessments).

Rating agencies have increasingly detailed procedures for verifying information received from issuers and monitoring of ratings. In order to ensure competent human resources, agencies have developed, often together with other partners, training programs in the field of credit risk and increased budgets for employee training.

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