CREDIT-RATING BUSINESS IN PAKISTAN: NORMS & PRACTICES

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ABSTRACT: *The paper aims to present duopoly based credit-rating business in Pakistan that comprises on two companies i.e., (a) Pakistan Credit Rating Agency Limited (PACRA) and (b) Japan Credit Rating – Vital Information Services Credit Rating Co. Ltd. (JCR-VIS). This research presents comparisons between two credit rating agencies on six operational issues; (a) Services Offered; (b) Pricing Issues; (c) Rating Processes; (d) Rating Scales and (e) Strategic Issues for both companies. It provides valuable insights in understanding the local credit rating industry and selection of a particular agency for credit rating.*

I. INTRODUCTION

The objective of this study was to examine the norms and practice at duopoly based credit rating business in Pakistan. The two companies are a) Pakistan Credit Rating Agency Limited (PACRA) and (b) Japan Credit Rating – Vital Information Services Credit Rating Co. Ltd. (JCR-VIS). This research presents comparisons between two credit rating agencies on six operational issues; (a) Services Offered; (b) Pricing Issues; (c) Rating Processes; (d) Rating Scales and (e) Strategic Issues for both companies.

II. LITERATURE REVIEW

Worldwide the credit rating industry is somewhat oligopolistic in nature [1] and exhibits the few distinctive characteristics [2]. Firstly the two firms (Moody's Investor Services [Moody's] and Standard and Poor's [S&P]) dominated the US and worldwide credit rating industry. Secondly, the industry has fewer other players and most of them have positioned themselves in some particular sector except for two bigger giants i.e. Moody's and S&P. Thirdly the barriers to market entry are high and the possible entrants must have the "heritage of reputation". Fourth, the rating agency business is itself reputation-based and the corporate sector pays little attention to a rating that is not widely recognized. Finally and probably most importantly high profit margins: most of companies operating in this business earn 50% or more gross profit margins while the two bigger giants had revenues of approximately US$ 2.0 billion in 2009. Five major credit rating agencies (CRAs) share the 80% business volume and these companies and their scope of work is presented in Table 1:

Major Criticism: The high-earning, credibility-seeking, credit rating industry worldwide has been subject to the various criticisms [4] as well such as; (a) they do not downgrade companies promptly enough; (b) large corporate rating agencies have been criticized for having too familiar a relationship with client management; (c) the lowering of a credit score by a CRA can create a vicious cycle, as not only interest rates for that company would go up, but other contracts with financial institutions may be affected adversely, causing an increase in expenses and ensuing decrease in credit worthiness;(d) they have made errors of judgment in rating structured products, particularly in assigning higher ratings to mediocre structured debt, which in a large number of cases has subsequently been downgraded or defaulted;(e) larger ratings agencies, have been implicitly allowed by governments to fill a quasi-regulatory role, but because they are for-profit entities their incentives may be misaligned and many more.

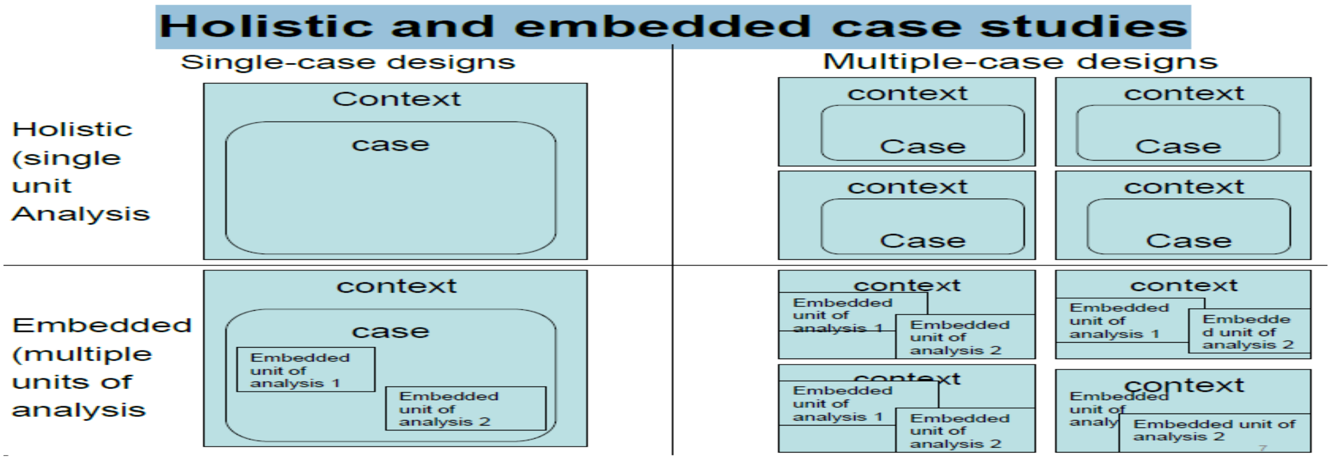
Table 1 Top 5 International Rating Agencies [3]

Rating Agency	Scope of Work
IBCA[i]	Financial Institutions, Insurance companies, sovereign countries.
Thomson BankWatch[ii]	Financial Institutions worldwide
Fitch[iii]	Public and Private fixed income securities in USA
Duff & Phelps[iv]	Corporate Debt securities, Securitized Ratings & insurance companies
Standard & Poor's[v]	Comprehensive – covers all entities listed above and more
Moody's[vi]	Comprehensive – covers all entities listed above and more

Recent Trends: During the last decade, a new trend has been observed in credit rating agencies especially among the largest four players. Once known as "sleepy agencies"[5], now had begun to be more aggressive in their marketing tactics. S&P had substantially increased its international presence with aggressive marketing endeavours and prompt acquisition and affiliation strategy. It had opened several offices worldwide in Asia and tied up with Asian rating agencies. Moody's had adopted aggressive marketing activities but decided against linking up with Asian rating agencies. Fitch has acquired IBCA in 1997, Duff & Phelps and Thomson BankWatch [6] during 2000 which made it the third largest full-service credit rating agency while keeping pace with growth of capital markets worldwide with the help of promotional activities and affiliation strategy.

III. METHODOLOGY

Case study research design has been selected for this research. In a case study method a 'case" on which the research would be conducted is chosen, which should fulfil the following requirements; a) it should be a complex functional unit, b) be contemporary and c) be investigated in its natural context [7]. This research fulfils the requirements outlined earlier. The research using the case study method mainly focuses on capturing the depth of a single or two cases, and this methodology is much supported by the researchers in the context of social sciences [8]. This research



uses multi-case study design [9] with a series of comparison between them.

There are four types of case research designs in literature review: 1) Single Case Holistic; 2) Single Case Embedded; 3) Multiple Cases Holistic; and 4) Multiple Cases Embedded [10]. (See Figure below)

In Pakistan many case studies on this subject area have been written but all of them using Single Case Holistic method [11] Elsewhere [12 - 19]; a few of them also used Single Case Embedded method [20,21], but presentation of Multiple Case Embedded method on this subject area is absolutely absent in the contemporary literature available in Pakistan. This research is also unique for its methodological part as it uses Multiple Case Embedded method. For this research two embedded case studies have been prepared to reflect the duopoly based credit-rating industry in Pakistan as there are only two players; JCR-VIS and PACRA.

CASE STUDY – I JCR-VIS: JCR-VIS is a joint venture between JCRvii, VISviii, KSEix and ISEx. JCR-VIS is Pakistan's only data bank and financial research organization, operating as a "Full Service" rating agency and known for providing high quality independent rating services in Pakistan. Initially the company was incorporated as a joint venture between VIS, KSE, ISE and DCR back in 1997. Subsequent to DCR's merger with Fitch IBCA, DCR sold its interests in DCR-VIS to VIS. In 2001, JCR and VIS entered into a joint venture agreement whereby JCR acquired 15% share in DCR-VIS Credit Rating Co. Ltd. of Pakistan. Subsequently JCR-VIS was established in 2001 as a joint venture between JCR, VIS, KSE, and ISE. As a result of this joint venture, the name of the company changed from DCR-VIS Credit Rating Co. Ltd. to JCR-VIS Credit Rating Co. Ltd. (JCR-VIS) [22].

CASE STUDY – II PACRA: Pakistan Credit Rating Agency (PACRA) is a joint venture among IBCAxi, IFCxii and LSExiii. It was established in 1994 as the first credit rating agency in Pakistan and has completed well over a hundred ratings, including major industrial corporations, financial institutions and debt instruments. In addition to local ratings, PACRA is also active in international rating assignments with the collaboration of Fitch [23,24,25].

IV. DATA COLLECTION

This paper has been prepared with the use of mixed methods i.e., secondary data and smaller level of primary data. The official websites of JCR-VIS [26] and PACRA [27] were extensively examined.

V. FINDINGS

The findings have been classified on five operational issues; (a) Services Offered; (b) Pricing issues; (c) Credit Rating Processes; (d) Credit Rating Scales and (e) Strategic issues for both companies.

a) Services Offered: Both companies offer services in five basic categories i.e., (a) Entity Ratings; (b) Instrument Ratings; (c) Real Estate Grading; (e) Indicative Ratings; and (f) International services. A number of observations can be made from the table 2. Firstly, two major streams of business for rating agencies include Entity ratings and Instrument ratings. Entity rating is the opinion of the general creditworthiness of a company's senior unsecured debt. Instrument ratings include the rating of financial instruments like TFC/CP denotes its creditworthiness with respect to a particular debt security based on relevant risk factors. Both companies are offering services to both entity ratings and instrument ratings. Secondly, JCR-VIS has some edge over PACRA as they also offer Microfinance Ratings. JCR-VIS is the only pre-approved rating agency by the Microfinance Rating and Assessment Fund for ratings of microfinance institutions (MFIs) in Pakistan and other South Asian countries. Thirdly, JCR-VIS also provides ratings based on corporate governance compliance to SECP and SBP which gave them a first mover advantage in the relevant market segments Fourth, one of the new developments in the local rating business is the rating of real estate agencies and developers. PACRA has joined hands with NESPAK for Real Estate Grading System which gave them a head start in this particular segment.

Table – 2 Comparative Analysis of Services Offered

	JCR-VIS [28]	PACRA [29]
ENTITY RATINGS		
Commercial Banks, Development Financial Institutions, Investment Banks,	√	√
Leasing Companies, Modarabas , Security Firms Housing Finance Companies	√	√
Mutual Funds, Asset Management Companies, Insurer Financial Strength (IFS)	√	√
Micro Finance Banks	√	N/A
Industrial Corporations	√	√
INSTRUMENT RATINGS		
Long Term Corporate Debt Instruments, Short Term Corporate Debt Instruments	√	√
REAL ESTATE GRADING		
Real Estate Developer	√	√
CORPORATE GOVERNANCE RATINGS		
Corporate Governance Ratings / NPO Governance Ratings	√	N/A
INDICATIVE RATING		
Financial Risk Assessment	√	√

* Source: company websites

Fifth, both companies conduct indicative ratings for entities those wish to get an initial idea regarding their ratings prior to going for a full formal rating review. The indicative ratings – as the name suggests – merely indicate the rating band or category in which the entity's ratings are likely to fall, if a formal rating review were to be conducted. As such, indicative ratings are not meant for public dissemination and are meant only for the consumption of the management of the entity.

Lastly, both companies provide international rating scales in collaboration with their international partners. JCR-VIS provides international rating in collaboration with JCR while PACRA work with Fitch for their international rating assignments. These international services include (a) Foreign currency ratings; (b) Local currency ratings on international scale; and (c) Local currency ratings on national scale.

Both agencies have received endorsement from Securities & Exchange Commission of Pakistan (SECP) and State Bank of Pakistan (SBP). Additionally they have also leveraged their reputation by strategically aligning their companies with international credit rating associations, global credit rating agencies and other strategic companies.

b) **Pricing Issues:** Table 3 illustrates the comparative rating fees for both JCR-VIS and PACRA which reflect that both companies are offering their services for almost same rating fees. With respect to pricing, rating fees varied based on a range of factors including the size of the entity or size of the financial instrument. However for real-estate and corporate governance assignments the rating fees is fixed. It also offers customized deals with incentives to high value customers for additional services.

c) **Credit Rating System:** The credit rating system is based on two integral components; (a) Credit Rating Committee; and (b) Credit Rating Processes.

Table –3 Comparative Analysis of Credit Rating Fees

	JCR-VIS [30]	PACRA [31]
ENTITY RATINGS		
Commercial Banks/DFI		
Large [Total assets ≥ 5% of overall banking assets]	1,000,000	1,000,000
Medium [Total assets < 5% & ≥ 2% of overall banking assets]	800,000	800,000
Small [Total assets < 2% of overall banking assets]	600,000	600,000
Micro Finance Banks	550,000	N/A
Leasing Companies, Investment Banks, Security Firms, Housing Finance Co.	500,000	500,000
Modarabas	350,000	350,000
Industrial Corporations	350,000	350,000
Mutual Funds	100,000	125,000
Asset Management Companies	500,000	500,000
Large AMC[AUM ≥ 10.0 Bn]	350,000	350,000
Small AMC[AUM < 10.0 Bn]		
Insurer Financial St. (IFS)		
Large Ins. Co.[GPW ≥ 1.0 Bn]	500,000	500,000
Small Ins. Co.[GPW < 1.0 Bn]	350,000	350,000
INSTRUMENT RATINGS		
Long Term Debt Instruments [TFC, Sukooks, etc.]	**300,000	**300,000
Short Term Debt Instruments [TFCs, Commercial Papers]	**300,000	**300,000
REAL ESTATE GRADING		
Real Estate Developer	450,000	450,000
CORPORATE GOVERNANCE RATINGS		
Corporate Governance / NPO Governance Ratings	350,000	N/A
INDICATIVE RATING		
Financial Risk Assessment	80% fees	35% fees

* Source: company websites ** Minimum

Credit Rating Committee: At JCR-VIS Credit Rating Committee is headed by CEO and consists of five voting members and one non-voting member. The required quorum for a rating committee meeting is a minimum of two voting members which shall include one advisor. The relevant analysts for each project present the case to the rating committee and assist in the deliberations on the ratings. On the other hand at PACRA the rating committee comprises of only two persons i.e., Chief Executive Officer (CEO) and Chief Operating Officer (COO).

Once a rating is finalized, the client is under ongoing surveillance by agency during which interim and annual results are reviewed, at least on a quarterly basis, and other client developments are monitored, based on which agency may re-evaluate the rating at any time if such action is warranted. In addition, rated companies are subject to detailed review, normally on an annual basis. During and after the process agency does not reveal confidential information obtained during the rating exercise to anyone except the regulators, provided the request is made in writing. This policy is based on exceptions for regulatory queries.

d) ***Credit Rating Scales:*** Credit rating scales represent the credit worthiness of specific company based on their financial performance and financial strength. JCR-VIS provides rating grades which are more detailed in their description. These rating scales differ for different duration and industry segments. Medium to long-term credit ratings (a horizon of 2 to 3 years) range from 'AAA', reflecting the strongest credit quality, to 'C', reflecting the lowest credit quality. Default grades are tagged separately.

e) **Strategic Issues:** For international initiatives JCR-VIS have some edge over PACRA as they were involved in establishing the Islamic International Rating Agency (IIRA), Bahrain. IIRA was established to carry out rating operations principally in Islamic countries. Its shareholders include Islamic Development Bank and 14 other banks and financial institutions from around the Muslim world. They were also involved in setting up a rating company in Bangladesh in 1997 and having close working relationships with Rating Agency Malaysia Berhad (RAM) of Malaysia [34,35].

f) In local credit rating industry the major business development activities are "PULL" based due to regulatory requirements. SBP & SECP have made the rating of banks and other financial institutions mandatory. To get their entity rating banks and financial institutions have only two choices, PACRA or JCR-VIS.

g) The major clientele comprises banks and financial institutions, who want their risk analysis portfolio to be rated. Both companies also carry out indicative corporate entity rating: that is when the companies want to issue

IPO, Public Issue or TFC, that have to get a good credit rating from the agency.

Table – 4 Comparative Analysis of Credit Rating Scales (medium to long-term)

JCR-VIS [32]		PACRA[33]	
Grade	**Description**	**Grade**	**Description**
AAA	Highest credit quality. The risk factors are negligible, being only slightly more than for risk-free Government of Pakistan's debt.	AAA	Strongest Investment-grade ratings
AA+, AA, AA	High Credit quality. Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.	AA	Strong Investment-grade ratings
A+, A, A	Good credit quality. Protection factors are adequate. Risk factors may vary with possible changes in the economy.	A	Low Investment-grade ratings
BBB+, BBB, BBB	Adequate credit quality. Protection factors are reasonable and sufficient. Risk factors are considered variable if changes occur in the economy.	BBB	Lowest Investment-grade ratings
BB+, BB, BB	Obligations deemed likely to be met. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.	BB	Lowest Investment-grade ratings
B+, B, B	Obligations deemed less likely to be met. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.	B	Lowest speculative grade rating
CCC	Considerable uncertainty exists towards meeting the obligations. Protection factors are scarce and risk may be substantial.	CCC	Moderately speculative grade
CC	A high default risk.	N/A	Moderately high speculative
C	A very high default risk.	C	Highly speculative
		SD	Selective Default
D	Defaulted obligations.	D	Defaulter

Initially CEOs of banks and other corporations contact senior management at the agency for their credit rating. CFOs, Head of credit or Head of risk assessment hold the follow-up meetings with senior management at credit rating agency. As these meetings are held at senior level and both companies are equally popular among senior managers in Pakistan for their services; senior management at both companies do not feel need for mass media promotion activities. Secondly legal regulations restrict credit rating agencies to advertise on mass media. Both companies do not have particular marketing or business development department, senior management is responsible for major promotional decisions.

For different product categories both companies have segmented the market in a similar manner. Entity ratings market has been segmented on the basis of size of the entity, nature of the entity. For instrument ratings market is divided on the basis of Islamic or Interest based, duration and size of the instrument. For the remaining three services i.e., Real Estate Grading, Corporate Governance Ratings, Indicative Ratings, the market is still evolving and hence no further segmentation and targeting exercises have been conducted so far. The corporate sector in Pakistan has a traditionally North-South divide. Karachi is located in south of Pakistan and it is the largest city, main seaport and financial centre of the country. Most of the multinational companies, Banks, Financial Institutions have their head offices in Karachi. State Bank of Pakistan also has its head office here. As JCR-VIS was established in collaboration with Karachi and Islamabad stock exchanges; it has the major support from local business community. In contrast PACRA was established in Lahore which is the hub of major development activities. The contribution of Lahore to the national economy is supposed to be around 13%. Most of textile, leather, rice, chemical and other industrial units were established in Lahore and surrounding areas. Lahore is also base city for most of the wealthy business groups/families operating throughout the province of Punjab. LSE was very much instrumental in establishing PACRA and most of the companies listed in only LSE find it more convenient to work with PACRA

V CONCLUSIONS

The credit rating industry in Pakistan is duopolistic in nature and exhibits the few distinctive characteristics; (a) only two firms dominated the credit rating industry i.e., JCR-VIS and PACRA.; (b) both industry players have positioned themselves in geographically distant markets and taken advantage of north-south divide in local corporate sector; (c) barriers to market entry are high and the must have item is the "heritage of reputation"; (d) the rating agency business is itself reputation-based and the corporate sector pays little attention to a rating that is not widely recognized; (e) and most importantly high profit margins: both companies operating in this business earn 90% or more gross profit margins..

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[i] *IBCA is a small London based credit rating agency started in 1992 had an excellent reputation, particularly in European bank ratings. By the end of 1997, IBCA had revenues of over $30 million and some 180 employees. In 2000 it was merged with Fitch.*

[ii] *Thompson BankWatch, Inc., the only rating agency to exclusively follow financial institutions, is widely considered to set the industry standard for quality and timely delivery of credit ratings.*

[iii] *Fitch Fitch Ratings Inc. is a jointly owned subsidiary of Hearst Corporation and FIMALAC SA.[2] On April 12, 2012, Hearst increased their stake in the Fitch Group to 50%.[3] Previously, Hearst owned a 40% stake in the company, while FIMALAC was the majority owner with 60% stake.[4] Fitch Ratings and Fitch Solutions are part of the Fitch Group.*

[iv] *Duff & Phelps Credit Rating Co. (DCR) Duff & Phelps Corporation is a global valuation and corporate finance advisor. DCR was founded in 1932 and is headquartered in New York City. The company had over 1400 employees with offices across North America, Europe and Asia. In 2000 it was merged with Fitch.*

[v] *S&P Standard & Poor's Financial Services LLC (S&P) is an American financial services company. It is a division of McGraw Hill Financial that publishes financial research and analysis on stocks and bonds. S&P is considered one of the Big Threecredit-rating agencies. It has offices in 23 countries, and the head office is located in New York City.*[3]

[vi] *Moody Moody's Investors Service, often referred to as Moody's, is the bond credit rating business of Moody's Corporation, representing the company's traditional line of business and its historical name. Moody's Investors Service provides international financial research on bonds issued by commercial and government entities and, with Standard & Poor's and Fitch Group, is considered one of the Big Three credit rating agencies.*

[vii] *Japan Credit Rating Agency, Ltd (JCR) was established in April 1985 by a group of major Japanese institutional investors and was authorized by Japan's Ministry of Finance (MOF) as a recognized rating agency in 1987. JCR's rating services cover broad range of financial products including long-term bonds, senior debts, medium-term notes, and commercial paper for resident and non-resident entities, and multilateral development banks. In addition, JCR rates ability to pay insurance claims for the Japanese life and casualty insurance companies as well as structured financing for both residents and non-residents including asset-backed securities. JCR enjoys a strong support from Japan's prominent institutional investors. The 109 shareholders include Japan's major life and casualty insurance companies; all trust banks, 60 of 64 regional banks, The Norinchukin Bank and The Bank of Tokyo Mitsubishi.*

[viii] *Vital Information Services (Pvt.) Limited (VIS) was incorporated in 1994 with the equity participation of leading financial institutions, the largest publication house of Pakistan (The Jang Group), Faheem Ahmad and other professionals. The company provides independent capital market research based services to companies, small and large investors, etc. VIS' major strength is its exhaustive database on corporate Pakistan and ability to perform statistical and financial analyses on this database. VIS has a major interest in a credit bureau NEWS-VIS Credit Information Services (Pvt.) Ltd. and Digital Works, the first digital archiving service bureau of Pakistan.*

[ix] *Karachi Stock Exchange (KSE) is the premier stock exchange of the country. KSE came into existence in 1947. Today, there are 762 listed companies with a listed capital of Rs. 234.45 billion and an approximate market capitalization of Rs. 400 billion.*

[x] *Islamabad Stock Exchange (ISE)Islamabad Stock Exchange (ISE) was incorporated as a guarantee-limited company on 25 October 1989 and started trading in July 1992.*

[xi] *IBCA is a small London based credit rating agency started in 1992 had an excellent reputation, particularly in European bank ratings. By the end of 1997, IBCA had revenues of over $30 million and some 180 employees. In 2000 it was merged with Fitch.*

[xii] *International Finance Corporation (IFC) It is a member of the World Bank Group and is headquartered in Washington, D.C., United States. It was established in 1956 as the private sector arm of the World Bank Group to advance economic development by investing in strictly for-profit and commercial projects that purport to reduce poverty and promote development.*

[xiii] *Lahore Stock Exchange (LSE) It came into existence in October 1970.Now with 37 sectors of the economy and 519 listed companies with total capital of Rs. 555.67 billion having market capitalization of around Rs. 2.51 trillion. The LSE has 152 members of which 81 are corporate, and 54 are individual members.*