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Effective Credit Rating Issues and Intercession for Advancement of Bangladesh: An Ethical Perspective

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Abstract

Rating agencies play a pivotal role in the infrastructure of financial system. They reduce the information cost by reducing information asymmetry and thereby improve the market efficiency. Rating business is becoming attractive to the investors which in turn exaggerate the competition in the market. Unhealthy competition is divulging credit rating companies to exploit their business in order to increase their profit. This paper examines the intervention of credit rating companies in the financial system of Bangladesh from an ethical standpoint. It addresses the emergence of rating agencies and their role in the financial system. This paper also sheds light on regulatory and litigation exposures which rating agencies must follow to remain ethical in conducting their business. Through credit rating, better investment climate, better investor's protection, high degree of professional competencies of experts, good corporate governance, stable capital and financial markets etc. can be developed.

Keywords: *Credit Rating, Ethics, Regulation, Emergence, Unethical Practices, Finance and Financial Market*

1. Introduction

1.1 Background of the Study

Finance is the life blood of economic initiative. It proliferates enterprising view to new dimension and exerts other resources to divest in the economic portfolio. Common perception is money brings money. This attribute is a generic proponent of investment and convert the

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portfolio in to a large volume operating leverage. This symmetric circulation of money positively swells the investment volume of a country. Bangladesh has a huge human resource endowment to foster its development but still lack sufficient and proper efforts for proper utilization of resources. This intimates the need of strong motivational drive for creation of entrepreneurial community and pro-investment societal exposition. During last few years, political instability and sluggish growth of the economy were the causes of low rate of investment in the country. During the last twenty years, GDP growth was edged at around 4 percent due to low level of investment. This vulnerability consequently made the policy framer/ political key men more concerned for triggering investment through existing resource endowments. This imperative pauperized investment to rise steadily from the beginning of 1990s. The following table supports the above exposition and shows the investment / GDP ratio.

Year	**2008-2009**	**2009-2010**	**2010-2011**	**2011-2012**	**2012-2013**	**2013-2014**
Investment /GDP ratio	26.19	26.23	27.39	28.26	28.39	28.58

The above table shows the investment scenario which is in spoon feeding stage. This state attributes to non cohesive attempt of capital market failing to equate investor's confidence with the activities of the company participating in the market interventions. Keeping this attribute of capital market the Government has taken integrated efforts to grow investor's interest for participation in the financial market. To upkeep the image of the financial market, the govt. has already enacted the Board of Investment act 1989, Security Exchange Commission (SEC) act 1993. As an effort of expanding capital market operations the govt. has also opened Chittagong Stock Exchange (CSE) and Central Depository System (CDS). It has formed mutual funds and merchant banking organizations.

In spite of the above efforts, investors lack confidence in the capital market due to its irrational behavior and unethical interactions. Investors with high expectations are continuously deceiving by the low-scored companies in the capital market. This unethical and unexpected dealing has frustrated the investors and as a consequence SEC has put some regulatory bindings on the dealings of the under-rated companies in the capital market.

1.2 Significance of the Study

Kerwer (2001) stated ahead of the global financial crisis, amidst the high demand of ratings for the debt instrument, it was very hard to hold the rating agencies accountable for their action. Furthermore they almost never have to justify their decisions, let alone provide compensation to others for the adverse consequences of their mistakes. A rating agency's negative judgment on a borrower's credit-worthiness can significantly raise the cost of borrowing for both firms and sovereign states. In Bangladesh some recent scandals like Hallmark scam have shown us the weak situation and vulnerable market condition due to huge unethical practices in credit rating practices by the companies. This is an early warning to be prepared for the vast shock that can attack any time. This situation can be exaggerated if unethical practices are used with wrong decisions. In this context, this study aims to provide some future steps to reduce unethical practices in credit rating practices in Bangladesh.

Previewing the imperatives of the tool, the author has marched her efforts to study the credit rating practices in Bangladesh from ethical perspective and to suggest measures to make credit rating more effective by undertaking a study titled "Effective credit rating issues and intercession for advancement of Bangladesh: an ethical perspective".

1.3 Objectives of the Study

The objectives of the study are to focus on the prolific issues of effective credit rating and outline suggestions for investment supporting credit rating system, to portrait the credit rating agencies and their activities in Bangladesh and to articulate the importance of credit rating business in Bangladesh.

- Have a look on the emergence of credit rating practices in Bangladesh
- Sheds light on the regulatory framework of the credit rating companies in Bangladesh
- View the current state of practice of credit rating in Bangladesh from ethical viewpoint
- Outline suggestions for investment supporting credit rating system from ethical standpoint

1.4 Methodology of the Study

Research Design: This study is qualitative in nature. Secondary data have been used to conduct the study.

Data Sources: Relevant secondary data regarding history of emergency, regulatory framework, current practice of credit rating have been collected and compiled from several published documents by the respective credit rating companies operating in Bangladesh, Bangladesh Securities & Exchange Commission and also from Bangladesh Bank and Insurance Development & Regulatory Authority. More over publication on investment, finance and portfolio management, journals, daily newspapers, business magazines, credit rating companies' rules and websites related to the topic have also been reviewed.

Data Analysis & Interpretation: Simple calculations have been done to analyze the collected data. Tabular presentations of data have been used to present the data in an informative and meaningful way for the readers.

2. Conceptual and Regulatory Framework

2.1 Concepts of Credit Rating & Credit Rating Companies

Credit rating assesses the credit worthiness of an individual, corporation or even a country. Credit ratings are calculated from financial history and current assets and current liabilities. Typically, a credit rating tells a lender or investor the probability of getting back the invested fund with desired benefits. Credit rating as defined by the govt. through Bangladesh Gazette Notification, 1996 is “Credit rating by its name implies formal evaluation of credit and /or investment and capability of servicing obligations”. It is expected that credit rating lower the costs for both borrowers and lenders by reducing the information asymmetry problem. In order to convey a credit rating simple alphanumeric symbols are used by the rating agencies. Mazumder & Mazumder (2015) stated that credit ratings are assigned either to specific instruments or to the general debt obligations of issuers. At present credit rating companies have standardized credit ratings for long-term, short-term, fixed deposit and IPO grading scale.

Conceptual purview indicates that credit rating essentially reflects the capability of borrowers and meeting obligations of timely payment of interest and principal. The underlying essence of this phenomenon is higher the credit rating, the greater the capability of the borrower to fulfill his obligation.

“Credit Rating Company” as defined by Bangladesh Gazette Notification, 1996 (amended in 2009) means an investment adviser company which intends to engage or is so engaged primarily in the business of evaluation of credit or investment risk through a recognized and formal process of assigning rating to present or proposed loan obligations or equity of any business enterprise. A credit rating agency is a potential source of information for market participants who are trying to ascertain the creditworthiness of borrowers (White, 2009). Rating agencies are impartial, professional and best-judged opinion giving agencies in the investment decision process which guard the interest of general investors.

2.2 Emergences of Credit Rating Companies

Origin of credit can be affixed to interventions of American mercantile credit agencies in 1840 when they rated the merchant’s ability to pay financial obligations and stepped to provide regular statistics about the railroad companies for the benefits of investors. The early twentieth-century appearance and growth of rating agencies was pretty much a US development. There were no rating agencies in United States until 1909. By the 1930s, U.S. regulators were incorporating agency ratings into their regulations. Credit rating agencies expanded rapidly from the 1970s through the 1990s, much as they did from 1909, when John Moody introduced the concept, to the 1930s (Shylla, 2001). India, among the developing countries is in the lead position to set up a credit rating agency in 1988 (Mohanty and Sahu, 1997). Another study by Mazumder & Mazumder (2015) argued that Indian credit rating companies have acquired a leadership position in Asia behind only Japan. Japan Credit Rating (JCR) started providing rating services in 1985 while CRISIL was the first credit rating company in India which was established with a joint collaboration with S & P Corporation. At present there are six CRCs in India and two CRCs in Pakistan, Sri Lanka & Malaysia.

In Bangladesh, investors in the absence of proper rating of a portfolio hardly feel encourage to step in to investment intervention. The Govt. realizing the state of urgency for credit rating promulgated Rating Rules, 1996. As a result, CRISL was first of its kind, set up in Bangladesh in 2002. This opening pondered the issue of the setting of CRAB in 2003.

Table: Crcs Operating In Bangladesh At A Glance

Company Name	Establishment Year	Commencement Year	ECAI Status	Company Type
Credit Rating Information and Services Ltd. (CRISL)	1995	21 August, 2002	29 April, 2009	Public Limited Company (Joint Venture)
Credit Rating Agency of Bangladesh Limited	2003	24 February, 2003	29 April, 2009	Public Limited Company (Joint Venture)
Emerging Credit Rating Ltd. (ECRL)	2009	22 June, 2010	25 October, 2010	Public Limited Company (Joint Venture)
National Credit Rating Ltd. (NCRL)	2010	22 June, 2010	25 October, 2010	Public Limited Company (Joint Venture)
Argus Credit Rating Services Ltd. (ACRSL)	2011	21 July, 2011	16 November, 2011	Public Limited Company (Joint Venture)
WASO Credit Rating Company(BD) Ltd. (WCRCL)	2009	15 February, 2012	02 August, 2012	Public Limited Company (Joint Venture)
Alpha Credit Rating Ltd. (ACRL)	2011	20 February, 2012	29 October, 2012	Public Limited Company (Joint Venture)
The Bangladesh Rating Agency Ltd. (BDRAL) (SME only)	2009	07 March, 2012	31 October, 2013	Public Limited Company (Joint Venture)

Source: Website of the companies
Note: ECAI-External Credit Assessment Institution

2.3 Rating-Nature and Interventions

Ratings are categorized on the basis of length of time i.e., long-term and short-term rating, types of securities and aspects covered in the rating. Phenomenal rating services offered by rating companies entail the following:

Nature of rating	Meaning
Long-term debt i.e., debentures, bonds and preference shares rating	Rating of bond or debt securities issued by corporate, government and share issued by stock companies.
Short-term debt rating	Rating of short matured portfolios issued by manufacturing companies, finance companies, banks and financial institutions.
Equity rating	Rating of stocks/ shares issued by company.
Entity (individual organization) rating	Rating of individual organization's financial obligations meeting capacity. This also includes IPO rating.
Fixed deposits rating	Rating of fixed deposit programmes.
Insurance rating	Rating of insurance company's ability to meet policyholder's claims including both life and non-life insurers.
Mutual fund rating	Rating of mutual fund in terms of performance and investment quality.
Loan rating	Rating of long-term and short-term loan to evaluate borrower's ability to pay interest and principal of the loan.
Corporate governance rating	Rating of a corporate body to indicate the degree of assurance offered to its financial stakeholders with quality of corporate governance.
Performance rating of govt. agencies	Rating of govt. agencies concerning their credit worthiness and risks involved.

2.4 Regulatory Framework

Currently, a number of rules and regulation are in place to direct the practice of credit rating in Bangladesh. The mother regulation for the credit rating companies is the Credit Rating Companies Rules 1996 (amended in 2009) of the Securities and Exchange Commission. Bangladesh Bank on 29 May, 2004 through a circular, made credit rating mandatory for all banks going public. Furthermore, in 2006 by issuing another circular Bangladesh Bank made the annual credit rating mandatory for all banks. By following Bangladesh Bank, on 12March, 2007 Insurance Development and Regulatory Authority (IDRA) requires mandatory credit ratings for all non-life insurance companies on an annual basis and all life insurance companies on biennial basis.

2.5 Legal Validation of Credit Rating Business

In Bangladesh the govt. has enacted credit rating rules through promulgation of the Credit Rating Companies Rules, 1996. The company willing to do business as a credit rating company needs to get registration under the said rules if it fulfils or complies with the conditions or requirements as published in the Bangladesh Gazette Notification, 1996 (amended in 2009).

The management of the regulatory framework is not enough concerned about the unhealthy competition and practice of unethical activities of the credit rating agencies. Some legislative opinion remains the same as year before like the definition of rating agencies. The rating agencies are defined as investment advisory company by the SEC rule. Only Tk. 5.0 million is required as paid-up capital to start a new rating agency.

2.6 Direction from Ethical Perspective

The Credit Rating Companies Rules 1996 (amended in 2009) mandated some activities from ethical perspectives which are as follows:

- The CRC shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment in order to achieve and maintain objectivity and independence in the rating process.
- In implementing its rating process, CRC and its employees shall act fairly, neutrally and honestly with the investors, issuers, other market participants and the public. The CRC shall employ, as rating analysts, only those individuals with appropriate knowledge, related experience and high standards of integrity. The CRC shall establish an ethical standard and code of conduct for its employees and shall disclose it on its public website.
- The CRC and its employees shall not, either implicitly or explicitly, give any assurance or guarantee of a particular rating prior to the final rating assessment. This does not preclude a CRC from assigning target ratings used in structured finance and similar transactions. However, a CRC shall prohibit itself and its analysts from making the design of structured finance products that the CRC rates.
- Upon becoming aware that another employee or entity under common control with the CRC is or has engaged in any conduct that is illegal, unethical or contrary to the laws, guidelines and internal and external standards and code of conducts etc., a CRC employee shall report such information immediately to the Compliance Officer. CRC management shall prohibit retaliation by other CRC staff or by the CRC itself or by any of its directors against any employee who, in good faith, makes such reports.

3. Findings and Discussion

Credit Rating practice in Bangladesh is in infant stage but it has enormous scope to work for development of financial sector. Imperatives of Credit Rating attribute high values to the development of countries financial and capital markets. But in Bangladesh, inadequate institutional support and policy impediments are the main causes of vulnerability. Now the conditions are changing. Favorable climate has been created for domestic and foreign investment. Mentionable private sector investments and foreign investments are coming forth, attitude towards institutionalization of public savings are increasing. So the emerging practice of credit rating can address the need at this cross road of economic take- off from growth to stability. To this effect, SEC has made credit rating compulsory for the issuance of public debt or issuance of shares at a premium or issuance of right shares. Companies from different sectors specifically from banking sectors are welcoming the services of rating agencies for getting a rating for their instruments.

Current Scenario: Domestic savings are gradually increasing. So the pertinence of credit rating attributes to take off from stagnancy to growth. Furthermore, domestic credit rating agencies are issued license from Security and Exchange Commission without considering the need and size of the market. In addition to that Bangladesh Bank has been recognizing the newly established rating agencies as ECAIs without taking into account the cost benefit analysis of the increased competition. Extreme competition in the existing market is posing a threat to the Bangladesh rating industry. Rating agencies become engaged with unethical activities to survive in the competing market.

Impediments, Opportunities and Challenges of Credit Ratings

It can be undoubtedly hypothesized that credit rating will potent the growth of the capital market and for this due weight should be laid on the market forces. So imperatives of unbiased and objectively verifiable rating are the high voiced submission for financial market development. There are some remarks that credit rating methodologies applied by the rating agencies in Bangladesh are defective and not well understood.

Unhealthy Competition: At present there are eight credit rating agencies operating in Bangladesh to rate the local companies and the number is highest in any South Asia and East Asian country (Mazumder & Mazumder, 2015). Existence of so many credit rating agencies are giving an unjustified scope to bargain on unethical matters to the local companies. Now a day’s local companies bargain for fees to get better rating which is completely unethical. In addition to that, due to uneven competition several institutions acquire more than one rating from different agencies and use the only rating that provides the better rating which is also unethical as it hide the real scenario from the investors.

Violence of Test Services: Securities & Exchange Commission of Bangladesh has mandated one-year 'test services" for new companies for qualitative assessment. Several studies revealed that the companies new to this industry had not followed this provision. Our neighboring country India mandated at least three years 'test services' to start full-fledged professional work while Bangladesh has only one year 'test services'. From ethical standpoint it can be categorized as deceiving with low experience and knowledge for working which in turn create a weak rating detrimental to this industry.

Divergent Ratings: Divergent ratings of the same rated by different credit rating agencies pose some problems. Since credit rating uses forecasting techniques based on both quantitative and qualitative data, differences in rating judgment is obvious. However, rating with attachment of high degree of professionalism and objectivity would reduce the differences in rating outcome (Mohanty and Sahu, 1997).

Disclosure: Credit rating agencies in Bangladesh are not in mind or obligated to disclose their accounts and publish the rating-results to the public so far. This may encourage a rated company to deliberately suppress the bad ratings and disclose its good rating whenever more than one rating is done which have scope to deceive the potential investors. Due to less disclosure various unethical practices are taking place in this industry now a day.

Conflict of Interest: The CRCs Rules (amended in 2009) stated that the determination of a credit rating shall not be influenced by such factors, which are not relevant to the credit assessment such as existence of a business relationship between the CRC and the issuer or any other party. But several credit rating agencies are not complying with the rules. For example nine banks and financial institutions own 49 percent shares in BDRAL, one of the credit rating companies in Bangladesh. As there is a business relationship in between the CRC and the issuer which in turn bias the activities of the above mentioned rating company. Many of the credit rating agencies operating in Bangladesh maintain business relationship with their clients. CRCs receive revenue from the issuer as a result there is a chance that CRCs may have a tendency to downgrade the issuer' actual credit risk to maintain issuer's business. This violation can be considered as unethical side by side legal violation.

Data Trafficking: At present an investigation is running against one of the rating companies operating in Bangladesh which was found engaged in data trafficking to one of the neighboring country. The impact of such data trafficking might create bad impression for the overall credit rating of Bangladesh.

4. Recommendations

This section includes some suggestions in order to remove the question of credibility and integrity of this industry:

Promoting Good Corporate Governance: Corporate governance, as the best attempt established efficient management and good administration for enterprise development. Recently, South and East Asian countries showed interest to invest in Bangladesh in the promising sectors like solar energy, sea fish processing, textile, jute and paper pulp. Good corporate governance can enhance country's enterprise management capability image. For this credit rating can apply its imperative roles which would create confidence in the minds of foreign investors over the countries investment climate. Credit rating agencies with intervening attitude can develop corporate governance culture. Attributes of this perspective indicate that SEC can regulate credit rating agencies against the companies for violating corporate governance rules in the capital market.

Promoting Unsolicited Ratings: Like India, credit rating exercise in our country also commences only after receiving request from the client. But in western countries, rating agencies undertake voluntary rating even if the company does not approach them. This unsolicited rating is primarily intended towards the protection of interest of common investors (Mohanty and Sahu, 1997). In order to create investor's attraction more towards the capital markets by ensuring their interest to be protected, the unsolicited rating should be undertaken soon in Bangladesh. So credit rating agencies in this respect have no other alternatives but to improve their institutional capacity and credibility.

Monitoring: In case of ratings of institutions monitoring should constitute of a quarterly survey instead of half yearly and in case of monitoring of instruments monthly basis survey is suggested instead of quarterly.

Independence & Avoidance of Conflict of Interest: In order to maintain the ethical standard of credit rating industry of Bangladesh it is suggested that CRCs should be encouraged to disclose or publish their code of conducts, methodologies used for ratings and relevant information regarding performance in their respective websites. Furthermore, to ensure integrity in the rating process firewall should be placed among the departments of CRCs. Credit rating analysts will provide rating on the basis of the data where the identity of the issuer will not be placed to them. If this can be ensured, the analyst may be obliged to provide actual rating.

5. Conclusion

Credit rating companies have prolific interventions in making sound base for capital market. Ratings protect investors' interests and enhance the credibility of the company. Existence of too many players in a small market creates an unhealthy competition which fuels to the unethical activities in the credit rating industry of Bangladesh. Though there exists a well defined set of rules and regulation to conduct the credit rating in Bangladesh but the integrity of the CRCs are under question due to the violation of rules along with unethical practices.

Proper steps should be taken to protect the industry from any unwanted shock. To ensure integrity in this sector independence of the analyst must be ensured. Conflict of interest can be avoided by making a Chinese wall by blocking the information flow except the necessary information to rate among the rating agency and issuers. In order to control the unethical practices regulatory authority should come forward with an appropriate implementation of monitoring and supervising authority. Through proper utilization of these opportunities better investment climate, better investor's protection, high degree of professional competencies of experts, good corporate governance, stable capital and financial markets etc. can be developed.

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