USES AND USERS OF CREDIT RATINGS

Education Series #2

USES OF CREDIT RATINGS

Credit ratings are an independent, objective assessment of an entity's creditworthiness, which reflect its ability to meet financial obligations in full and in a timely manner.

Credit ratings serve a high number of purposes:
- **Signaling effect:** Issuers can demonstrate their creditworthiness to other stakeholders,
- **Certification effect:** Issuers can certify that their creditworthiness corresponds to certain defined eligibility criteria,
- **Benchmarking effect:** investors making their own creditworthiness assessment may compare this to an independent external benchmark,
- **Counterparty risk:** credit ratings may assist in defining terms in trade relations,
- **Debt covenant definitions:** credit ratings (and changes thereto) may impact on debt covenants (e.g. collateral requirements) or affect the applicable interest rate,
- **Pricing tool:** based on the credit rating, investors can price an issuer's debt obligation,
- **Portfolio management:** investors may define the allocation of their portfolio using credit ratings
- **Capital requirements calculations:** depending on the type of investor and the issuer's market segment, applicable regulations may define the capital requirement associated with a specific exposure,
- **Impairment and stress testing tool:** credit ratings (and changes of credit ratings) may feed into these calculation,
- **Monitoring of market trends:** used on an aggregate basis, credit ratings help in monitoring market trends, evaluate the economy's health and potentially guide policy-making decisions.

USERS OF CREDIT RATINGS

The CRA regulation defines a number of financial entities, who may use credit ratings for regulatory purposes, such as:
- **Banks** using the Standardized Approach may calculate their capital requirements using credit ratings, and larger banks using Internal models will see their capital requirements floored based on external ratings. Banks may equally define collateral requirements based on credit ratings.
- **Insurers** calculate their Solvency Capital requirements, especially the Counterparty Default Risk Module and the Market risk module, based on credit ratings.

In addition to the above regulatory uses, credit ratings may be used by other stakeholders:
- **Central Banks** may determine the eligibility of collateral based on credit ratings. Central Banks may also define their asset purchase programmes (e.g. the ECB APP and PEPP) based on external ratings,
- **Benchmark administrators** may a.o. refer to credit ratings in order to include an issuer or an issue in a benchmark,
- **Corporations** use credit ratings to assess and manage their exposure to credit risk. This involves analyzing the creditworthiness of counterparties, including customers, suppliers, and business partners. By tracking credit ratings, companies can set credit limits, adjust terms of trade, and take preemptive measures to minimize risk.
- **Investors** may also consider the credit rating in their investment decisions in addition to other valuation or impact measures.
- **Consultants/M&A advisors** scrutinize credit ratings of potential acquisition targets or merger partners to assess the potential impact on the combined entity's financial standing. This helps in making informed strategic decisions.

About EACRA:

The European Association of Credit Rating Agencies (EACRA) is a platform for cooperation among EU-based Credit Rating Agencies (CRAs). Our mission is to support CRAs in meeting regulatory requirements through effective communication, cross-border knowledge sharing, and the promotion of best practices. EACRA also seeks to advance the understanding and value of Credit Ratings within the financial community and among the general public, while advocating for the interests of CRAs across Europe. Established in November 2009 and registered in Paris, EACRA is listed in the French Association Directory (N° W751202513) and the EU Transparency Register (ID 24205924101-57).