

LESSON 40: CREDIT RATING: AN INTRODUCTION

Lesson Objectives

- To understand the concept of credit rating,
- Advantages and disadvantages of credit rating,
- Credit rating indicators, terminology
- Government and SEBI regulations related to credit rating activity.

Introduction

With the increasing market orientation of the Indian economy, investors value a systematic assessment of two types of risks, namely “business risk” arising out of the “open economy” and linkages between money, capital and foreign exchange markets and “payments risk”. With a view to protect small investors, who are the main target for unlisted corporate debt in the form of fixed deposits with companies, credit rating has been made mandatory.

India was perhaps the first amongst developing countries to set up a credit rating agency in 1988. The function of credit rating was institutionalised when RBI made it mandatory for the issue of Commercial Paper (CP) and subsequently by SEBI. when it made credit rating compulsory for certain categories of debentures and debt instruments. In June 1994, RBI made it mandatory for Non-Banking Financial Companies (NBFCs) to be rated. Credit rating is optional for Public Sector Undertakings (PSUs) bonds and privately placed non-conve11ible debentures upto Rs. 50 million. Fixed deposits of manufacturing companies also come under the purview of optional credit rating.

Origin

The first mercantile credit agency was set up in New York in 1841 to rate the ability of merchants to pay their financial obligations. Later on, it was taken over by Robert Dun. This agency published its first rating guide in 1859. The second agency was established by John Bradstreet in 1849 which was later merged with first agency to form Dun & Bradstreet in 1933, which became the owner of Moody’s Investor’s Service in 1962. The history of Moody’s can be traced back about a 100 years ago. In 1900, John Moody laid stone of Moody’s Investors Service and published his ‘Manual of Railroad Securities’.

Early 1920’s saw the expansion of credit rating industry when the Poor’s Publishing Company published its first rating guide in 1916. Subsequently Fitch Publishing Company and Standard Statistics Company were set up in 1924 and 1922 respectively. Poor and Standard merged together in 1941 to form Standard and Poor’s which was subsequently taken over by McGraw Hill in 1966. Between 1924 and 1970, no major new rating agencies were set up. But since 1970’s, a number of credit rating agencies have been set up all over the world including countries like Malaysia, Thailand, Korea, Australia, Pakistan and Philippines etc. In India, CRISIL (Credit Rating and Information Services of India Ltd.) was setup in 1987 as the first rating agency

followed by ICRA Ltd. (formerly known as Investment Information & Credit Rating Agency of India Ltd.) in 1991, and Credit Analysis and Research Ltd. (CARE) in 1994. All the three agencies have been promoted by the All-India Financial Institutions. The rating agencies have established their credit-ability through their independence, professionalism, continuous research, consistent efforts and confidentiality of information. Duff and Phelps has tied up with two Indian NBFCs to set up Duff and Phelps Credit Rating India (P) Ltd. in 1996.

Meaning and Definition

Credit rating is the opinion of the rating agency on the relative ability and willingness of tile issuer of a debt instrument to meet the debt service obligations as and when they arise. Rating is usually expressed in alphabetical or alphanumeric symbols. Symbols are simple and easily understood tool which help the investor to differentiate between debt instruments on the basis of their underlying credit quality. Rating companies also publish explanations for their symbols used as well as the rationale for the ratings assigned by them, to facilitate deeper understanding.

In other words, the rating is an opinion on the future ability and legal obligation of the issuer to make timely payments of principal and interest on a specific fixed income security. The rating measures the probability that the issuer will default on the security over its life, which depending on the instrument may be a matter of days to thirty years or more.

In fact, the credit rating is a symbolic indicator of the current opinion of the relative capability of the issuer to service its debt obligation in a timely fashion, with specific reference to the instrument being rated. It can also be defined as an expression, through use of symbols, of the opinion about credit quality of the issuer of security/instrument.

Importance of Credit Rating

Credit ratings establish a link between risk and return. They thus provide a yardstick against which to measure the risk inherent in any instrument. An investor uses the ratings to assess the risk level and compares the offered rate of return with his expected rate of return (for the particular level of risk) to optimise his risk-return trade-off.

The risk perception of a common investor, in the absence of a credit rating system, largely depends on his familiarity with the names of the promoters or the collaborators. It is not feasible for the corporate issuer of a debt instrument to offer every prospective investor the opportunity to undertake a detailed risk evaluation. It is very uncommon for different classes of investors to arrive at some uniform conclusion as to the relative quality of the instrument. Moreover they do not possess the requisite skills of credit evaluation.

Thus, the need for credit rating in today’s world cannot be over-emphasised. It is of great assistance to the investors in making

investment decisions. It also helps the issuers of the debt instruments to price their issues correctly and to reach out to new investors. Regulators like Reserve Bank of India (RBI) and Securities and Exchange Board of India (SEBI) use credit rating to determine eligibility criteria for some instruments. For example, the RBI has stipulated a minimum credit rating by an approved agency for issue of commercial paper. In general, credit rating is expected to improve quality consciousness in the market and establish over a period of time, a more meaningful relationship between the quality of debt and the yield from it. Credit Rating is also a valuable input in establishing business relationships of various types. However, credit rating by a rating agency is not a recommendation to purchase or sale of a security.

Investors usually follow security ratings while making investments. Ratings are considered to be an objective evaluation of the probability that a borrower will default on a given security issue, by the investors. Whenever a security issuer makes late payment, a default occurs. In case of bonds, non-payment of either principal or interest or both may cause liquidation of a company. In most of the cases, holders of bonds issued by a bankrupt company receive only a portion of the amount invested by them.

Thus, credit rating is a professional opinion given after studying all available information at a particular point of time. Such opinions may prove wrong in the context of subsequent events. Further, there is no private contract between an investor and a rating agency and the investor is free to accept or reject the opinion of the agency. Thus, a rating agency cannot be held responsible for any losses suffered by the investor taking investment decision on the basis of its rating. Thus, credit rating is an investor service and a rating agency is expected to maintain the highest possible level of analytical competence and integrity. In the long run, the credibility of rating agency has to be built, brick by brick, on the quality of its services provided, continuous research undertaken and consistent efforts made.

The increasing levels of default resulting from easy availability of finance, has led to the growing importance of the credit rating. The other factors are:

- i. The growth of information technology.
- ii. Globalisation of financial markets.
- iii. Increasing role of capital and money markets.
- iv. Lack of government safety measures.
- v. The trend towards privatisation.
- vi. Securitisation of debt.

Indications of the Assigned Ratings

Rating symbols assigned to a security issue is an indicator of the following:

- i. the nature and terms of the particular security being issued;
- ii. the ability and the willingness of the issuer of a security to make payments in time;
- iii. the probability that the issuer will make a default in payments; and

- iv. the degree of protection available to the investors if the security issuer company is liquidated, re-organised or declared bankrupt.

Factors Affecting Assigned Ratings

The following factors generally influence the ratings to be assigned by a credit rating agency:

1. The security issuer's ability to service its debt. In order, they calculate the past and likely future cash flows and compare with fixed interest obligations of the issuer.
2. The volume and composition of outstanding debt.
3. The stability of the future cash flows and earning capacity of company.
4. The interest coverage ratio i.e. how many number of times the issuer is able to meet its fixed interest obligations.
5. Ratio of current assets to current liabilities (i.e. current ratio (CR)) is calculated to assess the liquidity position of the issuing firm.
6. The value of assets pledged as collateral security and the security's priority of claim against the issuing firm's assets.
7. Market position of the company products is judged by the demand for the products, competitors market share, distribution channels etc.
8. Operational efficiency is judged by capacity utilisation, prospects of expansion, modernisation and diversification, availability of raw material etc.
9. Track record of promoters, directors and expertise of staff also affect the rating of a company.

Nature of Credit Rating

1. **Rating is based on information:** Any rating based entirely on published information has serious limitations and the success of a rating agency will depend, to a great extent, on its ability to access privileged information. Cooperation from the issuers as well as their willingness to share even confidential information are important pre-requisites. The rating agency must keep information of confidential nature possessed during the rating process, a secret.
2. **Many factors affect rating:** Rating does not come out of a predetermined mathematical formula. Final rating is given taking into account the quality of management, corporate strategy, economic outlook and international environment. To ensure consistency and reliability a number of qualified professionals are involved in the rating process. The Rating Committee, which assigns the final rating, consists of specialised financial and credit analysts. Rating agencies also ensure that the rating process is free from any possible clash of interest.
3. **Rating by more than one agency:** In the well developed capital markets, debt issues are, more often than not, rated by more than one agency. And it is only natural that ratings given by two or more agencies differ from each other e.g., a debt issue, may be rated 'AA+' by one agency and 'AA' or 'AA-' by another. It will indeed be unusual if one agency assigns a rating of AA while another gives a 'BBB'.

4. **Monitoring the already rated issues:** A rating is an opinion given on the basis of information available at particular point of time. Many factors may affect the debt servicing capabilities of the issuer. It is, therefore, essential that rating agencies monitor all outstanding debt issues rated by them as part of their investor service. The rating agencies should put issues under close credit watch and upgrade or downgrade the ratings as per the circumstances after intensive interaction with the issuers.
5. **Publication of ratings:** In India, ratings are undertaken only at the request of the issuers and only those ratings which are accepted by the issuers are published. Thus, once a rating is accepted it is published and subsequent changes emerging out of the monitoring by the agency will be published even if such changes are not found acceptable by the issuers.
6. **Right of appeal against assigned rating:** Where an issuer is not satisfied with the rating assigned, he may request for a review, furnishing additional information, if any, considered relevant. The rating agency will undertake a review and thereafter give its final decision. Unless the rating agency had over looked critical information at the first stage chances of the rating being changed on appeal are rare.
7. **Rating of rating agencies:** Informed public opinion will be the touchstone on which the rating companies have to be assessed and the success of a rating agency is measured by the quality of the services offered, consistency and integrity.
8. **Rating is for instrument and not for the issuer company:** The important thing to note is that rating is done always for a particular issue and not for a company or the Issuer. It is quite possible that two instruments issued by the same company carry different ratings, particularly if maturities are substantially different or one of the instruments is backed by additional credit reinforcements like guarantees. In many cases, short-term obligations, like commercial paper (CP) carry the highest rating even as the risk profile changes for longer maturities.
9. **Rating not applicable to equity shares:** By definition, credit rating is an opinion on the issuers capacity to service debt. In the case of equity there is no pre-determined servicing obligation, as equity is in the nature of venture capital. So, credit rating does not apply to equity shares.
10. **Credit vs. financial analysis:** Credit rating is much broader concept than financial analysis. One important factor which needs consideration is that the rating is normally done at the request of and with the active co-operation Of the issuer. The rating agency has access to unpublished information and the discussions with the senior management of issuers give meaningful insights into corporate plans and strategies. Necessary adjustments are made to the published accounts for the purpose of analysis. Rating is carried out by specialised professionals who are highly qualified and experienced. The final rating is assigned keeping in view the number of factors.
11. **Time taken in rating process:** The rating process is a fairly detailed exercise. It involves, among other things analysis of

published financial information, visits to the issuers offices and works, intensive discussion with the senior executives of issuers, discussions with auditors, bankers, creditors etc. It also involves an in-depth study of the industry itself and a degree of environment scanning. All this takes time, a rating agency may take 6 to 8 weeks or more to arrive at a decision. For rating short-term instruments like commercial paper (CP), the time taken may vary from 3 to 4 weeks, as the focus will be more on short-term liquidity rather than on long-term fundamentals. Rating agencies do not compromise on the quality of their analysis or work under pressure from issuers for quick results. Issuers are always advised to. approach the rating agencies sufficiently in advance so that issue schedules can be adhered to.

Instruments for Rating

Rating may be carried out by the rating agencies in respect of the following:

- i. Equity shares issued by a company.
- ii. Preference shares issued by a company.
- iii. Bonds/debentures issued by corporate, government etc.
- iv. Commercial papers issued by manufacturing companies, finance companies, banks and financial institutions for raising short-term loans.
- v. Fixed deposits raised for medium-term ranking as unsecured borrowings.
- vi. Borrowers who have borrowed money.
- vii. Individuals.
- viii. Asset backed securities are assessed to determine the risk associated with them. The objective is to determine quantum of cash flows emerging from the asset that would be sufficient to meet committed payments.

Rating Other than Debt Instruments

Credit Rating has been extended to all those activities where uncertainty and risk is involved. Now-a-days credit rating is not just limited to debts instruments but also covers the following:

I. Country Rating

A country may be rated whenever a loan is to be extended or some major investment is to be made in it by international investors to determine the safety and security of their investments. A number of factors such as growth rate, industrial and agricultural production, government policies, inflation, fiscal deficit etc. are taken into consideration to arrive at such rating. Any upgrade movement in such—ratings has a positive impact on the stock markets. Morgan Stanley, Moodys etc. give country ratings.

II. Rating of Real Estate Builders and Developers

CRISIL has started assigning rating to the builders and developers with the objective of helping and guiding prospective real estate buyers. CRISIL thoroughly scrutinises the sale deed papers, sanctioned plan, lawyers' report government clearance certificates before assigning rating to the builder or developer. Past experience of the builder, number of properties built by the builder, financial strength, time taken for completion are some of the factors taken into consideration by the

CRISIL before giving a final rating to the real estate builder/developer.

III. Chit Funds

Chit funds registered as a company are sometimes rated on their ability to make timely payment of prize money to subscribers. The rating helps the chit funds in better marketing of their fund and in widening of the subscribers base. This service is provided by CRISIL.

IV. Rating of States

States of India have also approached rating agencies for rating. Rating helps the State to attract investors both from India and abroad to make investments. Investors find safety of their funds while investing in a state with good rating. Foreign companies also come forward and set up projects in such states with positive rating. Rating agencies take into account various economic parameters such as industrial and agricultural growth of the State, availability of raw material, labor etc. and political parties agenda with respect to industry, labor etc., relation between Centre and State and freedom enjoyed by the states in taking decisions while assigning final rating to the states. States like Maharashtra, Madhya Pradesh, Tamil Nadu, Andhra Pradesh and Kerala have already been rated by CRISIL.

V. Rating of Banks

CRISIL and ICRA both are engaged in rating of banks based on the following six parameters also called CAMELS.

C - C stands for capital adequacy of banks. A bank need to maintain at least 10 % capital against risky assets of the bank.

A - A stands for asset quality. The loan is examined to determine non-performing assets. An asset/loan is considered non-performing asset where either interest or principal is unpaid for two quarters or more. Ratios like NPA to Net Advances, Adequacy of Provision & Debt Service Coverage Ratio are also calculated to know exact picture of quality of asset of a bank.

M - M stands for management evaluation. Here, the efficiency and effectiveness of management in framing plans and policies is examined. Ratios like ROI, Return on Capital Employed (ROCE), Return on Assets (ROA) are calculated to comment upon bank's efficiency to utilise the assets.

L - L indicates liquidity position. Liquid and current ratios are determined to find out banks ability to meet its short-term claims.

S - S stands for Systems and Control. Existing systems are studied in detail to determine their adequacy and efficacy.

Thus, the above six parameters are analysed in detail by the rating agency and then final rating is given to a particular bank. Ratings vary from A to D. Where A denotes financial, managerial and operational soundness of a bank, and D denotes that bank is in financial crisis and lacks managerial expertise and is facing operational problems.

VI. Rating (Recommendation) for Equities

These days analysts specialised in equity ratings make a forecast of the stock prices of a company. They study thoroughly the trend of sales, operating profits and other variables and make a forecast of the earning capacity and profitability position of a

company. They use financial statement analysis tools like ratio analysis, trend analysis, fund flow analysis and cash flow analysis to comment upon company's liquidity, solvency, profitability and overall efficiency position. Analysts suggests a target price of the stock giving signal to the investor to swing into action whenever the stock hits that particular price. The following are some of the recommendations made by the equity analysts for its investors:

- i. **Buy:** It shows the stock is worth buying at its current price.
- ii. **Buy on Declines:** This recommendation indicates stock is basically good but overpriced now. The investor should go for buying whenever the price declines.
- iii. **Long-term Buy:** This recommendation suggests that a stock should be bought and held for a longer period at least a year in order to realise gains.
- iv. **Strong Buy:** This buy recommendation strongly favors the purchase of a stock because analysts expect a steep rise in the prices of stock from its current price.
- v. **Out-performer:** This recommendation shows that whatever may be the mood of the stock market the stock will perform better than the market.
- vi. **Overweight:** This refers to that investor can increase the quantum or weight of that stock in his portfolio. This recommendation is applicable to those investors who keep number of stocks in their portfolio.
- vii. **Hold:** This recommendation is a suggestion to the investor to exit because stock prices are not likely to be appreciated significantly from the current price level.
- viii. **Sell/Dispose/Sub-Standard/Under-weight:** It indicates to the investor to sell/discard off or decrease the weight of stock from its portfolio because stock is fundamentally overvalued at its current level and the investor should exit from it immediately.

Functions of a Credit Rating Agency

A credit rating agency serves following functions:

1. **Provides unbiased opinion:** An independent credit rating agency is likely to provide an unbiased opinion as to relative capability of the company to service debt obligations because of the following reasons:
 - i. It has no vested interest in an issue unlike brokers, financial intermediaries.
 - ii. Its own reputation is at stake.
2. **Provides quality and dependable information:** A credit rating agency is in a position to provide quality information on credit risk which is more authentic and reliable because:
 - i. It has highly trained and professional staff who has better ability to assess risk.
 - ii. It has access to a lot of information which may not be publicly available.
3. **Provides information at low cost:** Most of the investors rely on the ratings assigned by the ratings agencies while taking investment decisions. These ratings are published in the form of reports and are available easily on the payment

of negligible price. It is not possible for the investors to assess the creditworthiness of the companies on their own.

4. **Provide easy to understand information:** Rating agencies first of all gather information, then analyse the same. At last these interpret and summarise complex information in a simple and readily understood formal manner. Thus in other words, information supplied by rating agencies can be easily understood by the investors. They need not go into details of the financial statements.
5. **Provide basis for investment:** An investment rated by a credit rating enjoys higher confidence from investors. Investors can make an estimate of the risk and return associated with a particular rated issue while investing money in them.
6. **Healthy discipline on corporate borrowers:** Higher credit rating to any credit investment enhances corporate image and builds up goodwill and hence it induces a healthy/discipline on corporate.
7. **Formation of public policy:** Once the debt securities are rated professionally, it would be easier to formulate public policy guidelines as to the eligibility of securities to be included in different kinds of institutional port-folio.

Advantages of Credit Rating

Different benefits accrue from use of rated instruments to different class of investors or the company. These are explained as under:

A. Benefits to Investors

1. Safety of investments. Credit rating gives an idea in advance to the investors about the degree of financial strength of the issuer company. Based on rating he decides about the investment. Highly rated issues gives an assurance to the investors of safety of Investments and minimizes his risk.
2. Recognition of risk and returns. Credit rating symbols indicate both the returns expected and the risk attached to a particular issue. It becomes easier for the investor to understand the worth of the issuer company just by looking at the symbol because the issue is backed by the financial strength of the company.
3. Freedom of investment decisions. Investors need not seek advise from the stock brokers, merchant bankers or the portfolio managers before making investments. Investors today are free and independent to take investment decisions themselves. They base their decisions on rating symbols attached to a particular security. Each rating symbol assigned to a particular investment suggests the creditworthiness of the investment and indicates the degree of risk involved in it.
4. Wider choice of investments. As it is mandatory to rate debt obligations for every issuer company, at any particular time, wide range of credit rated instruments are available for making investment. Depending upon his own ability to bear risk, the investor can make choice of the securities in which investment is to be made.
5. Dependable credibility of issuer. Absence of any link between the rater and rated firm ensures dependable

credibility of issuer and attracts investors. As rating agency has no vested interest in issue to be rated, and has no business connections or links with the Board of Directors. In other words, it operates independent of the issuer company, the rating given by it is always accepted by the investors.

6. Easy understanding of investment proposals. Investors require no analytical knowledge on their part about the issuer company. Depending upon rating symbols assigned by the rating agencies they can proceed with decisions to make investment in any particular rated security of a company.
7. Relief from botheration to know company. Credit agencies relieve investors from botheration of knowing the details of the company, its history, nature of business, financial position, liquidity and profitability position, composition of management staff and Board of Directors etc. Credit rating by professional and specialised analysts reposes confidence in investors to rely upon the credit symbols for taking investment decisions.
8. Advantages of continuous monitoring. Credit rating agencies not only assign rating symbols but also continuously monitor them. The Rating agency downgrades or upgrades the rating symbols following the decline or improvement in the financial position respectively.

B. Benefits of Rating to the Company

A company who has got its credit instrument or security rated is benefited in the following ways.

1. Easy to raise resources. A company with highly rated instrument finds it easy to raise resources from the public. Even though investors in different sections of the society understand the degree of risk and uncertainty attached to a particular security but they still get attracted towards the highly rated instruments.
2. Reduced cost of borrowing. Investors always like to make investments in such instrument, which ensure safety and easy liquidity rather than high rate of return. A company can reduce the cost of borrowings by quoting lesser interest on those fixed deposits or debentures or bonds, which are highly rated.
3. Reduced cost of public issues. A company with highly rated instruments has to make least efforts in raising funds through public. It can reduce its expenditure on press and publicity. Rating facilitates best pricing and timing of issues.
4. Rating builds up image. Companies with highly rated instrument enjoy better goodwill and corporate image in the eyes of customers, shareholders, investors and creditors. Customers feel confident of the quality of goods manufactured, shareholders are sure of high returns, investors feel secured of their investments and creditors are assured of timely payments of interest and principal.
5. Rating facilitates growth. Rating motivates the promoters to undertake expansion of their operations or diversify their production activities thus leading to the growth of the company in future. Moreover highly rated companies find it easy to raise funds from public through new issues or

