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CREDIT RATING

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Abstract: Credit rating business is an important segment in the financial services arena. With increased activity in the Financial sector both existing and new companies are opting for finance from the capital market and they also require the Rating to increase the credibility of the Company or Individually. Credit rating helps in the development of financial markets. Credit rating is an investor service and a rating agency is expected to maintain the highest possible level of analytical competence and integrity. The analytical framework of rating deals with evaluation of both the business and financial risks associated with that entity. Besides qualitative aspects like management capabilities also play a considerable role in determining a rating. Credit ratings establish a link between risk & return.

Key Words: corporation, risk & return, obligation, Credit Rating

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 and subsequently by SEBI. In June 1994, RBI made it mandatory for Non-Banking Financial Companies to be rated. Credit rating is optional for Public Sector Undertakings. Credit rating is the opinion of the rating agency on the relative ability and willingness of the 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 tools 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. A credit rating evaluates the credit worthiness of an issuer of specific types of debt, specifically, debt issued by a business enterprise such as a corporation or a government. It is an evaluation made by a credit rating agency of the debt issuers' likelihood of default. Credit ratings are determined by credit ratings agencies. The credit rating represents the credit rating agency's evaluation of qualitative and quantitative information for a company or government; including non-public information obtained by the credit rating agencies analysts. Credit ratings are not based on mathematical formulas. Instead, credit rating agencies use their judgment and experience in determining what public and private information should be considered in giving a rating to a particular company or government. A poor credit rating indicates a credit rating agency's opinion that the company or government has a high risk of defaulting, based on the agency's analysis of the entity's history and analysis of long term economic prospects.

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

Paper ID: UGC 48846-817

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.

Birth of Credit Rating - 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 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 creditability 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.

Importance and Role of Credit Rating - Credit ratings establish a link between risk and return. They 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 overemphasised. 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

Paper ID: UGC 48846-817

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, there are some other points which is growth of information technology, Globalisation of financial markets, Increasing role of capital and money markets, The trend towards privatisation Etc.

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.

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 carry the highest rating even as the risk profile changes for longer maturities.

9**. 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.

10. 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 issuer's 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 2 months or more to arrive at a decision. Rating agencies do not compromise on the quality of their analysis or work under pressure from issuers for quick results.

Credit Rating Agencies- Credit Rating Agencies may be simply defined as specialist in providing information regarding bond creditworthiness. Creditworthiness is the likelihood that an issuer will default on the interest or principal due on its bond. CRAs are thus Commercial firms that assess the ability of companies, institution and government to service their debts. They do this by assigning credit rating, typically in the form of a letter, grade scale, which symbolises the rating agency's opinion, as of a specific date, of the creditworthiness of a particular company, security or obligation. It is important to note that CRAs are not an absolute predictor of whether a particular debtor will default on a particular obligation, but is a subjective view regarding creditworthiness of a company, security or obligation.

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 authenticate and reliable because:
i. It has highly trained and professional staffs that have 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.

Important Considerations - A credit rating is an assessment of the creditworthiness of a debt instrument or obligor, based on a credit rating agency's analytical models, assumptions, and expectations. A credit rating may reflect a credit rating agency's subjective judgment of an issuer's business and management. While historical financial and operating experience and collateral performance may factor into the analysis of an obligor, credit ratings are simply a prediction of how an obligor may behave in the future. Predictions are based on the views of the credit rating agency, which may differ from your view and those of other industry participants. Credit rating changes can happen at any time, without warning, and at any rating level. Even top debt rated can default. Some credit rating agencies provide rating "outlooks" and rating "watches" to formally alert investors about potential revisions to those ratings. These alerts may not precede every rating action. You should understand the information that credit ratings are intended to convey and any limitations to the ratings. While institutional investors have the resources to perform their own credit assessment as part of their due diligence procedures, you may not have access to those resources on your own.

Role Of Credit Rating Agencies- Credit rating agencies (CRAs) specialize in analyzing and evaluating the creditworthiness of corporate and sovereign issuers of debt securities. Issuers with lower credit ratings pay higher interest rates embodying larger risk premiums than higher rated issuers. Moreover, ratings determine the eligibility of debt and other financial instruments for the portfolios of certain institutional investors due to national regulations that restrict investment in speculative-grade bonds. In making their ratings, CRAs analyze public and non-public financial and accounting data as well as information about economic and political factors that may affect the ability and willingness of a government or firms to meet

Paper ID: UGC 48846-817

their obligations in a timely manner. However, CRAs lack transparency and do not provide clear information about their methodologies. Ratings tend to be sticky, lagging markets, and then to overreact when they do change. This overreaction may have aggravated financial crises in the recent past, contributing to financial instability and cross-country contagion. The failure of big CRAs to predict the 1997–1998 Asian crisis and the bankruptcies of Enron, WorldCom and Parmalat has raised questions concerning the rating process and the accountability of the agencies and has prompted legislators to scrutinize rating agencies.

Typical Credit Rating Scale
AAA
AA
A
BBB
BB
B
CCC
CC
C
D (default)

For further refinement, some of the ratings above may be modified with a "+", "-", or a number.

Credit Rating In India- Credit ratings is playing an increasingly important role in financial markets. The most Significant change in the recent relates to emphasis on their accountability and more important, the caution in regulators' use of ratings. In India, rating is a more recent phenomenon, but the changing global perspectives on the subject do impact the financial system. India was perhaps the first amongst developing countries to set up a credit rating agency in 1988. The function of credit rating was

Paper ID: UGC 48846-817

institutionalized 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-convertible debentures up to Rs. 50 million. Fixed deposits of manufacturing companies also come under the purview of optional credit rating. Rating agencies are constantly subject to scrutiny, evaluation and questioning by investors, media and regulators. Since ratings are opinions, it is important that markets are convinced about their robustness before acting on them. Rating agencies therefore publish extensive data on rating default and transition statistics, and metrics on predictive capability of ratings vis-a-vis macroeconomic and corporate performance. 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 creditability 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.

Role Of Regulators In Credit Rating- In India, in 1998, the SEBI constituted a committee to look into a draft regulation for CRAs prepared internally. The committee held the view that in keeping with international practice, the SEBI Act 1992 should be amended to bring CRAs outside the purview of SEBI for a variety of reasons. According to the committee, a regulator will not be in a position to objectively judge the appropriateness of one rating over another. The competency and the credibility of a rating and the CRA should be judged by the market, based on historical record, and not by a regulator. The committee suggested that instead of regulation, SEBI could just recognize certain agencies for particular purposes only, such as allowing ratings by CRAs recognized by it for inclusion in the public/rights issue offer documents. In consultation with the Government, in July 1999, SEBI issued a notification bringing the CRAs under its regulatory ambit in exercise of powers conferred on it by Section 30 read with Section 11 of the SEBI Act 1992. The Act now requires all CRAs to be registered with SEBI. 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. Reserve Bank of India has decided to review and monitor the performance of credit rating agencies, for continuation of their accreditation. The move is aimed at ensuring greater accountability in the quality of the rating process and methodologies. All credit rating agencies whose ratings are used for regulatory purposes will be subject to regulatory oversight regime, which includes registration and compliance with the International Organisation of Securities Commissions (IOSCO) Code of Conduct Fundamentals. The Reserve Bank of India will liaise with SEBI, on the issue of rating agencies' adherence to the IOSCO Code of Conduct Fundamentals. RBI has accorded accreditation to four rating agencies registered with market regulator SEBI.

Credit Rating Service To Investors- 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 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.

Conclusion- It is an undisputed fact that CRAs play a key role in financial markets by helping to reduce the informative asymmetry between lenders and investors, on one side, and issuers on the other side, about the creditworthiness of companies or countries. An investment grade rating can put a security, company or country on the global radar, attracting foreign money and boosting a nation's economy. Indeed, for emerging market economies, the credit rating is Key to showing their worthiness of money from foreign investors. Credit rating helps the market regulators in promoting stability and efficiency in the securities market. Ratings make markets more efficient and transparent. Authorities have introduced a range of regulatory measures related to credit rating agencies in response to their failures in this crisis. While no consensus has formed around a single set of reforms, the measures announced thus far are aimed primarily at introducing direct government oversight to replace self-regulation and improving the accuracy of ratings and the integrity of the rating process, particularly for structured finance. Reducing the hardwiring of rating agencies in regulatory frameworks is essential to minimize complacency among market participants and regulators, though this step needs to be taken cautiously to avoid unintended consequences.

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