1. WHAT IS CREDIT RATING?

Credit Rating means an assessment made from credit-risk evaluation, translated into a current opinion as on a specific date on the quality of a specific debt security issued or on obligation undertaken by an enterprise in terms of the ability and willingness of the obligator to meet principal and interest payments on the rated debt instrument in a timely manner.
Thus Credit Rating is:

1. An expression of opinion of a rating agency.
2. The opinion is in regard to a debt instrument.
3. The opinion is as on a specific date.
4. The opinion is dependent on risk evaluation.
5. The opinion depends on the probability of interest and principal obligations being met timely.

Such opinions are relevant to investors due to the increase in the number of issues and in the presence of newer financial products viz. asset backed securities and credit derivatives.

Credit Rating does not in any way linked with:

1. Performance Evaluation of the rated entity unless called for.
2. Investment Recommendation by the rating agency to invest or not in the instrument to be rated.
3. Legal Compliance by the issuer-entity through audit.
4. Opinion on the holding company, subsidiaries or associates of the issuer entity.

It should be noted that rating is a continuous process and as new information come, an earlier rating can be revised. While the rating is usually instrument specific, certain credit rating agencies like CARE, undertakes credit assessment of borrowers for use by banks and financial institutions.

2. RATING SERVICES

Following rating services are generally provided by the credit rating agencies. For this purpose, the example of CARE has been taken:

(i) Credit Rating

CARE undertakes credit rating of all types of debt instruments, both short-term and long-term.

Credit rating is basically a view expressed by the credit rater on the ability of an issuer of a debt (i.e. bonds and debentures) to make timely payments. So, credit rating is basically a relative ranking of the credit quality of debt based instruments. After the liberalization of the Indian economy in 1991, credit rating agencies have started playing a significant role in assessing the credit quality of debentures and bonds issued. The process of credit rating also reinforces the faith of investors in debt based instrument issued by corporates.
(ii) Information Services

The broad objective of the Information Service will be to make available information on any company, local body, industry or sector required by a business enterprise. Credit Rating Agencies through detailed analysis will enable the users of the service, like individual, mutual funds, investment companies, residents or non-residents, to make informed decisions regarding investments.

CARE, also prepares ‘credit reports’ on companies, for the benefit of banks and business enterprises. It will generally benefit the banks, insurance companies and other business enterprises by being cautious in granting loans or investing in the debt securities of a company.

(iii) Equity Research

Equity Research is another activity which credit rating companies pursue. CARE also does this. It generally covers detailed analysis of the major stock exchanges and identification of potential winners and losers. This includes among other things, judging them on the basis of industry, economy, market share, management capabilities, international competitiveness and other relevant factors.

3. OBJECTIVES OF CREDIT RATING

(i) Rating debt obligations of companies.
(ii) Guiding investors regarding the risk of investment in a debt security as to timely repayment of interest obligations and principle amount.
(iii) Creating awareness of the concept of credit rating amongst corporations, merchant bankers, brokers and regulatory authorities.
(iv) It helps in the creation of environment that facilitates debt rating.
(v) Inculcating a positive environment regarding investment in debt securities.
(vi) Helps in creating confidence in the minds of investors.
(vii) Enable the companies to be quality conscious regarding their securities and creating a positive pressure on them to fulfill their debt obligations.

4. TYPES OF CREDIT RATING

(a) Banks and Financial Institution ratings
(b) IPO Grading
(c) Structured Finance Ratings
(d) Sub-sovereign ratings
(e) Issuer Rating
(f) Insurance/ CPA ratings
(g) Corporate ratings
(h) Infrastructure ratings
(i) Corporate Governance ratings
(j) Fund credit Quality rating

5. USES OF CREDIT RATING

For users –
(i) Aids in investment decisions.
(ii) Helps in fulfilling regulatory obligations.
(iii) Provides analysts in Mutual Funds to use credit ratings as one of the valuable inputs to their independent evaluation system.

For issuers –
(i) Requirement of meeting regulatory obligations as per SEBI guidelines.
(ii) Recognition given by prospective investors of providing value to the ratings which helps them to raise debt / equity capital.

The rating process gives a viable market driven system which helps individuals to invest in financial instruments which are productive assets.

6. CREDIT RATING PROCESS

The default-risk assessment and quality rating assigned to an issue are primarily determined by three factors:
i) The issuer’s ability to pay,
ii) The strength of the security owner's claim on the issue, and
iii) The economic significance of the industry and market place of the issuer.
The steps involved are:

- **Request from issuer and analysis** – A company approaches a rating agency for rating a specific security. A team of analysts interact with the company's management and gathers necessary information. Areas covered are: historical performance, competitive position, business risk profile, business strategies, financial policies and short/long term outlook of performance. Also factors such as industry in which the issuer operates, its competitors and markets are taken into consideration.

- **Rating Committee** – On the basis of information obtained and assessment made the team of analysts present a report to the Rating Committee. The issuer is not allowed to participate in this process as it is an internal evaluation of the rating agency. The nature of credit evaluation depends on the type of information provided by the issuer.

- **Communication to management and appeal** – The Rating decision is communicated to the issuer and then supporting the rating is shared with the issuer. If the issuer disagrees, an opportunity of being heard is given to him. Issuers appealing against a rating decision are asked to submit relevant material information. The Rating Committee reviews the decision although such a review may not alter the rating. The issuer may reject a rating and the rating score need not be disclosed to the public.

- **Pronouncement of the rating** – If the rating decision is accepted by the issuer, the rating agency makes a public announcement of it.

- **Monitoring of the assigned rating** – The rating agencies monitor the on-going performance of the issuer and the economic environment in which it operates. All ratings are placed under constant watch. In cases where no change in rating is required, the rating agencies carry out an annual review with the issuer for updating of the information provided.
f) **Rating Watch** – Based on the constant scrutiny carried out by the agency it may place a rated instrument on Rating Watch. The rating may change for the better or for the worse. Rating Watch is followed by a full scale review for confirming or changing the original rating. If a corporate which has issued a 5 year 8% debenture merges with another corporate or acquires another corporate, it may lead to the listing of the specified.

g) **Rating Coverage** – Ratings are not limited to specific instruments. They also include public utilities; financial institutions; transport; infrastructure and energy projects; Special Purpose Vehicles; domestic subsidiaries of foreign entities. Structured ratings are given to MNCs based on guarantees or Letters of Comfort and Standby Letters of Credit issued by the banks. The rating agencies have also launched Corporate Governance Ratings with emphasis on quality of disclosure standards and the extent to which regulatory obligations have been complied with.

h) **Rating Scores** – A comparative summary of Rating Score used by four rating agencies in India is given below.

<table>
<thead>
<tr>
<th>Sample of Rating Scores</th>
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</thead>
<tbody>
<tr>
<td><strong>Debentures</strong></td>
</tr>
<tr>
<td><strong>CRISIL</strong></td>
</tr>
<tr>
<td>Highest Safety</td>
</tr>
<tr>
<td>High Safety</td>
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<tr>
<td>Adequate Safety</td>
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<tr>
<td>Moderate Safety</td>
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<tr>
<td>Inadequate Safety</td>
</tr>
<tr>
<td>High Risk</td>
</tr>
<tr>
<td>Substantial Risk</td>
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<tr>
<td>Default</td>
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<td>Fixed Deposits</td>
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<td>Highest Safety</td>
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<td>Adequate Safety</td>
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7. **CREDIT RATING METHODOLOGIES**

The general methodology adopted by credit rating companies is to analyze various aspects of a business. They are briefly discussed as below:

(i) **BUSINESS RISK**

Business risk occurs when there is a possibility of a company earning lower profits than anticipated.
or incurring a loss. Business risk can be segregated into four categories - Strategic risk, compliance risk, operational risk and reputational risk. We have briefly discussed each one as follows:

(a) **Strategic Risk:** A successful business always needs a comprehensive and detailed business plan. Everyone knows that a successful business needs a comprehensive, well-thought-out business plan. But it’s also a fact of life that, if things change, even the best-laid plans can become outdated if it cannot keep pace with the latest trends. This is what is called as strategic risk. So, strategic risk is a risk in which a company’s strategy becomes less effective and it struggles to achieve its goal. It could be due to technological changes, a new competitor entering the market, shifts in customer demand, increase in the costs of raw materials, or any number of other large-scale changes.

We can take the example of Kodak which was able to develop a digital camera by 1975. But, it considers this innovation as a threat to its core business model, and failed to develop it. However, it paid the price because when digital camera was ultimately discovered by other companies, it failed to develop it and left behind. Similar example can be given in case of Nokia when it failed to upgrade its technology to develop touch screen mobile phones. That delay enables Samsung to become a market leader in touch screen mobile phones.

However, a positive example can be given in the case of Xerox which invented photocopy machine. When laser printing was developed, Xerox was quick to lap up this opportunity and changes its business model to develop laser printing. So, it survived the strategic risk and escalated its profits further.

(b) **Compliance Risk:** Every business needs to comply with rules and regulations. For example with the advent of Companies Act, 2013, and continuous updating of SEBI guidelines, each business organization has to comply with plethora of rules, regulations and guidelines. Non compliance leads to penalties in the form of fine and imprisonment.

However, when a company ventures into a new business line or a new geographical area, the real problem then occurs. For example, a company pursuing cement business likely to venture into sugar business in a different state. But laws applicable to the sugar mills in that state are different. So, that poses a compliance risk. If the company fails to comply with laws related to a new area or industry or sector, it will pose a serious threat to its survival.

(c) **Operational Risk:** This type of risk relates to internal risk. It also relates to failure on the part of the company to cope with day to day operational problems. Operational risk relates to ‘people’ as well as ‘process’. We will take an example to illustrate this. For example, an employee paying out ₹ 1,00,000 from the account of the company instead of ₹ 10,000.

This is a people as well as a process risk. An organization can employ another person to check the work of that person who has mistakenly paid ₹ 1,00,000 or it can install an electronic system that can flag off an unusual amount.

(d) **Reputational Risk:** Reputational impact mostly follows a decision under business risk. For
example closing of project in a country on the ground of viability, (which GM has done in India) creates a bad reputation for the company. For example, in the above case, it is observed that employees are reacting negatively to the decision and started feeling insecure.

On the other hand, adding related products down the line adds customer confidence and boost investor's confidence. For example, several Indian banks have embarked on opening e-trading account. This has added to the reputation and market confidence.

(ii) FINANCIAL RISK

Financial Risk is referred to as the unexpected changes in financial conditions such as prices, exchange rate, Credit rating, and interest rate etc. Though political risk is not a financial risk in direct sense but same can be included as any unexpected political change in any foreign country may lead to country risk which may ultimately result in financial loss.

Accordingly, the Financial Risk can be broadly divided into following categories:

(a) Counter Party Risk
(b) Political Risk
(c) Interest Rate Risk
(d) Currency Risk

Now, let us discuss each of the above mentioned risks:

(a) **Counter Party Risk:** This risk occurs due to non-honoring of obligations by the counter party which can be failure to deliver the goods for the payment already made or vice-versa or repayment of borrowings and interest etc.

Thus, this risk also covers the credit risk i.e. default by the counter party.

(b) **Political Risk:** Generally this type of risk is faced by overseas investors, as the adverse action by the government of host country may lead to huge loses. This can be on any of the following forms:

- Confiscation or destruction of overseas properties.
- Rationing of remittance to home country.
- Restriction on conversion of local currency of host country into foreign currency.
- Restriction on borrowings.
- Invalidation of Patents
- Price control of products

(c) **Interest Rate Risk:** This risk occurs due to change in interest rate resulting in change in asset and liabilities. This risk is more important for banking companies as their balance sheet’s items are more interest sensitive and their base of earning is spread between borrowing and lending rates.
As we know that the interest rates are of two types i.e. fixed and floating. The risk in both of these types is inherent. If any company has borrowed money at floating rate then with increase in floating rate, the liability under fixed rate shall remain the same. On the other hand, with falling floating rate, the liability of the company to pay interest under fixed rate shall comparatively be higher.

(d) Currency Risk: This risk mainly affects the organization dealing with foreign exchange as their cash flows changes with the movement in the currency exchange rates. This risk can affect the cash flow adversely or favorably. For example, if rupee depreciates vis-à-vis US$ receivables will stand to gain in comparison to the importer who has the liability to pay bill in US$. The best case we can quote, Infosys (Exporter) and Indian Oil Corporation Ltd. (Importer).

(iii) MANAGEMENT EVALUATION

In order to evaluate the management of a company, the best way is to see the company’s Management discussion and analysis (MD&A) report which every listed company is compulsory required to provide. In case of unlisted companies also, the credit rating companies can influence the companies to include MD&A in their Annual Report.

Actually, MD&A is the section of a company’s annual report in which management provides a summary of the previous year’s operations and how the company performed financially. Management also gives an outline for the next year by highlighting future plans and some brief about the new projects to be launched by the company.

(iv) BUSINESS ENVIRONMENT ANALYSIS

A business environment analysis includes examining factors which influence from outside of a business. These business environment factors can range from new laws such as Companies Act, 2013; new trends i.e. the latest trend is to shop online; and new technology, for instance battery cars which in future can be charged on road itself without the even the need to stop the car.

Now, after considering the above mentioned environmental factors, the next step in the business environment analysis will be to determine as to how much impact they will have on the business. After that strategies will be developed to ward off any negative impact that has arisen.

8. CAMEL MODEL IN CREDIT RATING

CAMEL Stands for Capital, Assets, Management, Earnings and Liquidity. The CAMEL model adopted by the Rating Agencies deserves special attention; it focuses on the following aspects:
1) **Capital** – Composition of Retained Earnings and External Funds raised; Fixed dividend component for preference shares and fluctuating dividend component for equity shares and adequacy of long term funds adjusted to gearing levels; ability of issuer to raise further borrowings.

2) **Assets** – Revenue generating capacity of existing/proposed assets, fair values, technological/physical obsolescence, linkage of asset values to turnover, consistency, appropriation of methods of depreciation and adequacy of charge to revenues. Size, ageing and recoverability of monetary assets viz. receivables and its linkage with turnover.

3) **Management** – Extent of involvement of management personnel, team-work, authority, timeliness, effectiveness and appropriateness of decision making along with directing management to achieve corporate goals.

4) **Earnings** – Absolute levels, trends, stability, adaptability to cyclical fluctuations and ability of the entity to service existing and additional debts proposed.

5) **Liquidity** – Effectiveness of working capital management, corporate policies for stock and creditors, management and the ability of the corporate to meet their commitment in the short run.

These five aspects form the five core bases for estimating credit worthiness of an issuer which leads to the rating of an instrument. Rating agencies determine the pre-dominance of positive/negative aspects under each of these five categories and these are factored in for making the overall rating decision.

9. **RATING REVISIONS**

Credit Rating is an opinion expressed by a credit rating agency at a given point of time based on the information provided by the company and collected by credit rating agency. However, the information
collected from the company at the time of giving credit rating to it is amenable to change. Therefore, revision of credit rating is required.

To protect the interest of investors, SEBI has mandated that every credit rating agency shall, during the lifetime of the securities rated by it, continuously monitor the rating of such securities and carry out periodic reviews of all published ratings.

Moreover, India Ratings & Research (A Fitch Group Company) continuously monitors the ratings assigned to a particular instrument. In case of any changes in the ratings so assigned, India Ratings discloses the same through press releases and on its websites.

For instance, the CRISIL has updated long term credit rating of Sterlite Technologies Limited to ‘CRISIL AA-/Stable from CRISIL A+/Watch Developing’ and also its short term credit rating have been upgraded to CRISIL A1+ from CRISIL A1/Watch Developing. Additionally, CRISIL has removed its rating on bank loan facilities and debt instruments of the company from ‘Watch with Developing Implications’ and it has also withdrawn its rating on ‘bonds’ at the Company’s request, as there is no amount outstanding against the said instrument.

**10. CREDIT RATING AGENCIES IN INDIA**

Around 1990, Credit Rating Agencies started to be set up in India.

Among them the most important ones are:

1) **Credit Rating Information Services of India Ltd. (CRISIL)** – Launched in the pre-reforms era, CRISIL has grown in size and strength over the years to become one of the top five globally rated agencies. It has a tie up with Standard and Poor’s (S & P) of USA holding 10% stake in CRISIL. It has also set up CRIS – RISC a subsidiary for providing information and related services over the internet and runs an online news and information service. CRISIL’s record of ratings covers 1800 companies and over 3600 specific instruments.

2) **Investment Information and Credit Rating Agency (ICRA)** – It began its operations in 1991. Its major shareholders are leading financial institutions and banks. Moody’s Investor Services through their Indian subsidiary, Moody’s Investment Company India (P) Ltd. is the single largest shareholder. ICRA covers over 2500 instruments.
11. CREDIT RATING AGENCIES ABROAD

(i) Standard and Poor’s (S & P) Ratings
S&P Global Ratings have been in the credit rating business for more than 150 years. They are the world’s leading provider of credit ratings. Their credit ratings are important not only for the corporates but also for the government and the financial sector. Their credit rating is basically an expression of opinion about the credit quality of a company i.e. whether that company is able to meet its financial obligations in time or not. S & P is operating in about 28 countries.

(ii) Fitch Ratings
Fitch is among the top three credit rating agencies in the world. Fitch Ratings is headquartered in both New York and London. Fitch Ratings’ long-term credit ratings are assigned on an alphabetic scale from ‘AAA’ to ‘D’. It was first introduced in 1924 and later adopted and licensed by S&P. It is a global leader in financial information services with operations in more than 30 countries.

(iii) Moody’s Ratings
Moody’s is an important contributor in the global financial market providing credit rating services that helps in the building up of a transparent and integrated financial market. The Corporation, which reported revenue of $3.6 billion in 2016, employs approximately 10,700 people worldwide and maintains a presence in 36 countries.

12. CREDIT RATING AGENCIES AND THE US SUB-PRIME CRISIS

Credit rating agencies played a very important role at various stages in the subprime crisis. They have been highly criticized for understating the risk involved with new, complex securities that fueled the United States housing bubble, such as mortgage-backed securities (MBS) and collateralized debt obligations (CDO).

An estimated $3.2 trillion in loans were made to homeowners with bad credit and undocumented incomes (e.g., subprime or Alt-A mortgages) between 2002 and 2007. These mortgages could be
bundled into MBS and CDO securities that received high ratings and therefore could be sold to global investors. Higher ratings were believed justified by various credit enhancements including over-collateralization (i.e., pledging collateral in excess of debt issued), credit default insurance, and equity investors willing to bear the first losses. The critics claim that the rating agencies were the party that performed the alchemy that converted the securities from F-rated to A-rated. The banks could not have done what they did without the complicity of the rating agencies. “Without the AAA ratings, demand for these securities would have been considerably less. Bank write downs and losses on these investments totalling $523 billion as of September 2008.

The ratings of these securities were a lucrative business for the rating agencies, accounting for just under half of Moody’s total ratings revenue in 2007. Through 2007, ratings companies enjoyed record revenue, profits and share prices. The rating companies earned as much as three times more for grading these complex products than corporate bonds, their traditional business. Rating agencies also competed with each other to rate particular MBS and CDO securities issued by investment banks, which critics argued contributed to lower rating standards.

13. LIMITATIONS OF CREDIT RATING

1) Rating Changes – Ratings given to instruments can change over a period of time. They have to be kept under rating watch. Downgrading of an instrument may not be timely enough to keep investors educated over such matters.

2) Industry Specific rather than Company Specific – Downgrades are linked to industry rather than company performance. Agencies give importance to macro aspects and not to micro ones and over-react to existing conditions which come from optimistic/pessimistic views arising out of up/down turns.

3) Cost Benefit Analysis – Rating being mandatory, it becomes a must for entities rather than carrying out Cost Benefit Analysis. Rating should be left optional and the corporate should be free to decide that in the event of self-rating, nothing has been left out.

4) Conflict of Interest – The rating agency collects fees from the entity it rates leading to a conflict of interest. Rating market being competitive there is a possibility of such conflict entering into the rating system.

5) Corporate Governance Issues – Special attention is paid to
   a) Rating agencies getting more of its revenues from a single service or group.
   b) Rating agencies enjoying a dominant market position engaging in aggressive competitive practices by refusing to rate a collateralized/securitized instrument or compelling an issuer to pay for services rendered.
   c) Greater transparency in the rating process viz. in the disclosure of assumptions leading to a specific public rating.
14. CONTEMPORARY ASPECTS IN CREDIT RATING

SEBI tells rating agencies to disclose probability of default for issuers they rate

According to the latest Sebi circular, rating companies, in consultation with the regulator, will now create a uniform probability of default benchmark for each rating category on their website, for one-year, two-year and three-year cumulative default rates, both for the short term and long term.

Sebi also tweaked the methodology to arrive at default rates. It will now be based on marginal default methodology. This would ensure that a three-year default rate is greater than the one-year rate.

Tracking the probability of default is a departure from earlier practices and is also a step towards aligning Indian rules with global standards. So far in India, credit decisions have been more or less based only on assigned ratings. Globally, however, credit decisions are based on two more criteria—probability of default and tracking deviation of bond spreads.

Probability of default describes the likelihood of a default over a particular period. It provides the likelihood that a borrower will be unable to meet its debt obligations and is typically used globally in credit analyses and risk management frameworks.

The rating agencies would also be assessed based on probability of default. For an AAA-rated paper, for instance, the probability of default for a 1-year and 2-year paper should be zero; for a three-year paper, a 1% default probability would be accepted.

For AA, it will be zero for a one-year paper; for a two-year paper, the acceptable deviation is 2%. It will be 3% for an A-rated paper.

In line with global standards, the regulator in November had asked rating agencies to track deviation in bond spreads. The idea behind the move was to provide more information to bond subscribers and reduce reliance on assigned ratings.

Sebi has also asked rating agencies to disclose all factors to which ratings are sensitive.

"This is critical for the end-users to understand the factors that would have the potential to impact the creditworthiness of the entity," Sebi said in the circular. (Source: www.livemint.com)