

## CREDIT RATING: CONCEPT, TYPES AND FUNCTIONS

Many a times, it has happened that investors in debentures or fixed deposits were shown rosy pictures of companies and offered very high rates of interests by bogus companies and in the end the investor neither got his money back nor the promised interest. Actually, it is very difficult for an individual investor to gather details about creditworthiness of a company, neither he has the time nor the skills to undertake risk evaluation.

Every investor wants to ensure safety of his investment. Credit rating agencies investigate the financial position of the company issuing various kinds of instruments and assess risks involved in investing money in them. In the system of credit rating, the credit rating agency rate the risks involved in investment in instruments of a particular company, they may rank it from very safe to very risky. At present credit rating is done only for debt-instruments and rarely for preference or equity shares.

### DEFINITION

Credit rating system can be defined as an act of assigning values to credit instruments by assessing the solvency i.e., the ability of the borrower to repay debt, and expressing them through pre-determined symbols.

Investopedia defines Credit Rating as “An assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation”. A credit rating can be assigned to any entity that seeks to borrow money – an individual, corporation, state or provincial authority, or sovereign government.

### CHARACTERISTICS OF CREDIT RATING

1. **Assessment of issuer's capacity to repay.** It assesses issuer's capacity to meet its financial obligations i.e., its capacity to pay interest and repay the principal amount borrowed.
2. **Based on data.** A credit rating agency assesses financial strength of the borrower on the financial data.
3. **Expressed in symbols.** Ratings are expressed in symbols e.g. AAA, BBB which can be understood by a layman too.
4. **Done by expert.** Credit rating is done by expert of reputed, accredited institutions.
5. **Guidance about investment-not recommendation.** Credit rating is only a guidance to investors and not recommendation to invest in any particular instrument.

### WHAT CREDIT RATING IS NOT

1. **Not for company as a whole.** Credit rating is done for a particular instrument i.e., for a particular class of debentures and not for the company as a whole, it is quite possible that two instruments issued by the same company may carry different rating.
2. **Does not create a fiduciary relationship.** Credit rating does not create a fiduciary relationship (relationship of trust) between the credit rating agency and the investor.
3. **Not attestation of truthfulness of information provided by rated. company.** Rating does not imply that the credit rating agency attests the truthfulness of information provided by the rated company.
4. **Rating not forever.** Credit rating is not a one-time evaluation of risk. which remains valid for the entire life of a security. It can change from time to time.

## COMPULSORY CREDIT RATING

Obtaining credit rating is compulsory in the following cases

1. **For debt securities.** The Reserve Bank of India and SEBI have made credit rating compulsory in respect of all non-government debt securities where the maturities exceed 18 months
2. **Public deposits.** Rating of deposits in companies has also been made compulsory.
3. **For commercial papers (CPs).** Credit rating has also been made compulsory for commercial papers. As per Reserve Bank of India guidelines rating of P2 by CRISIL or A2 by ICRA or PP2 by CARE is necessary for commercial papers.
4. **For fixed deposits with non-banking financial institutions (NBFCs).** Under the Companies Act, credit rating has been made compulsory for fixed deposits with NBFs.

## FACTORS CONSIDERED IN CREDIT RATING

1. **Issuers ability to service its debt.** For this credit rating agencies calculate
  - a) Issuer company's past and future cash flows.
  - b) Assess how much money the company will have to pay as interest on borrowed funds and how much will be its earnings.
  - c) How much are the outstanding debts?
  - d) Company's short term solvency through calculation of current ratio.
  - e) Value of assets pledged as collateral security by the company.
  - f) availability and quality of raw material used, favorable location, cost advantage.
  - g) Track record of promoters, directors and expertise of the staff.
2. **Market position of the company.** What is the market share of various products of the company, whether it will be stable, does the company possess competitive advantage due to distribution network, customer base research and development facilities etc.
3. **Quality of management.** Credit rating agency will also take into consideration track record, strategies, competency and philosophy of senior management.
4. **Legal position of the instrument.** It means whether the issued instrument is legally valid, what are the terms and conditions of issue and redemption; how much the instrument is protected from frauds, what are the terms of debenture trust deed etc.
5. **Industry risks.** Industry risks are studied in relation to position of demand and supply for the products of that industry (e.g. cars or electronics) how much is the international competition, what are the future prospects of that industry, is it going to die or expand?
6. **Regulatory environment.** Whether that industry is being regulated by government (like liquor industry), Whether there is a price control on it, whether there is government support for it, can it take advantage of tax concessions etc.
7. **Other factors.** In addition to the above, the other factors to be noted for credit rating of a company are its cost structure, insurance cover undertaken, accounting quality, market reputation, working capital management, human resource quality, funding policy, leverage, flexibility, exchange rate risks etc.

## CREDIT RATING PROCESS

In India credit rating is done mostly at the request of the borrowers or issuer companies. The borrower or issuer company requests the credit rating agency for assigning a ranking to the proposed instrument. The process followed by most of the credit rating agencies is as follows:

1. **Agreement.** An agreement is entered into between the rating agency and the issuer company. It covers details about terms and conditions for doing the rating.
2. **Appointment of analytical team.** The rating agency assigns the job to a team of experts. The team usually comprises of two analysts who have expert knowledge in the relevant business area and is responsible for carrying out rating.
3. **Obtaining information.** The analytical team obtains the required information from the client company and studies company's financial position, cash flows, nature and basis of competition, market share, operating efficiency arrangements, managements track cost structure, selling and distribution record, power (electricity) and labour situation etc.
4. **Meeting the officials.** To obtain clarifications and understanding the client's business the analytical team visits and interacts with the executives of the client.
5. **Discussion about findings.** After completion of study of facts and their analysis by the analytical team the matter is placed before the internal committee (which comprises of senior analysts) an opinion about the rating is taken.
6. **Meeting of the rating committee.** The findings of internal committee are referred to the "rating committee" which generally comprises of a few directors and is the final authority for assigning ratings.
7. **Communication of decision.** The rating decided by the rating committee is communicated to the requesting company.
8. **Information to the public.** The rating company publishes the rating through reports and the press.
9. **Revision of the rating.** Once the issuer company has accepted the rating, the rating agency is under an obligation to monitor the assigned rating. The rating agency monitors all ratings during the life of the instrument.

## TYPES OF CREDIT RATING

1. **Rating of bonds and debentures.** Rating is popular in certain cases for bonds and debentures. Practically, all credit rating agencies are doing rating for debentures and bonds.
2. **Rating of equity shares.** Rating of equity shares is not mandatory in India but credit rating agency ICRA has formulated a system for equity rating. Even SEBI has no immediate plans for compulsory credit rating of initial public offerings (IPOs).
3. **Rating of preference shares.** In India preference shares are not being rated, however Moody's Investor Service has been rating preference shares since 1973 and ICRA has provision for it.
4. **Rating of medium term loans (Public deposits, CDs etc.).** Fixed deposits taken by companies are rated on regular scale in India.
5. **Rating of short-term instruments [Commercial Papers (CPs)].** Credit rating of short term instruments like commercial papers has been started from 1990. Credit rating for CPs is mandatory which is being done by CRISIL, ICRA and CARE.

6. **Rating of borrowers.** Rating of borrowers, may be an individual or a company is known as borrower's rating.
7. **Rating of real estate builders and developers.** A lot of private colonisers and flat builders are operating in big cities. Rating about them is done to ensure that they will properly develop a colony or build flats. CRISIL has started rating of builders and developers.
8. **Rating of chit funds.** Chit funds collect monthly contributions from savers and give loans to those participants who offer highest rate of interest. Chit funds are rated on the basis of their ability to make timely payment of prize money to subscribers. CRISIL does credit rating of chit funds.
9. **Ratings of insurance companies.** With the entry of private sector insurance companies, credit rating of insurance companies is also gaining ground. Insurance companies are rated on the basis of their claim paying ability (whether it has high, adequate, moderate or weak claim-paying capacity). ICRA is doing the work of rating insurance companies.
10. **Rating of collective investment schemes.** When funds of a large number of investors are collectively invested in schemes, these are called collective investment schemes. Credit rating about them means (assessing) whether the scheme will be successful or not. ICRA is doing credit rating of such schemes.
11. **Rating of banks.** Private and cooperative banks have been failing quite regularly in India. People like to deposit money in banks which are financially sound and capable of repaying back the deposits. CRISIL and ICRA are now doing rating of banks.
12. **Rating of states.** States in India are now being also rated whether they are fit for investment or not. States with good credit ratings are able to attract investors from within the country and from abroad.
13. **Rating of countries.** Foreign investors and lenders are interested in knowing the repaying capacity and willingness of the country to repay loans taken by it. They want to make sure that investment in that country is profitable or not. While rating a country the factors considered are its industrial and agricultural production, gross domestic product, government policies, rate of inflation, extent of deficit financing etc. Moody's, and Morgan Stanley are doing rating of countries.

## **FUNCTIONS/IMPORTANCE OF CREDIT RATING**

1. **It provides unbiased opinion to investors.** Opinion of good credit rating agency is unbiased because it has no vested interest in the rated company.
2. **Provide quality and dependable information.** Credit rating agencies employ highly qualified, trained and experienced staff to assess risks and they have access to vital and important information and therefore can provide accurate information about creditworthiness of the borrowing company.
3. **Provide information in easy to understand language.** Credit rating agencies gather information, analyse and interpret it and present their findings in easy to understand language that is in symbols like AAA, BB, C and not in technical language or in the form of lengthy reports.
4. **Provide information free of cost or at nominal cost.** Credit ratings of instruments are published in financial newspapers and advertisements of the rated companies. The public has not to pay for them. Even otherwise, anybody can get them from credit rating agency on payment of nominal fee. It is beyond the capacity of individual investors to gather such information at their own cost.
5. **Helps investors in taking investment decisions.** Credit ratings help investors in assessing risks and taking investment decision.
6. **Disciplines corporate borrowers.** When a borrower gets higher credit rating, it increases its goodwill and other companies also do not want to lag behind in ratings and inculcate financial

discipline in their working and follow ethical practice to become eligible for good ratings, this tendency promotes healthy discipline among companies.

7. **Formation of public policy on investment.** When the debt instruments have been rated by credit rating agencies, policies can be laid down by regulatory authorities (SEBI, RBI) about eligibility of securities in which funds can be invested by various institutions like mutual funds, provident funds trust etc. For example, it can be prescribed that a mutual fund cannot invest in debentures of a company unless it has got the rating of AAA.

## **BENEFITS OF CREDIT RATING**

Credit rating offers many advantages which can be classified into

- A. Benefits to investors.
- B. Benefits to the rated company.
- C. Benefits to intermediaries.
- D. Benefits to the business world.

## **BENEFITS TO INVESTORS**

1. **Assessment of risk.** The investor through credit rating can assess risk involved in an investment. A small individual investor does not have the skills, time and resources to undertake detailed risk evaluation himself. Credit rating agencies who have expert knowledge, skills and manpower to study these matters can do this job for him. Moreover, the ratings which are expressed in symbols like AAA, BB etc. can be understood easily by investors.
2. **Information at low cost.** Credit ratings are published in financial newspapers and are available from rating agencies at nominal fees. This way the investors get credit information about borrowers at no or little cost.
3. **Advantage of continuous monitoring.** Credit rating agencies do not normally undertake rating of securities only once. They continuously monitor them and upgrade and downgrade the ratings depending upon changed circumstances.
4. **Provides the investors a choice of Investment.** Credit ratings agencies helps the investors to gather information about creditworthiness of different companies. So, investors have a choice to invest in one company or the other.
5. **Ratings by credit rating agencies is dependable.** A rating agency has no vested interest in a security to be rated and has no business links with the management of the issuer company. Hence ratings by them are unbiased and credible.

## **BENEFITS TO THE RATED COMPANY**

1. **Ease in borrowings.** If a company gets high credit rating for its securities, it can raise funds with more ease in the capital market.
2. **Borrowing at cheaper rates.** A favourably rated company enjoys the confidence of investors and therefore, could borrow at lower rate of interest.
3. **Facilitates growth.** Encouraged by favourable rating, promoters are motivated to go in for plans of expansion, diversification and growth. Moreover, highly rated companies find it easy to raise funds from public through issue of ownership or credit securities in future. They find it easy to borrow from banks.
4. **Recognition of lesser known companies.** Favourable credit rating of instruments of lesser known or unknown companies provides them credibility and recognition in the eyes of the investing public.
5. **Adds to the goodwill of the rated company.** If a company is rated high by rating agencies it will automatically increase its goodwill in the market.
6. **Imposes financial discipline on borrowers.** Borrowing companies know that they will get high credit rating only when they manage their finances in a disciplined manner i.e., they maintain good operating efficiency, appropriate liquidity, good quality assets etc. This develops a sense of financial discipline among companies who want to borrow.
7. **Greater information disclosure.** To get credit rating from an accredited agency, companies have to disclose a lot of information about their operations to them. It encourages greater information disclosures, better accounting standards and improved financial information which in turn help in the protection of the investors.

## **BENEFITS TO INTERMEDIARIES**

1. **Merchant bankers' and brokers' job made easy.** In the absence of credit rating, merchant bankers or brokers have to convince the investors about financial position of the borrowing company. If a borrowing company's credit rating is done by a reputed credit agency, the task of merchant bankers and brokers becomes much easy.

## **BENEFITS TO THE BUSINESS WORLD**

1. **Increase in investor population.** If investors get good guidance about investing the money in debt instruments through credit ratings, more and more people are encouraged to invest their savings in corporate debts.
2. **Guidance to foreign investors.** Foreign collaborators or foreign financial institutions will invest in those companies only whose credit rating is high. Credit rating will enable them to instantly identify the position of the company.

## **CREDIT RATING AGENCIES IN INDIA**

There are 6 credit rating agencies which are registered with SEBI. These are CRISIL, ICRA, CARE, Fitch India, Brickwork Ratings, and SMERA.

### **1. Credit Rating and Information Services of India Limited (CRISIL)**

- It is India's first credit rating agency which was incorporated and promoted by the erstwhile ICICI Ltd, along with UTI and other financial institutions in 1987.
- After 1 year, i.e. in 1988 it commenced its operations
- It has its head office in Mumbai.
- It is India's foremost provider of ratings, data and research, analytics and solutions, with a strong track record of growth and innovation.
- It delivers independent opinions and efficient solutions.
- CRISIL's businesses operate from 8 countries including USA, Argentina, Poland, UK, India, China, Hong Kong and Singapore.
- CRISIL's majority shareholder is Standard & Poor's.
- It also works with governments and policy-makers in India and other emerging markets in the infrastructure domain.

### **2. Investment Information and Credit rating agency (ICRA)**

- The second credit rating agency incorporated in India was ICRA in 1991.
- It was set up by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.
- It is a public limited company.
- It has its head office in New Delhi.
- ICRA's majority shareholder is Moody's.

### **3. Credit Analysis & Research Ltd. (CARE)**

- The next credit rating agency to be set up was CARE in 1993.
- It is the second-largest credit rating agency in India.
- It has its head office in Mumbai.
- CARE Ratings is one of the 5 partners of an international rating agency called ARC Ratings.

### **4. ONICRA**

- It is a private sector agency set up by Onida Finance.
- It has its head office in Gurgaon.
- It provides ratings, risk assessment and analytical solutions to Individuals, MSMEs and Corporates.
- It is one of only 7 agencies licensed by NSIC (National Small Industries Corporation) to rate SMEs.
- They have Pan India Presence with offices over 125 locations.

*Sources: Financial Market Operation by I.M. Pandey and Affairscloud.com*

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