LESSON – 7B

CREDIT RATING

7B.0 Objective:

After studying this lesson, you will be able to understand

- Meaning of Credit rating.
- Bases of Credit rating.
- Benefits of Credit rating.
- Problems of Credit rating.

Structure:

7b.1 Introduction to credit rating
7b.2 Bases for credit rating
7b.3 Rating symbols
7b.4 Importance of rating
7b.5 Leading international players in rating
7b.6 Indian credit rating agencies
7b.7 Guidelines for credit rating
7b.8 Benefits of credit rating to investors
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7b.15 Summary
7b.16 Self Assessment Questions
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7b.1 Introduction:

The History of credit ratings can be traced to the beginning of this century when large funds had to be raised by corporate world in the United States of America for construction of rail roads.

Since the amounts required were substantial the rail road companies wanted to mobilise funds from savers. In this process it was felt that credit rating would be an aid for instilling confidence in the investing public. Rating started in 1909. When John Moody, a financial analyst on Wall Street published ratings on bonds issued by Rail Road companies using rating symbols ranging from ‘Aaa’ to ‘C’. A year later Moody extended his ratings to utility and Industrial Bonds.

Subsequently, the business saw the entry of Poor’s publishing company, which issued its first rating in 1916 followed in 1922 by Standard Statistics Company in 1922 and in 1924 by the Fitch Publishing Company. The number of bond rating agencies in the United States reverted to three when standard statistics and Poor’s Publishing company merged to form Standard and Poor’s (S&P) in 1941.

At the outset the opinions offered on credit risk of instruments were more in the form of a right – the right to express an opinion Slowly these got embedded in legislation particularly after the greatest depression in 1929 and by 1933 credit rating took regulatory roots. The major credit goes to the Rail Road company that provided the real catalyst for the growth of credit rating. In June 1970 the world's largest Transport company U.S. PENN CENTRAL filed for Bankruptcy after defaulting on a $ 82 million outstanding domestic commercial paper (CP). Subsequently the Federal Reserve made it mandatory for commercial paper to be rated. Today in the U.S. ratings are an integral part of corporate and financial culture with nearly 100 percent of the public capital market being rated. In fact, it is mandatory for American Companies to have ratings from two agencies.

Hence, credit rating is essentially the symbolic indicator of the current opinion of a rating agency on the relative ability and willingness of the issuer of a financial (debt) instrument to meet the debt service obligation as and when they arise. It provides a relative ranking of the credit quality of debt instruments or their grading according to investment qualities.

Credit rating is an objective independent assessment of the credit worthiness of a borrower / issuer in terms of business and financial risk. A rating is defined as a current opinion regarding the credit quality of the issuer with reference to the particular instrument rated.

The rating offers an opinion regarding the issuer ability to meet in a timely manner his obligations on payment of interest and principal on the debt instrument to which the rating has been assigned. The important aspect here is that the rating is applicable only for the specific instrument and not the company issuing the debt instrument. Credit rating is only a measure of credit risk of particular debt instrument. It is only an opinion and is not a market rating or a recommendation to purchase, sell or hold that debt instrument. Another factor is that credit rating is not a general-purpose evaluation of the company. A rating is also not a guarantee. The rating of a debt instrument is under constant surveillance over its life and the rating can change either downward or upward depending upon circumstances.

7b.2 Bases of Credit Rating:

The credit ratings are based on the current information provided to the credit rating agencies by the borrowing company or obtained by the credit rating agencies from sources they consider realiable. In determining credit ratings the credit rating agencies will analyse various aspects of the borrowing company VIZ.,

a) Business Analysis: That relates to risk, market position of the company, operating efficiency and legal position of the company.

b) Financial Analysis: That includes accounting quality, earnings protection, adequacy of cash flows and financial flexibility.

c) Management Evaluation: That relates to human resource management, planning, control, business policy and decision making, foresightedness, challenges, threats, opportunities, strength etc.,

d) Geographical Analysis: That includes the location of the company etc.,

e) Regulatory and Competitive Environment Analysis: That relates to the structure and regulatory framework and their impact on the company.

f) Fundamental Analysis: That relates to liquidity and management, profitability and financial position and interest and tax sensitivity of the company.

7b.3 Rating Symbols:

The rating is expressed in symbols (ALPHA / ALPHA NUMERIC) that convey in a summarized manner to an investor the rating agency's current opinion as to the future risks associated with a particular debt obligation. The ratings assigned by all the credit rating Agencies are meant to indicate the likelihood of default or delayed payment of the security. Most of the agencies have their own systems of symbols. The majority use letters for ranking the risk of default from highly safe to highly speculative. The agencies also attach a plus or minus symbol to ratings in order to provide finer gradation in terms of risk profile.

Agencies also have different sets of symbols for different kinds of instruments. In most of the cases the distinction is made on the basis of the nature of the instrument – The Tenure. Agencies have different sets of symbols for indicating long term ratings (mainly Fixed Deposits) and short term papers (Commercial Paper, Certificate of Deposit).

7b.4 Importance of Rating:

Ratings have gained wide acceptance not only in the United States but also in other countries. Regulatory authorities in most of the countries have been quick to sanction official recognition to ratings.

In certain countries, ratings are required for listing of debt instruments. Thus a higher rated instrument may provide higher liquidity than a lower rated instrument. Over the time the Agencies have increased the range of cover age. Today the Leading American Agencies rate not only long Term Bonds issued by U.S. Corporations but also a wide variety of other debt instruments including Municipal Bonds, Asset backed securities, Medium Term Note Programmes, Commercial Paper Programmes and Bank Certificate of Deposit.

Credit Ratings are today used in the Financial Markets of most of the developed economies and in several emerging market countries as well. The major Rating Agencies S&P. MOODY's and DUFF and PHELPS have expanded their horizons and have setup overseas offices.

7b.5 Leading International Players in Rating:

Till the late sixties credit rating was essentially a U.S. Phenomenon. Rating of emerging market debt instruments by U.S. rating agencies commenced in 1977. When Standard & Poor rated debt instruments of Latin American Countries. Rating agencies came up in the seventies in Canada, the U.K. and Japan with growth in debt Markets. The eighties saw the spread of credit rating to South Asian Countries such as the Philippines, Malaysia, India, Singapore and latin American Countries such as Chile, Argentina and Brazil. Today credit rating has become a Global Phenomenon.

Today the world's largest rating agencies are Standard and Poor's (S&P) followed by Moody's Investor Service. A part from rating Agencies which rate all debt instruments, there are also specialised agencies that rate only specific institutions like THOMSON BACKWATCH which rates only Financial Institutions and A.M Best which only rates Insurance Companies claims paying abilities.

7b.6 Indian Credit Rating Agencies:

The credit rating agencies play an important role in the Indian financial markets in protecting and safeguarding the inverter's interest. Credit Rating Agencies VIZ., Crisil, Care and Duff and Phelps Credit Rating India Pvt. Ltd., are playing a very significant role in rating the debt instruments. These Agencies give opinion on the relative ability and willingness of the issues of a financial (debt) instrument to meet the debt servicing obligations as and when they arise. These agencies rate the debt instruments VIZ., Bond Commercial Paper, Debentures, Company Deposits etc., Credit ratings in India covered only debt instruments and not the equity shares but in developed nations equity shares are also being rated for the benefit of guidance of investors. Presently the equity is also being rated in India by ICRA.

In abroad especially in the U.S. the investors in debt Instruments wholly depend upon the credit ratings given by reliable / dependable credit rating agencies but in India the investors in debt instrument are varied nature. Most of the investors decide about their investment considering many other bases i.e. Hearsay, Advertisement etc., A few of the Investors usually take decisions about their investment wholly based on credit rating. The importance of credit rating system is essentially the consequence of the developments besides increasing levels of defaults resulting from the growing access to the financial markets VIZ the growth of Information Technology, the increased securitisation of borrowing and lending, globalization of financial markets, the increasing role of capital and money markets consequent to disintermediation and withdrawal of Government safety nets and the trends towards privatization.

Developing Nations are short of financial resources. Limited Funds available at their disposal are to be sagaciously to earn better return. Savings of the public in general are to be mobilized for Investment in trade and Industry. Hence, to motivate savers to invest in industry and trade it is necessary that their funds should be invested in safe enterprises where financial risk is least. It is only when savers have develop confidence in the company they would invest their savings. Safety of their investment can be pre-assessed if the companies ability and capacity to pay off the principal and other accruing dues is indicted in advance through a reliable credit rating Agency. A well rated company can get funds from the credit lending institution. Even the lower risk profile company can obtain easily funds at lower rate of interest as low risk profile investors would put their money therein.

7b.7 Guidelines for Credit Rating:

In our country it is mandatory to get the debt instruments rated by the approved credit rating agencies as stated below:

a) It is mandatory to get the debt instruments (Debentures and Bonds) rated in case of public issue when the conversion / redemption period exceeds 18 months.

b) The Non Banking Financial Companies which have net owned funds of more than Rs. 20 million must have got their FD rated within 31st March 1995.

c) In case of commercial paper the issue must have rating not below the A.2 grade of ICRA or its equivalent for other rating agencies in India.

7b.8 Benefits of Credit Rating to Investors:

Credit rating is highly beneficial to the investors in the following ways:

(i) Credit rating gives superior information at low cost.
(ii) It enables the investors to take calculated risk.
(iii) Credit rating encourages to invest in companies to get high returns.
(iv) Credit rating reduces dependence on brokers and merchant bankers.
(v) An alternate method for investment based on name recognition.
(vi) Credit rating encourages disintermediation.
(vii) Credit rating will multiply investor population.
(viii) The investors get the benefit of ongoing surveillance.

7b.9 Benefits to the Issuers:

1. A credit rating serves as a marketing tool for placement of debt obligations and offers an issuer the opportunity to access a wide range of funding alternatives.
2. Institutional investors usually operate under strict investment guidelines that often require the securities in which they invest to carry a credit rating assigned by a recognized

rating agency. Some institutions and banks have specified the minimum credit rating for a company to be eligible for finance.

3. Ratings help the process of disintermediation by helping companies mobilise funds directly from the capital markets. Credit rating is also useful while negotiating leases or long term contracts because it is quicker and easier to establish credibility and standing of the company as a counter party when independent opinion is available.

4. Rating can help companies to lower their cost of borrowing, as companies with high ratings are able to raise funds at lower interest. Cost credit ratings also act as a guide to companies which get a lower rating – the management is forewarned of the perception of its risk in the market enabling it to take corrective steps to change this risk perception.

7b.10. Benefits to the Intermediaries:

For intermediaries such as merchant an bankers and brokers, ratings help in providing advice to their clients as to the risk of a particular investment.

It also helps investment brokers and bankers in pricing debt. As the rate of interest on debt instruments of corporate is linked to ratings companies and intermediaries are facilitated in determining the pricing of debt offerings through ratings.

7b.11. Instruments Rated in India:

Credit rating in India is normally limited to rating of all rupee dominated debt obligations. The debt instruments rated include long term instruments such as bonds and debentures, fixed deposit programmes and short term instruments such as commercial paper programmes and certificates of deposit.

Other instruments rated are preference shares and other new and innovative instruments like structured obligations including asset based securities and Municipal bonds. Performance rating of parallel marketers of Liquefied Petroleum Gas (LPG) as well as of plantation companies is also undertaken.

7b.12. Regulatory Framework:

As in other countries, in India credit rating is mandatory while issuing certain debt instruments. Rating exercises are normally initiated at the request of a company. In evaluating and monitoring ratings the agencies employ both qualitative and quantitative criteria in accordance with the industry practice world wide. The methodology involves an analysis of past performance of the company and an assessment of its future prospects.

The past is not considered as a guide to the future but to understand why the company performed the way it did. More important a rating Agency has to look ahead over the life of the debt instrument.

Rating agencies go into the entire gamut of company’s financial and operational strengths. An assessment of the “BUSINESS RISKS” and “FINANCIAL RISKS” associated with the issuer / borrowing entity is undertaken. The business risks analysed include industry risks, market position of the company within the industry (including product profile, competitiveness – external and domestic) and operating efficiency of the borrowing company.

In financial risk analysis the accounting quality of the entity its past financial performance as well as its future financial performance are examined. The funding sources available to the company and the financial flexibility available in case of a short term financial crunch is also analysed. Stress is also laid on the evaluation of the management.

The ratings are based on current information provided to the rating agency by the borrowing company or facts obtained by the agency from sources it considered reliable.

7b.13. Problems in Credit Rating:

1. Possibility of confusion due to existence of various credit rating agencies, which rate the same debt instrument differently.
2. The credit rating agencies do not have common rigid formula to rate a particular debt instrument. Hence subjective bias in the areas i.e., Management Quality, Asset Quality, Auditor's Quality, Accounting Quality, etc., may arise in credit ratings.
3. Credit rating agencies can give only an indication and cannot give any foolproof and cent percent reliability of its assessment.
4. The assigned rating to a debt instrument is supposed to be monitored and revised either upward or downward depends upon the position and reliability of the issue. However, in this aspect credit rating agencies in India are lacking. Rarely the assigned ratings are revised and made publicity.
5. Under the prevailing situation a company in India is free to accept or reject any rating deliberately suppressing the low rating and publishing / accepting high rating. It is rated by more than one credit rating agencies. This practice misleads the potential investors.
6. In western countries the rating agencies under take voluntary rating even if the issuer company does not approach them. This unsolicited rating is primarily intended towards protection of the interest of the common investors. This aspect is lacking in India.
7. The practical difficulties in assessing some of the criteria VIZ. Quality of personnel, Quality of service etc., are not overcome.
8. Some of the credit rating agencies follow qualitative aspects for rating which may not be more realisable and accurate.

7b.14. Problems for Investors in Debt Instruments:

Although the credit ratings establish a link between risk and return they simply provide a yardstick against which one can measure the risk inherent in any instrument. An investor uses the credit ratings to assess the risk level and compares the offered rate of return trade off. The risk perception of a common investor in the absence of a credit rating highly depends on his familiarity with the names of promoters, common sense, advice from friends and relatives, messages in News Papers etc.,

At present a company desirous of credit rating its debt instrument needs to approach a credit rating agency and pay a fee for this service. Hence, there is no compulsion on the corporate sector to obtain or publicise the credit rating. This can lead the company to its rating as another publicity exercise if it is good one and obliterate it from its prospectus and publicity if it is not so good one and obliterate it from its prospectus and publicity if it is not so good. As far the investors in debt instruments are concerned most of them do not give much importance to the credit ratings. They either go for expert opinion from brokers in debt market or get advise from their friends / relatives / neighbours / peer groups etc., Another problem is the existence of more number of credit rating agencies which rate the same debt instrument differently at a time.

7b.15. Summary:

Credit rating is rating of borrower's solvency and ability to repay the borrowed amount when it becomes due. It is evaluation of risk involved in a financial transaction of lending and borrowing. When debt instruments like debentures and bonds are issued by companies rating is mandatory. Number of factors are taken into account. CRISIL, ICRA, CARE etc are some of the rating agencies in India.

7b.16. Self Assessment Questions:

1. Discuss the origin of credit rating.
2. Define credit rating and discuss its importance.
3. Explain the process of rating and discuss various factors taken into account.
4. What are the benefits of credit rating ?

7b.17. Further Readings:

1. VK Bhalla, *Management of Financial Services*, Anmol Publications Pvt. Ltd, New Delhi.
2. S. Gurusamy, *Financial Services and Systems,* Vijay Nicole Imprints Pvt. Ltd, Chennai.
3. M Y Khan, *Financial Services*, Tata McGraw Hill Publishing Co. Ltd., New Delhi.
4. VA Avadhani, *Financial Services,* Himalaya Publishing House, New Delhi.