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CREDIT RATING - ROLE IN MODERN FINANCIAL SYSTEM

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ABSTRACT

Credit rating business is a niche segment in the financial services arena. In the post-reforms era, with increased activity in the Indian Financial sector both existing and new companies are opting for finance from the capital market. The competition among firms for a slice of the savings cake has increased. Credit rating business in India is a sweet spot as it is on the cusp of robust growth potential, driven by three triggers: Strong capex cycle in Indian economy, lower penetration of corporate bond market and regulatory push due to implementation of Basel II norms. 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. They thus provide a yardstick against which to measure the risk inherent in any instrument. Analytical framework of rating deals with evaluation of both the business & financial risks associated with that entity. The Reserve Bank of India liaises with SEBI, on the issue of rating agencies' adherence to IOSCO Code of Conduct Fundamentals.

Given the slump faced by economies globally and the rise in the number of defaultees, it is about time that the channel had a strong credit rating system in place to ensure smooth operation for the entire chain. The most significant change in recent relates to emphasis on their accountability and more important, the caution in regulators' use of ratings.

KEYWORDS: Credit rating, Financial markets, Basil II norms, Business and Financial risk.

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. Given the slump faced by economies globally and the rise in the number of defaultees, it is about time that the channel had a credit rating system in place to ensure smooth operation for the entire chain. 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. The credit rating is used by individuals and entities that purchase the bonds issued by companies and governments to determine the likelihood that the government will pay its bond obligations.

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.

SOVEREIGN CREDIT RATINGS

A sovereign credit rating is the credit rating of a sovereign entity, i.e., a national government. The sovereign credit rating indicates the risk level of the investing environment of a country and is used by investors looking to invest abroad. It takes political risk into account.

The table shows the ten least-risky countries for investment as of June 2011. Ratings are further broken down into components including political risk, economic risk. Euro money's bi-annual country risk index monitors the political and economic stability of 185 sovereign countries. Results focus foremost on economics, specifically sovereign default risk and/or payment default risk for exporters (a.k.a. "trade credit" risk).

A. M. Best defines "country risk" as the risk that country-specific factors could adversely affect an insurer's ability to meet its financial obligations.

COUNTRY RISK RANKINGS (JUNE 2011)

Least risky countries, Score out of 100

Rank	Previous	Country	Overall score
1	1	Norway	92.44
2	6	Luxembourg	90.86
3	2	Switzerland	90.20
4	4	Denmark	89.07
5	3	Sweden	88.72
6	12	Singapore	87.65
7	5	Finland	87.31
8	7	Canada	87.24
9	6	Netherlands	86.97
10	13	Germany	85.73

Source: Euro money Country risk June 2011

ROLE OF CREDIT RATING

Credit rating establishes a link between risk and return. They thus provide a yardstick against which to measure the risk inherent in any instrument. An investor uses the ratings to assess the risk level and compares the offered rate of return with this expected rate of return (for the particular level of risk) to optimize 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 overemphasized. It is of great assistance to the investors in making investment decisions. It also helps the issuers of the debt instruments to price their issues correctly and to reach out to new investors. The analysis is based on an all-round analysis of quantitative as well as qualitative factors like past performance, economic environment, market positioning, quality of management and predictions about future, and is thus as complete as can be. The increasing levels of default resulting from easy availability of finance, has led to the growing importance of the credit rating. The other factors are:

i. The growth of information technology.

ii. Globalization of financial markets.

iii. Increasing role of capital and money markets.

iv. Lack of government safety measures.

v. The trend towards privatization.

vi. Securitization of debt.

CREDIT RATING IN INDIA

Credit ratings are 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 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 macro-economic 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. According to the G-20 Working Group recommendations, 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. This will allow them to use their rating for assigning risk weights within the framework of the Basel II Accord.

CREDIT RATINGS AND BASEL II

Regulatory changes in banks' capital requirements under Basel II have resulted in a new role to credit ratings. The major objective of Basel II is to revise the rules of the 1988 Basel Capital Accord in such a way as to align banks' regulatory capital more closely with their risks, taking account of progress in the measurement and management of these risks and the opportunities which these provide for strengthened supervision. Under Pillar 1 of Basel II, regulatory capital requirements for credit risk are calculated according to two alternative approaches: (i) the Standardized Approach; and (ii) the Internal Ratings-Based Approach. Under the Standardized Approach (SA) the measurement of credit risk is based on external credit assessments provided by External Credit Assessment Institutions (ECAIs) such as credit rating agencies or export credit agencies. Under the Internal Ratings-Based Approach (IRBA), subject to supervisory approval as to the satisfaction of certain conditions, banks use their own rating systems to measure some or all of the determinants of credit risk. Under the Foundation Version (FV), banks calculate the Probability of Default (PD) on the basis of their own ratings but rely on their supervisors for measures of the other determinants of credit risk. Under the Advanced Version

(AV), banks also estimate their own measures of all the determinants of credit risk, including Loss Given Default (LGD) and Exposure at Default (EAD). Under the regulatory capital requirements for operational risk, there are three options of progressively greater sophistication: (i) under the Basic Indicator Approach (BIA), the capital charge is a percentage of banks' gross income; (ii) under the Standardized Approach (SA), the capital charge is the sum of specified percentages of banks' gross income from eight business lines (or alternatively for two of these business lines, retail and commercial banking, of different percentages of loans and advances) and (iii) under the Advanced Measurement Approach (AMA), subject to the satisfaction of more stringent supervisory criteria, banks estimate the required capital with their own internal systems for measuring operational risk. Pillars 2 and 3 of Basel II are concerned with supervisory review of capital adequacy and the achievement of market discipline through disclosure.

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.

FACTORS AFFECTING ASSIGNED RATINGS

1. The security issuer’s ability to service its debt. In order, they calculate the past and likely future cash flows and compare with fixed interest obligations of the issuer.

2. The volume and composition of outstanding debt.

3. The stability of the future cash flows and earning capacity of company.

4. The interest coverage ratio i.e. how many number of times the issuer is able to meet its fixed interest obligations.

5. Ratio of current assets to current liabilities (i.e. current ratio) is calculated to assess the liquidity position of the issuing firm.

6. The value of assets pledged as collateral security and the security's priority of claim against the issuing firm's assets.

7. Market position of the company products is judged by the demand for the products, competitor's market share, distribution channels etc.

8. Operational efficiency is judged by capacity utilization, prospects of expansion, Modernization and diversification, availability of raw material etc.

9. Track record of promoters, directors and expertise of staff also affect the rating of a company.

ROLE OF CREDIT RATING AGENCIES

CRAs' role has expanded with financial globalization and has received an additional boost from Basel II which incorporates the ratings of CRAs into the rules for setting weights for credit risk. 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 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.

CRISIL

Credit Rating and Information Services of India Ltd. (CRISIL) (BSE: 500092, NSE: CRISIL) is India's leading Ratings, Research, Risk and Policy Advisory Company based in Mumbai. CRISIL's majority shareholder is Standard & Poor's, a division of The McGraw-Hill Companies and the world's foremost provider of financial market intelligence. CRISIL pioneered ratings in India more than 20 years ago, and is today the undisputed business leader[citation needed], with the largest number of rated entities and rating products: CRISIL's rating experience covers more than 24654 entities, including 14,500 small and medium enterprises (SMEs).

CRISIL offers domestic and international customers (CRISIL Global Research and Analytics consisting of Irevna and Pipal Research caters to international clients) with independent information, opinions and solutions related to credit ratings and risk assessment; energy, infrastructure and corporate advisory; research on India's economy, industries and companies; global equity research; fund services; and risk management.

A CRISIL rating reflects CRISIL's current opinion on the relative likelihood of timely payment of interest and principal on the rated obligation. It is an unbiased, objective, and independent opinion as to the issuer's capacity to meet its financial obligations.

So far, CRISIL has rated 30,000 debt instruments, covering the entire debt market.

The debt obligations rated by CRISIL include:

i. Non-convertible debentures/bonds/preference shares

ii. Commercial papers/certificates of deposits/short-term debt

iii. Fixed deposits

iv. Loans

v. Structured debt

CRISIL Ratings' clientele includes all the industry majors - 23 of the BSE Sensex constituent companies and 39 of the NSE Nifty constituent companies, accounting for 80 per cent of the equity market capitalisation, are CRISIL's clients.

CRISIL's credit ratings are

i. An opinion on probability of default on the rated obligation

ii. Forward looking

iii. Specific to the obligation being rated

But they are not

iv. A comment on the issuer's general performance

v. An indication of the potential price of the issuers' bonds or equity shares

vi. Indicative of the suitability of the issue to the investor

vii. A recommendation to buy/sell/hold a particular security

viii. A statutory or non-statutory audit of the issuer

ix. An opinion on the associates, affiliates, or group companies, or the promoters, directors, or officers of the issuer

CRISIL ratings are based on a robust and clearly articulated analytical framework, which ensures comprehensiveness, standardisation, comparability, and effective communication of the ratings assigned and of every timely rating action. The assessment is based on the highest standards of independence and analytical rigour.

CRISIL rates a wide range of entities, including:

x. Industrial companies

xi. Banks

xii. Non-banking financial companies (NBFCs)

xiii. Infrastructure entities

xiv. Microfinance institutions

xv. Insurance companies

xvi. Mutual funds

xvii. State governments

xviii. Urban local bodies

SHORT-TERM RATING

A short-term rating is a probability factor of an individual going into default within a year. This is in contrast to long-term rating which is evaluated over a long timeframe. In the past institutional investors preferred to consider long-term ratings. Nowadays, short-term ratings are commonly used.

First, the Basel II agreement requires banks to report their one-year probability if they applied internal-ratings-based approach for capital requirements. Second, many institutional investors can easily manage their credit/bond portfolios with derivatives on monthly or quarterly basis. Therefore, some rating agencies simply report short-term ratings.

CORPORATE CREDIT RATINGS

The credit rating of a corporation is a financial indicator to potential investors of debt securities such as bonds. Credit rating is usually of a financial instrument such as a bond, rather than the whole corporation. These are assigned by credit rating agencies such as A. M. Best, Dun & Bradstreet, Standard & Poor's, Moody's or Fitch Ratings and have letter designations such as A, B, C. The Standard & Poor's rating scale is as follows, from excellent to poor: AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB-, BB+, BB, BB-, B+, B, B-, CCC+, CCC, CCC-, CC, C, D.

Anything lower than a BBB- rating is considered a speculative or junk bond. The Moody's rating system is similar in concept but the naming is a little different. It is as follows, from excellent to poor: Aaa, Aa1, Aa2, Aa3, A1, A2, A3, Baa1, Baa2, Baa3, Ba1, Ba2, Ba3, B1, B2, B3, Caa1, Caa2, Caa3, Ca, C.

A. M. Best rates from excellent to poor in the following manner: A++, A+, A, A-, B++, B+, B, B-, C++, C+, C, C-, D, E, F, and S. The CTRISKS rating system is as follows: CT3A, CT2A, CT1A, CT3B, CT2B, CT1B, CT3C, CT2C and CT1C. All these CTRISKS grades are mapped to one-year probability of default.

<table>
<tr><th colspan="2">Moody's</th><th colspan="2">S&P</th><th colspan="2">Fitch</th><th></th></tr>
<tr><th>Long-term</th><th>Short-term</th><th>Long-term</th><th>Short-term</th><th>Long-term</th><th>Short-term</th><th></th></tr>
<tr><td>Aaa</td><td rowspan="6">P-1</td><td>AAA</td><td rowspan="4">A-1+</td><td>AAA</td><td rowspan="4">F1+</td><td>Prime</td></tr>
<tr><td>Aa1</td><td>AA+</td><td>AA+</td><td rowspan="3">High grade</td></tr>
<tr><td>Aa2</td><td>AA</td><td>AA</td></tr>
<tr><td>Aa3</td><td>AA-</td><td>AA-</td></tr>
<tr><td>A1</td><td>A+</td><td rowspan="2">A-1</td><td>A+</td><td rowspan="2">F1</td><td rowspan="3">Upper medium grade</td></tr>
<tr><td>A2</td><td>A</td><td>A</td></tr>
<tr><td>A3</td><td rowspan="2">P-2</td><td>A-</td><td rowspan="2">A-2</td><td>A-</td><td rowspan="2">F2</td></tr>
<tr><td>Baa1</td><td>BBB+</td><td>BBB+</td><td rowspan="3">Lower medium grade</td></tr>
<tr><td>Baa2</td><td rowspan="2">P-3</td><td>BBB</td><td rowspan="2">A-3</td><td>BBB</td><td rowspan="2">F3</td></tr>
<tr><td>Baa3</td><td>BBB-</td><td>BBB-</td></tr>
<tr><td>Ba1</td><td rowspan="5">Not prime</td><td>BB+</td><td rowspan="5">B</td><td>BB+</td><td rowspan="5">B</td><td rowspan="3">Non-investment grade speculative</td></tr>
<tr><td>Ba2</td><td>BB</td><td>BB</td></tr>
<tr><td>Ba3</td><td>BB-</td><td>BB-</td></tr>
<tr><td>B1</td><td>B+</td><td>B+</td><td rowspan="2">Highly speculative</td></tr>
<tr><td>B2</td><td>B</td><td>B</td></tr>
</table>

B3		B-		B-		
Caa1		CCC+	C	CCC	C	Substantial risks
Caa2		CCC				Extremely speculative
Caa3		CCC-				In default with little prospect for recovery
Ca		CC				
		C				
C		D	/	DDD	/	In default
/				DD		
/				D		

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 (corporate risk) or countries (sovereign risk). 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.

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