CREDIT RATING

Definition and History

The concept was introduced in 1909 by John Moody and was introduced in India during 1988.

A credit rating is the rating agency's forward looking opinion on the likelihood and repayment of a rated obligation in full and on time.

Credit rating is a technique of credit risk evaluation for corporate debt instruments reflecting a borrower's expected capability and inclination to pay interest and principal in a timely manner.

In evaluation, both quantitative and qualitative criteria are applied.

Objective of Credit Rating

The objective of credit rating is to enable an investor to get an indication of the debt servicing capacity of a product issued by a company.

The limitations of credit rating are:

1. No general evaluation.
2. No recommendation.
3. No guarantee about losses.
4. Do not consider various aspects which may influence investment decision.
5. No privity of contract between lender/investor and rating agency.

Need for Credit Rating

There are several instances of fly-by-night operator having cheated unwary investors.

It is difficult to distinguish between safe and good investment opportunities and unsafe and bad investments.

The borrower's size or name is no guarantee of timely payment of interest and principal.

Credit Rating is used extensively for evaluating debt instruments such as bond and debentures (long-term) and commercial papers and other money market instruments (short-term).

SEBI has made rating of all debt instruments compulsory irrespective of their maturity.

Rating Agencies in India

- Credit Rating Information and Services of India Limited (CRISIL) – subsidiary of S&P
- Credit Analysis and Research (CARE)
- Investment Information and Credit Rating Agency of India Limited (ICRA)
- Fitch Ratings
- Brickwork Ratings India Pvt.Ltd.

Global Rating Agencies include Fitch Ratings, Standard and Poor's (S&P), AM Best, Moody's.

Procedure for Credit Rating

- Application
- Agreement with client
- Monitoring of Ratings
- Rating Process
- Professional Rating Committees
- Rating Decision
- Responsibilities of rating agencies
- Dissemination to public
- Rating review for a possible change
- Rating change
- Credit rating watch
- Rating methodology: Business Analysis, Financial Analysis, Management evaluation, Regulatory and competitive environment, Fundamental Analysis
- Acceptance or refusal of credit ratings
- Split Rating
- Publication of ratings

Types of Analysis

Business Analysis: Industry risk, market position, operating efficiency as well as legal position of the company.

Financial Analysis: Accounting quality, earnings position, adequacy of cash flows, financial flexibility

Management evaluation: Goals, philosophy, strategies, ability, management talent and succession plan, competence, commitment, consistency, credibility

Regulatory and competitive environment: Regulatory Structure, legal framework, competitive environment

Fundamental analysis: Liquidity management, asset quality, profitability and financial position, interest and tax sensitivity

CRISIL Rating Process

Issuer – Request for rating – Signs rating agreement, provides information and rating fees – Rating team assigned, team collects information, conduct preliminary analysis – Team conducts site visits and perform analysis – Management interaction with the rating team – Analysis presented to rating committee – Rating assigned and communicated to issuer – Accepts the rating or appeal – Rating disseminated and carried in www.crisil.com – All ratings kept under continuous surveillance through validity

Credit Rating Symbols

CRISIL Long-term Debt Instruments:

AAA – CRISIL AAA (Highest Safety)

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A – CRISIL A (Adequate Safety)

BBB – CRISIL BBB (Moderate Safety)

BB – CRISIL BB (Moderate Risk)

B – CRISIL B (High Risk)

C – CRISIL C (Very High Risk)

D - CRISIL D (Default)

(+) and (-) signs are also used

Credit Rating Symbol

CRISIL Short-term Debt Instruments

P1 – CRISIL A1

P2 – CRISIL A2

P3 – CRISIL A3

P4 – CRISIL A4

P5 – CRISIL D

Credit Rating

IPO grading is based on:

IPO Grade 1 : Poor fundamentals

IPO Grade 2: Below-average fundamentals

IPO Grade 3: Average fundamentals

IPO Grade 4: Above-average fundamentals

IPO Grade 5: Strong fundamental

Where is credit rating compulsory?

1. Debt Instruments : All debt instruments (FCD, PCD, NCD) have to be compulsorily be rated by approved credit rating agency, irrespective of their maturity/conversion period. For public/rights issues of debt instruments, the SEBI guidelines 2000 stipulates credit rating to be obtained from not less than two rating agencies and shall be of at least investment grade (BBB- or above). But to reduce cost of issuance of debt, it has been now decided that rating from one credit rating agency would be sufficient.

2. Commercial Paper : Commercial paper can be issued in India if it has a rating not below P2 (CRISIL A2) from any rating agency.

3. Acceptance of public deposits by NBFC require an investment grade rating.

4. IPO Grading: In May, 2007 SEBI made it compulsory for all IPOs to be graded by credit rating agencies Which has been done away with in December, 2013 and it is now voluntary.

Why Credit Ratings will Change?

Change in Economic factors

Change in Industry specific factors

Change in Company specific factors

SEBI's Guidelines for CRA (Credit Rating Agency)

- CRAs should maintain records of the rating committee for a period of five years.
- CRAs should publish information about historical default rates of their rating categories and whether the default rates of these categories have changed over time.
- CRAs should ensure that its analysts do not participate in any kind of market and business development, including negotiation of fees with the issuer whose securities are being rated.
- CRAs, while rating structured rating products, are barred from providing consultancy or advisory services regarding the design of structured finance instrument.
- In case of unsolicited credit ratings, credit rating should be accompanied by the word "UNSOLICITED".
- CRAs should disclose policies, methodology and procedures of solicited and unsolicited credit ratings, history of all outstanding securities, general nature of compensation arrangement with issuer and details of any relationship with issuer whose securities are rated.

Credit Rating Process for Individuals

Credit Rating process for individuals involves:

Developing credit file – A credit file is a compilation of the past credit history of an individual/entity based on record and evidence.

Determining credit score – A credit score is a three-digit numeric summary of the credit history.

Preparing credit report – A credit history is the summary of the credit history of the entity along with its present financial position.

Assigning credit rating – A credit rating is assigned based on a credit history or report including information about late payments and bankruptcy.

Credit Information Bureau (India) Ltd- CIBIL

In the US, there are government-funded repositories, such as Equifax, Trans-world, Trans union, Dun & Bradstreet, etc. which act as credit rating agencies for retail borrowers.

They provide member banks/NBFCs with credit history of individuals in terms of repayment of past loans, status of current loans, and position of currently active credit cards with their repayment history.

There are other information like bankruptcy, litigation, court case, etc.

Based on overall credit history of the customer, he/she is given a credit rating, called FICO score (Fair Issac Corporation score)

CIBIL

- But in India this could not be replicated because of practical difficulties.
- The most important factor that prevent replication is the absence of Social Security Number (SSN) to identify an individual.
- The SSN number in USA contain all information of an individual regarding social history, financial history, criminal history, etc.
- CIBIL is India’s first credit information bureau, a repository of factual information on the credit history and repayment records of consumer and commercial borrowers.
- CIBIL was launched in 2000 and Consumer bureau was launched on 5 April, 2004. It was established by Government of India and RBI.

CIBIL

- The first promoters and member banks of CIBIL were the SBI and HDFC.
- The logistics and technology were provided by internationally reputed rating agencies like Dun & Bradstreet and Trans-union. The Credit Information Companies (Regulation) Act, 2005 and various rules and regulations issued by RBI have empowered CIBIL to collect the data from various types of lenders and then share the same within the group.
- The major objectives of CIBIL include : Collection of comprehensive credit information on consumer and commercial borrowers, maintaining a database of credit information and selling the information in the form of credit reports to a closed user group of members.
- A credit score in the range of 300-900 is assigned based on detailed credit history and full evidence of credit-worthiness of an individual or corporation for the past three years.
- Banks check the credit score of loan applicants and 80% of the loans are sanctioned by banks for a credit score more than 750.
- Credit rating agencies enable borrowers to avail loans at a competitive rate.

Factors affecting Credit Rating

- Past repayment history (35%)
- Total outstanding debt (30%)
- Duration of credit history (15%)
- State of financial health (10%)
- Types of credits availed (10%)
- Inquiries on credit report

New Trends in Rating Services

- Credit rating of SMEs: SME Rating Agency of India Ltd. (SMERA) is the country's first rating agency that focusses on MSME segment.
- Concessional funding: A good rating help units gain faster and cheaper credit for their ventures.
- Education institutions: CRISIL and ICRA have started rating the programmes offered by business and engineering schools. GOI have started NIRF (National Institution Ranking Framework) for engineering and management colleges.

Global Controversies in Credit Rating

- After the sub-prime crisis in US, there is a widespread criticism about the role of rating agencies.
- Institutional investors, such as pension fund managers in US, are required by law to base their portfolio allocation on the verdicts of rating agencies.
- There has been a lawsuit of $5 billion against S&P which has rated most of the $1.41 trillion collateralized debt obligations backed mortgage bonds between 2004 and 2007.
- The charges are double dealing, frauds and conflict of interest.