CHAPTER 13

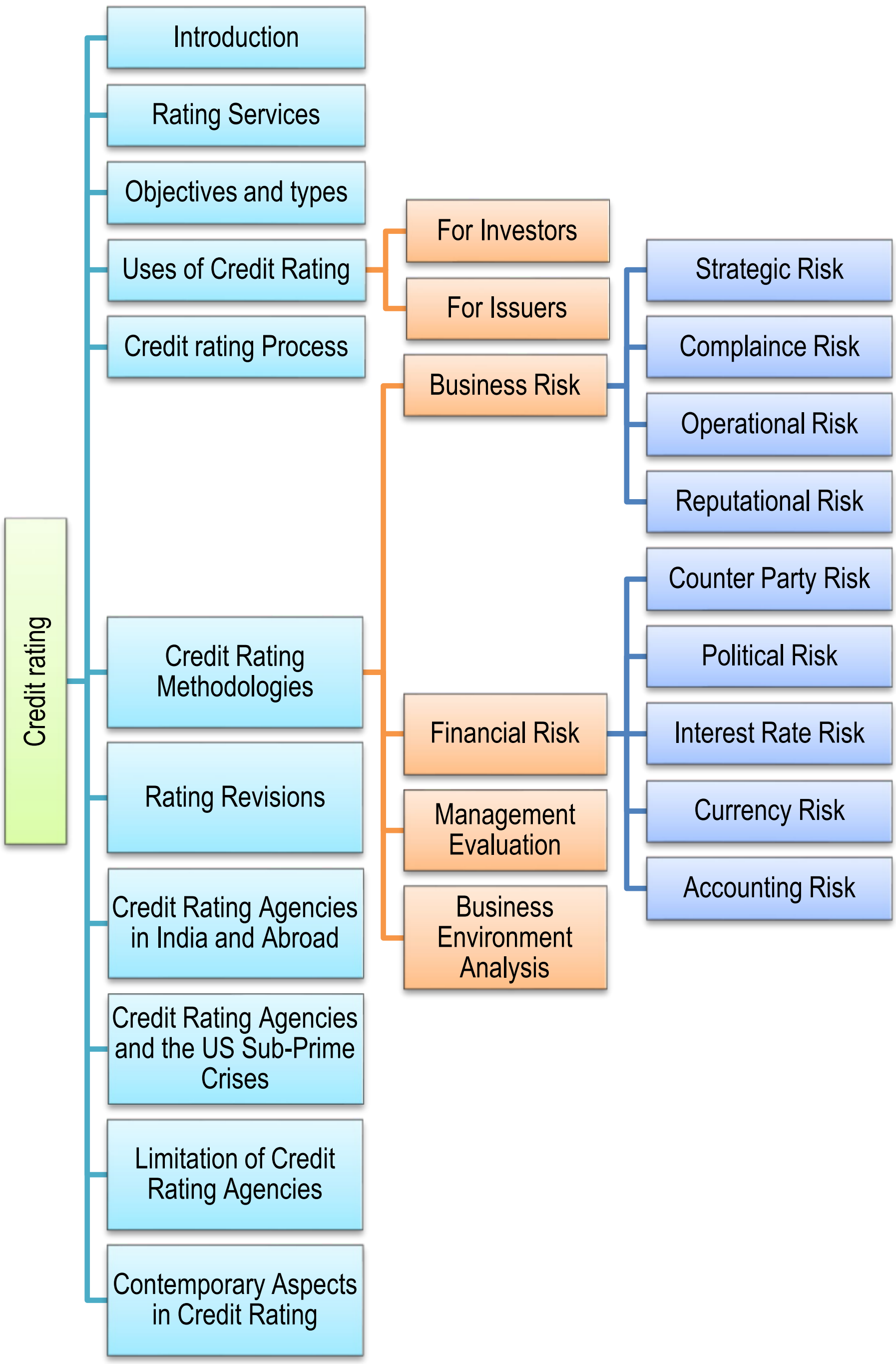
CREDIT RATING

LEARNING OUTCOMES

After going through the chapter student shall be able to understand:

- Introduction
- Rating Services
- Objectives and types
- Uses of Credit Rating
- Credit Rating Process
- Credit Rating Methodology
- Camel Model of Credit Rating
- Rating Revisions
- Credit Rating Agencies in India and abroad
- Credit Rating Agencies and the US sub-prime crisis
- Limitations of Credit Rating Agencies

CHAPTER OVERVIEW



1. WHAT IS CREDIT RATING?

A credit rating represents the rating agency's opinion on the instrument issued by the issuer company and the likelihood of default on the principal and the interest payment. A simple alphanumeric symbol is normally used to convey a credit rating. However, one should keep in mind that credit ratings do not guarantee the performance of the Company/Instrument. It is only an opinion expressed and may not be taken as any kind of assurance.

Thus, Credit rating is:

- Not an Insurance Against Default
- No Judgment on General Performance or Market Value
- Usually assigned to Debt Instruments, Not to Equity
- Important Input, but not the only Basis for Investment Decisions
- Dynamic and Subject to Change
- Different Rating Scales for Different Contexts

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, undertake credit assessment of borrowers for use by banks and financial institutions.

2. RATING SERVICES/ TYPES OF CREDIT RATINGS

Following rating services are generally provided by the credit rating agencies. For this purpose, the example of Credit Rating information Services of India Limited (CRISIL) has been taken:

(i) Corporate sector Ratings

Companies willing to launch Debt instruments in the market or those wanting to establish a good public image may undergo for such ratings. CRISIL follows a three-pronged approach to arrive at the standalone credit rating of a firm, comprising evaluation of Business Risk, Management Risk and Financial Risk. Also, the support obtained from a parent, group or joint venture is also considered to arrive at the overall credit rating.

(ii) Financial sector Ratings

These services assess financial institutions like Banks, NBFC's, Housing Finance companies, securities firms, etc. that are planning to issue instruments like bonds, bank loan instruments, Certificate of Deposits in the market. CRISIL ratings uses the 'CRAMEL' framework to rate finance companies which entails assessment on six major parameters such as capital, resource raising ability, asset quality, management, earnings, and liquidity.

(iii) Structured Finance

Structured Finance is a financial instrument available to companies with complex financing needs, which cannot ordinarily be solved with conventional financing. Collateralized debt obligations (CDO's), synthetic financial instruments, collateralized bond obligations, syndicated loans are a few examples of structured finance instruments. Credit ratings by CRISIL seek to ensure that the ratings assigned factor in all the key risks that the investors are exposed to in these transactions and specifically capture the nuances of the underlying asset class.

(iv) Credit Quality Ratings

The ratings indicate opinion on the credit quality of the debt securities held by a Debt fund. The ratings express an opinion on the expected default probability of the debt securities that the funds hold. These ratings are assigned only to funds that invest entirely in debt.

(v) Recovery Risk Rating

Recovery risk ratings indicate the variability in the extent of a recovery from a loan, post default. The ratings give insight into the potential loss in case of default. The key drivers for analysis are collateral coverage, quality of assets and seniority of the instrument.

(vi) Expected Loss (EL) ratings

CRISIL, in consultation with Ministry of Finance and other stakeholders have developed a credit rating framework for operational infrastructure projects based on 'expected loss methodology'. The ratings assigned are an opinion on the expected loss to be incurred over the life of the debt instrument and consider not only the probability of default, but post default recoveries too. The ratings are assigned on an innovative seven point EL rating scale from EL1 to EL7, with EL1 representing the lowest expected loss.

(vii) Insurance Hybrids

The Insurance Regulatory and Development Authority (IRDA) has allowed insurance companies to raise non-equity form of capital such as subordinated debt or preference shares. Rating methodology adopted by CRISIL for such hybrid instruments considers the credit profile of the insurers through corporate credit ratings, and factors in additional risks that these instruments carry on account of restriction on debt servicing. CRISIL uses criteria's such as Industry Risk and Business Risk across segments, Financials, Risk Management Systems, Goals and Strategies, Parental Support.

(viii) Independent Credit Evaluation

CRISIL conducts independent evaluations of the residual debt for resolution plans involving restructuring or changes in ownership of large accounts (accounts where the aggregate exposure of the lender is Rs1 billion and above). In fact, RBI notification dated August 6, 2020, has mandated ICE for resolution plans to deal with COVID-19 related stress. For a resolution plan to be considered for implementation without reference to NCLT, RBI guidelines require a minimum credit score.

(ix) REITS/INVITS Ratings

Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs) are innovative vehicles that allow developers to monetise revenue generating real estate and infrastructure assets, while allowing investors/unit holders to invest in these assets without owning them. REITs and InvITs enjoy favourable tax treatments and relaxation in capital gains tax. CRISIL has developed specific criteria for rating that focus on quality of the underlying asset portfolio and cash flows, and considers leverage, experience of the investment manager, risk management policies, etc. *(Source: www.crisil.com)*

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 principal 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 an 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 create a positive pressure on them to fulfill their debt obligations.

4. USES OF CREDIT RATING

For Investors –

(i) Aids in investment decisions.

(ii) CRA's shall observe a high standard of integrity and provide credible information about the company/instrument.

(iii) Provides analysts in Mutual Funds to use credit ratings as one of the valuable inputs to their independent evaluation system.

(iv) Assists investors to compare a wide variety of alternative instruments.

(v) Saving in time and cost as the investor need not carry out an in-depth analysis.

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.

(iii) A highly rated instrument can raise funds at lower rates of interest.

(iv) Better credit rating motivates the issuers and encourages them to maintain their image thereby resulting in Goodwill enhancement.

(v) Most companies use ratings as a marketing tool.

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

5. CREDIT RATING PROCESS

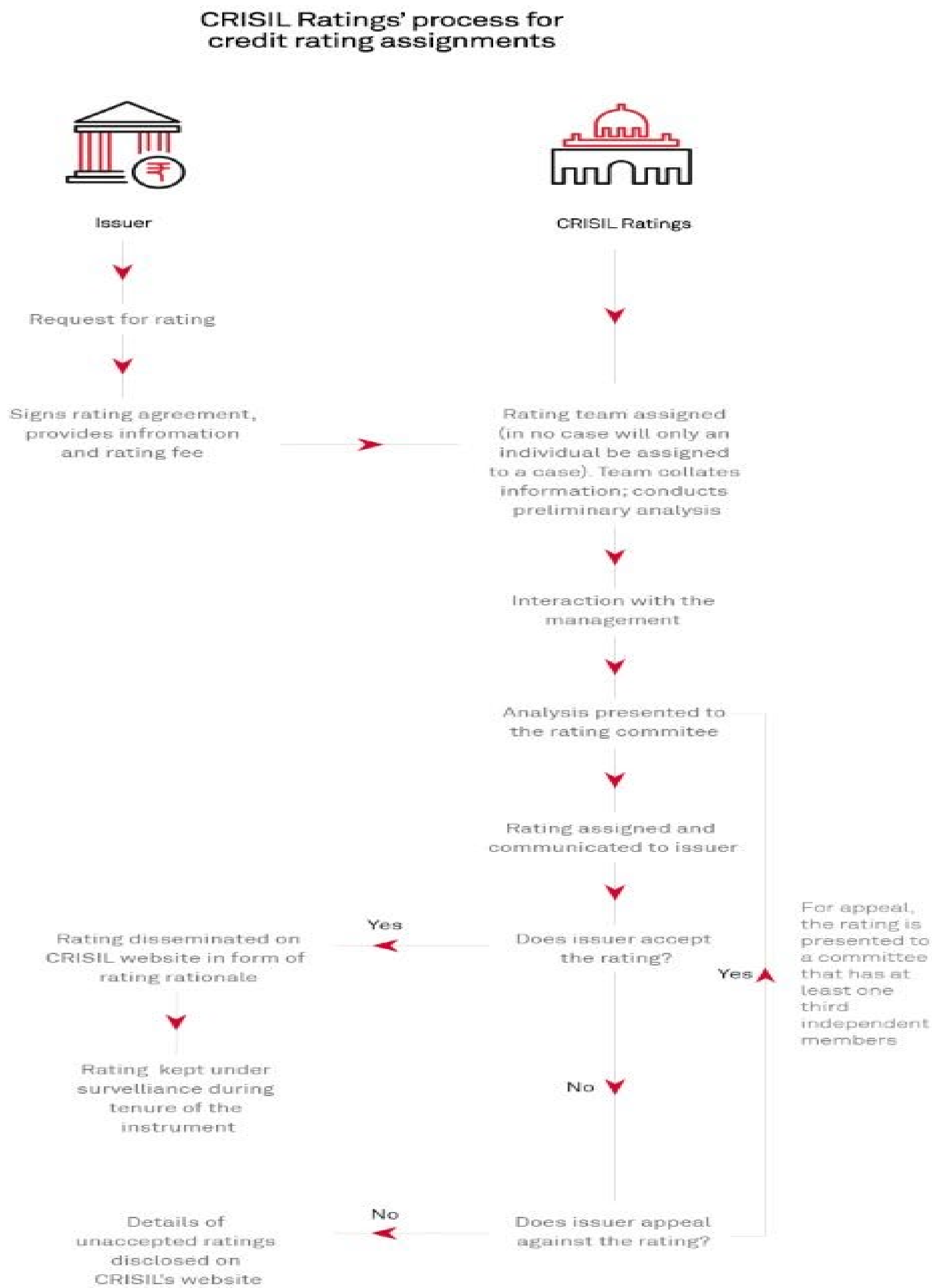
The default-risk assessment and quality rating assigned to an issue are primarily determined by three factors:

(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 marketplace of the issuer.

The steps involved are:



(Source: www.crisil.com)

a) **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 gather 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 the industry in which the issuer operates, its competitors and markets are taken into consideration.

b) **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.

c) **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.

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

e) **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.

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.

Sample of Rating Scores

Debentures	CRISIL	ICRA	CARE	FITCH
Highest Safety	AAA	LAAA	CARE AAA (L)	AAA (ind)
High Safety	AA	LAA	CARE AA (L)	AA (ind)
Adequate Safety	A	LA	CARE A (L)	A (ind)
Moderate Safety	BBB	LBBB	CARE BBB (L)	BBB (ind)
Inadequate Safety	BB	LBB	CARE BB (L)	BB (ind)
High Risk	B	LB	CARE B (L)	B (ind)
Substantial Risk	C	LC	CARE C (L)	C (ind)
Default	D	LD	CARE D (L)	D (ind)
Fixed Deposits				
Highest Safety	FAAA	MAAA	CARE AAA	TAAA
High Safety	FAA	MAA	CARE AA	TAA
Adequate Safety	FA	MA	CARE A	TA

Note: Ratings may apply modifiers ("+" (plus)/ ''- '' (minus)) with the rating symbols. The modifiers reflect the comparative standing within the category.

6. 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 a 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, an 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. A similar example can be given in the case of Nokia when it failed to upgrade its technology to develop touch screen mobile phones. That delay enabled 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 the photocopy machine. When laser printing was developed, Xerox was quick to lap up this opportunity and changed its business model to develop laser printing. Therefore, 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 must comply with plethora of rules, regulations and guidelines. Noncompliance 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, a real problem then occurs. For example, a company pursuing cement business is likely to venture into sugar business in a different state. But the 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 the 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.

The operational efficiency of the company can enable it to avail better ratings from the Credit rating agencies. Locational advantages, Relationship with labour, Favorable cost structure or advanced manufacturing technologies compared to competitors may act in the favor of the company and will enable the company to earn better ratings.

(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 General Motors has done in India) creates a bad reputation for the company. In the above case, it was observed that employees have reacted 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 the direct sense, but it actually is 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

(e) Accounting 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 the host country may lead to huge losses. 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 a change in interest rate resulting in a change in assets and liabilities. This risk is more important for banking companies as their balance sheets are more interest sensitive and their base of earnings is spread between borrowing and lending rates.

As we know, the interest rates are of two types i.e. fixed and floating. The risk in both 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 the 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).

(e) Accounting Risk: For any evaluator, it is very important that the financial records are written as per the acceptable policies and standards. Any deviations from the standard should be highlighted or may result in evaluators reaching to wrong conclusions. Thus, Overstatement/understatement of profits, auditors' qualifications, methods of income recognition, off balance sheet liabilities, etc. can affect the credit ratings of a company.

(iii) MANAGEMENT EVALUATION

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 the case of unlisted companies also, the credit rating companies can influence the companies to include MD&A in their Annual Report.

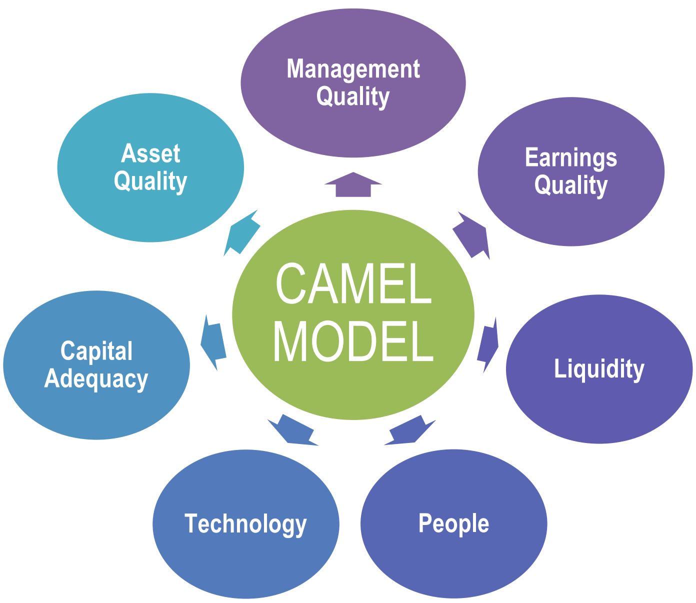
Actually, MD&A is the section of a company's annual report in which management provides a summary of the previous year's operations and how the company performed financially. Management also gives an outline for the next year by highlighting the future and some briefs about the new projects to be launched by the company. Also, track record of managerial planning and control system, depth of managerial talent, succession plans, capacity to overcome adverse situations, philosophy and strategies of the management affects the credit rating.

(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 trends 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. The credit rating agencies would not only consider the factors influencing the specific industry but also consider the macro-economic factors which affect the economy. For e.g.: Likely recession in economy, constant inflation, etc. and would evaluate the impact of the same on the concerned business. After that strategies will be developed to ward off any negative impact that has arisen.

7. CAMELS MODEL IN CREDIT RATING

CAMELS is a recognised international rating system that bank supervisory authorities use to rate financial institutions according to six factors represented by its acronym: Capital adequacy, Asset quality, Management, Earnings and Liquidity and Sensitivity. The CAMELS model adopted by the Rating Agencies deserves special attention; it focuses on the following aspects:



1) **Capital adequacy –** It includes assessing institutions capital adequacy through capital trend analysis. Examiners also check if institutions comply with regulations pertaining to risk-based net-worth requirements. To get a higher rating an institution must comply with interest and dividend rules and practices.

2) **Asset quality –** It covers an institutional loan's quality, which reflects the earnings of the institution. Examiners also check how companies are affected by the fair market value of their investments when compared with bank's book value of investments It also includes size, ageing, and recoverability of monetary assets viz receivables and its linkage with turnover.

3) **Management –** It includes the extent of involvement of management personnel, teamwork, authority, timeliness, effectiveness, and appropriateness of decision making along with directing management to achieve corporate goals. Management assessment determines whether an institution can react properly to financial stress.

4) **Earnings –** A bank's ability to produce earnings to be able to sustain its activities, expand and remain competitive. Examiners determine this by assessing the bank's earnings, earnings growth, stability, net margins, net worth level.

5) **Liquidity –** It includes 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.

6) **Sensitivity –** Sensitivity covers how particular risk exposures can affect institutions. Thus, examiners verify the vulnerability of the institution to internal and external factors.

These six aspects form the core basis 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 categories and these are factored in for making the overall rating decision.

8. 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 agencies. 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, 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.

(a) **Default rates**: Default rates is the number of defaults among rated firms during a specific time period, expressed as percentage of the total number of the firms with outstanding ratings. Default ratings are calculated under each category and over multiple periods. Credit ratings are opinions on the risk of default. Thus, higher the rating, lower should be the probability of the default. An inverse correlation between credit ratings and default probability, called as the test of ordinality, is desirable for credit rating agencies. The following table shows Cumulative Default Rates (CDRs) of CRISIL:

Table: Average CDRs for long-term ratings – monthly static pools

One-two-and three-year CDRs (FY11-21)				
Rating category	**Issuer-months**	**One-year**	**Two-year**	**Three-year**
CRISIL AAA	13,149	0.00%	0.00%	0.00%
CRISIL AA	33,357	0.03%	0.11%	0.22%
CRISIL A	63,679	0.16%	0.72%	1.39%
CRISIL BBB	1,95,414	0.75%	2.06%	3.62%
CRISIL BB	3,18,637	3.50%	7.43%	11.31%
CRISIL B	2,72,105	8.41%	16.90%	24.03%
CRISIL C	8,306	20.83%	34.89%	45.24%
Total	**9,04,647**			

(*Source: CRISIL Ratings)*

(b) **Transition rates**: These rates indicate the number of instances when credit ratings among rated firms have changed over a specified period, expressed as a percentage of the total number of firms with outstanding ratings. It is important that the ratings remain stable over the life of the instrument and thereby enable investors to hold on to instruments invested into for longer periods.

Table: Average one-year transition rates for long-term ratings (FY11-21) – monthly static pools

Rating category	Issuer-months	CRISIL AAA	CRISIL AA	CRISIL A	CRISIL BBB	CRISIL BB	CRISIL B	CRISIL C	CRISIL D
CRISIL AAA	13,149	98.60%	1.40%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
CRISIL AA	33,357	1.30%	96.28%	2.26%	0.12%	0.01%	0.00%	0.00%	0.03%
CRISIL A	63,679	0.02%	2.68%	92.56%	4.31%	0.22%	0.03%	0.03%	0.16%
CRISIL BBB	1,95,414	0.00%	0.05%	2.46%	90.90%	5.57%	0.19%	0.07%	0.75%
CRISIL BB	3,18,637	0.00%	0.00%	0.01%	3.73%	88.76%	3.78%	0.23%	3.50%
CRISIL B	2,72,105	0.00%	0.00%	0.00%	0.04%	8.03%	83.07%	0.45%	8.41%
CRISIL C	8,306	0.00%	0.00%	0.01%	0.00%	1.32%	19.40%	58.44%	20.83%
Total	9,04,647								

Source: CRISIL Ratings

The highlighted diagonals indicate the stability rate under each rating category. Between fiscals 2011 and 2021, 96.28% of 'CRISIL AA' ratings remained in that category, 1.3% were upgraded to 'CRISIL AAA' and 2.4% were downgraded to lower categories.

9. 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 been India's leading rating agency with over 60% share of the Indian Rating market. 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.

3) **Credit Analysis and Research Ltd. (CARE) –** It was established in 1993. UTI, IDBI and Canara Bank are the major promoters. CARE has over 2500 instruments under its belt and occupies a pivotal position as a rating entity.

4) **Fitch Ratings India (P) Ltd. –** The Fitch Group, an internationally recognized statistical rating agency has established its base in India through Fitch Rating India (P) Ltd. as a 100% subsidiary of the parent organization. Its credit rating applies to a variety of corporates / issues and is not limited to governments, structured financial arrangements and debt instruments.

5) **Onida Individual Credit Rating agency (ONICRA) –** It is India's first individual credit rating company, established in 1993. There was a dearth of individual credit rating firms in India. ONICRA helps the lending institutions by providing credit ratings for individual customers or loan applicants. Various services offered include Credit rating, employee screening, customer verification, SSI/SME rating, banking information service.

All the agencies as discussed are recognized by SEBI.

10. 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 can meet its financial obligations in time or not. S & P operates 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 to 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.

11. 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 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 totaling $523 billion as of September 2008.

The ratings of these securities were 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 to rate particular MBS and CDO securities issued by investment banks, which critics argued contributed to lower rating standards.

12. LIMITATIONS OF CREDIT RATING

1) **Rating Changes –** Ratings given to instruments can change over a period of time. They must be kept under rating watch. Downgrading of an instrument may not be timely enough to keep investors educated over such matters. Ratings do not guarantee any financial strength to the investors.

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. The rating market being competitive there is a possibility of such conflict entering into the rating system.

5) **Information provided by Borrower –** Ratings are always based on the information provided by the borrower or the issuer and this could be subject to inaccuracy.

6) **Lack of Accountability –** The process of credit rating lacks accountability as it is mere expression of opinion. The lack of experienced and skilled staff may not do justice to their task and may lead to inappropriate conclusions.

7) **Corporate Governance Issues –** Special attention is paid to:

   a) Rating agencies get 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.

13. CONTEMPORARY ASPECTS IN CREDIT RATING

13.1 SEBI telling rating agencies to disclose probability of default for issuers they rate.

According to a SEBI circular, rating companies, in consultation with the regulator, are now creating 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 is now 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 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 market regulator had also 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)*

13.2 RBI asking credit rating agencies to use artificial intelligence, social media to catch stress signals.

The Reserve Bank of India has asked rating agencies to enhance the quality of monitoring rated entities through means like social media and corporate filings, and not just depend on information given by companies.

Rating agencies in meeting with RBI top brass, including governor Shaktikanta Das and deputy governors, sought access to Central Repository of Information on Large Credits (CRILC) maintained by central bank.

Banking regulator informed agencies that it would consider plea for access to CRLIC. It advised them to become proactive and not just look at information after critical events have happened. It also emphasized the need to pick up signals and work on them before defaults happen.

There was also nudging from the banking regulator to use intelligent information systems be it machine learning and Artificial Intelligence (AI) that could capture social media alerts and trends useful for rating purposes. This issue may also be discussed at the panel of market regulators comprising SEBI, IRDAI, PFRDA, among others, for improving the quality of oversight.

During the meeting, held through video conference, Credit Rating Agencies (CRAs) presented assessment of the macroeconomic situation and outlook on various sectors including the financial sector. They also shared perspectives on the overall financial health of the entities rated by the CRAs and major factors that affect credit ratings in current context, RBI said in a statement.

RBI also gave feedback on ways to further strengthen the rating processes and engagement with key stakeholders. Another official said rating agencies expressed concerns over rising share of companies in "not cooperating" categories. These entities should be taken off from monitoring after remaining in this category for 6-12 months. *(Source: Business Standard)*

TEST YOUR KNOWLEDGE

Multiple Choice Questions (MCQs)

1. Which of the following companies is primarily engaged in rating of Individuals

    (a) ICRA

    (b) CRISIL

    (c) ONICRA

    (d) CARE

2. The rate that measures the changes in the ratings of a company/instrument over a specified period and expressed in percentage terms is

   (a) Transition rate

   (b) Default rate

   (c) Recovery rate

   (d) Negative rate

3. Which out of the following is not a parameter under consideration in the CAMELS model of credit rating

   (a) Capital adequacy

   (b) Financial performance

   (c) Sensitivity

   (d) Management

4. Credit rating services might be of least utility to

   (a) Lender

   (b) Borrower

   (c) Customer

   (d) Government

5. Credit rating is not

   (a) Important input for investment decisions

   (b) Dynamic

   (c) Safeguard against Default

   (d) Assigned to debt instruments

6. Which among the following is not a problem associated with credit rating agencies in India?

   (a) Conflict of interest

   (b) More competition

   (c) Poor Rating Quality

   (d) Independence of the ratings committee

7. Which among the following is a solution in addressing the challenges in credit rating agencies?

   (a) Persistence of conflict of interest

   (b) Introduction of more players

   (c) Non rotation of credit rating agencies

   (d) Unawareness among investors

Theoretical Questions

1. Discuss the various rating services provided by the credit rating agencies.
2. Explain the Credit rating process usually practiced in India by Credit Rating Agencies.
3. Briefly describe the business risk and the various aspects related to it.
4. Explain the CAMELS model of credit rating?
5. Write a note on the limitations of credit rating services.

ANSWERS/SOLUTIONS

Answer to Multiple Choice Questions

1.	**(c)**	**2.**	**(a)**	**3.**	**(c)**	**4.**	**(c)**	**5.**	**(c)**
6.	**(b)**	**7.**	**(b)**						

Answers to the Theoretical Questions

1. Please refer to paragraph 2

2. Please refer to paragraph 5

3. Please refer to paragraph 6

4. Please refer to paragraph 7

5. Please refer to paragraph 12