Financial Institutions and Markets
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Lecture – 34
Credit Rating Agencies

So, after discussing about the merchant banks and the venture capital which are the most important or non banking financial companies which play the significant role for the financial development. We can discuss about the credit rating agencies today whose role is quite significant in terms of the investment in the financial market and as well as from the investor point of view to look for certain companies who are good for the investments or who are basically eligible for the investment in the financial system.

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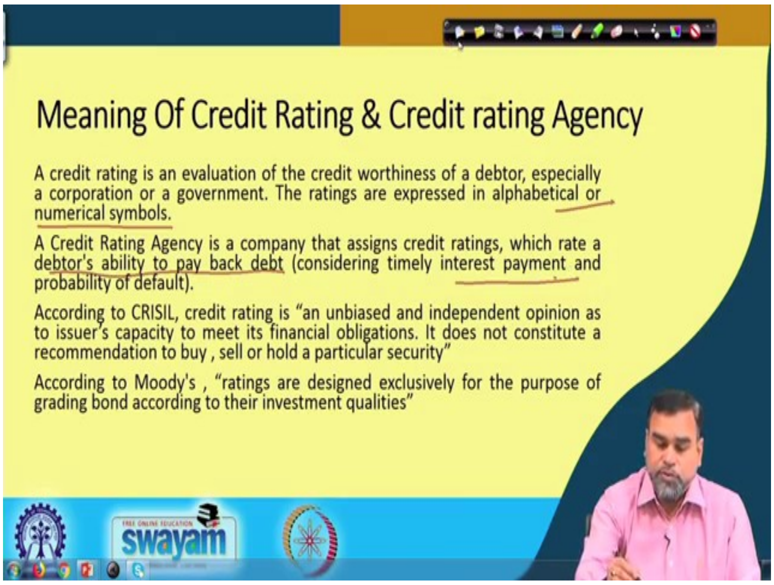

So, let us see that what do mean by the credit rating and what do you mean by the credit rating agency. Whenever you talk about the credit rating it is basically what? The credit rating is basically a process it is basically an evaluation of the credit worthiness of a debtor, especially it can be for a company or the corporation or for a government. So, you see that basically what; whenever we are trying to find out the credit worthiness of a particular entity whether that entity belongs to a company or it belongs to a particular organization or particular country. So, whether that particular company is able to repay the loan or not arrive the company is issuing the debt whether what kind of credit rating is involved with that particular company.

So, those things can be judged on the basis of the whatever rating the company has; so credit rating basically gives you kind of qualitative idea about the company what kind of that company is and whether the company is able to repay the loan in the future or not. So, whatever debt the company has issued whether the company is able to pay the periodical coupons and as well as the principal in the end or not.

So, that is basically measured through a process which is called the credit rating and the ratings are basically given in the alphabetical sense or we can say that a b c kind of process the ratings are always provided. So, here that is why these are the numerical alphabetical or the numerical symbols always we give for the different type of ratings what we give to the different company or the country.

And who gives the rating? The ratings are basically given by the credit rating agencies. So, here the rating agency considers certain kind of factor and follow certain kind of process and using that factors and following that process they try to find out that what kind of rating the company will get or they try to give a particular rating which measures the qualitative measures of the credit worthiness of that particular company.

So, here what basically it try to make or try to always measure, they try to measure the debtors ability to pay back the debt and already you know that whenever the company has gone for the debt financing or the one financing always there are 2 major components one is your interest payment and another one is the principal. And they consider whether the company is able to repay the interest in the periodical manner or not that is number one and what is the probability of default the company might have or may have to pay that particular interest in the future time.

So, this is what basically the basic job of the credit rating agency. So, in India we have different kind of different types of agencies or there are many agencies which go provide this kind of ratings and internationally also we have many credit rating agencies which provide this kind of ratings to the company. So, according to CRISIL if you see CRISIL is a credit rating agency, which gives the credit rating an unbiased and independent opinion as to issuer’s capacity to meet its financial obligations. It does not constitute a recommendation to buy, sell or hold a particular security.

The CRISIL rating agency, basically it does not give or credit rating does not mean that you invest in that company or you buy then that company or you sell in that company. So, sold that particular stock or buy that particular bond or sell that particular bond those buying and selling of a security provided by that particular company in terms of debt financing or equity financing. That is not basically the rating tells, what the rating tells? The rating tells that whether the issuer has the capacity to pay this financial obligations whatever they have.

If they have issued the debt, if they have issued this bond whether they are able to repay this coupon and as well as the principle in the future or not that thing basically you can judge on the basis of the rating what the company gets. But it never says that whether you should buy that particular stock or you should sell that particular stock or you buy that particular bond or sell that particular bond. So, those kind of things are not basically always we judge whenever we get this credit rating.

So, according to Moody's which is a global player what this Moody's tells the ratings are designed exclusively for the purpose of grading the bond according to their investment qualities. So, there are two types of broad categories of the bonds always we observe or we find in the market, one is investment grade bonds and other one is not investment grade bonds.

So, investment grade bond means up to a certain rating the bonds are considered as the investment grade bonds which are eligible to be traded in the market and from those the investor can participate in the trading process of those types of bonds. In another type of bonds are those which are basically not eligible for the trading in the financial system or the financial market.

So, therefore, whether you want to buy this particular stock or buy this particular bond or you sell this particular bond that is not basically we can judge from the rating, but we can get this overall idea that what kind of the company it is, whether the companies has the credit worthiness to made it is financial obligations in the future or not. This is what basically the rating agencies job or the objective of the credit rating what we can say.

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Why we need a credit rating already we say that the basic views of rating is to get this idea to or to get this kind of information whether the company is able to fulfill the financial obligation or not. So, this is what basically the financial obligations are basically always made by this particular company in the future or not that is basically judged by the credit rating, rating from that particular company. So, why we need the rating? Basically if any company gets a good rating the confidence of the investor to invest that company increases or the probability of the investors' confidence on investing in those kind of bonds or those kind of companies stock increase.

So, that basically always helps us to create the confidence in the investors mind that whenever they are going to take a position in the financial market for a particular bond or particular stock. Then whether the particular stock is going to do well in the future or not that particular kind of implications they can draw if the rating of the company is better or it is a good rating the company has got. So, the investor's confidence is always maintained, if are anybody gets a good rating of that particular company acquired the investor in that.

It protect the interest of the investors because all those information the investor may not get. So, all those always investor feel that all those investor inform whatever information the investor want to get for investment, they may not have all those information, but all the information are reflected through the rating for the company has to because of that it protects the interest of the investors.

Then motivate the savers to invest because if there are certain people as relatively risk averse a nature and they do not want to take much risk in the financial system. In that particular point of time, if they realize that one companies rating is better and the credit worthiness of the company is quite high.

So, in that contest there may be motivated to save more and that savings maybe sometimes those savers can be converted into investors in the market and they can participate in the capital market for the investment, both in terms of stock investment and as well as the bond investment mostly they will be at least they will be interested to invest in the bonds. So, that is basically motivation which is created in the mind of the savers to become the investors. So, that is another thing what you can judge whenever we talk about the credit rating, this is the requirements or reasons for the credit rating always you can say.

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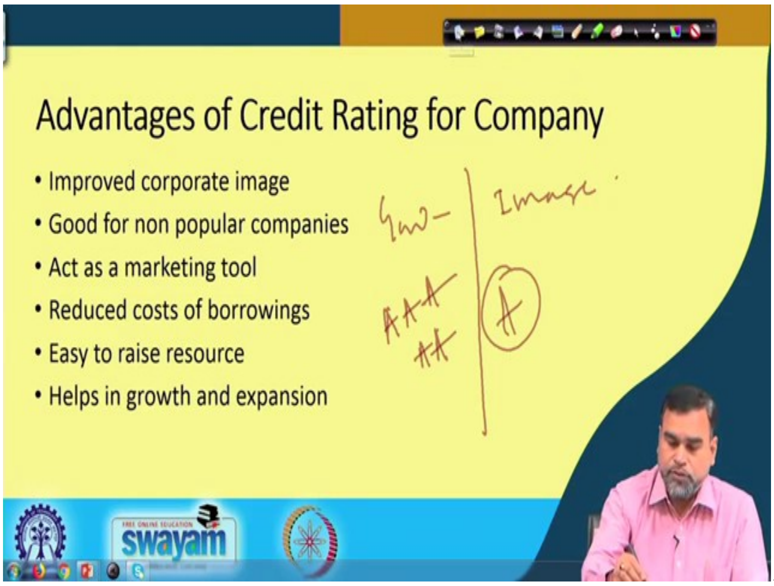

So, there are certain advantage always the company get the rating is required from both investors prospective and as well as the company's prospective and what are those advantages of credit rating for the company. Why the company wants the credit rating? What is the basic reasons behind that? First of all it helps us to create the image within the corporate sector, any company gets good rating or rating is good then it creates a good image in the market and there are certain companies there are not quite popular their information about the company is not available to the common man or the common mass.

So, in that particular point of time if the investors are little bit reluctant to invest in those kind of companies or the particular bonds and stocks issued by these companies then how basically they can get this information how that the company is good or bad. So, that information basically they can always realize or always you can get, they can get from the ratings of that particular company.

If the rating is good it creates an impression that the company must be good, it is a good company that is why they will be ready to invest in that particular company. Then also it acts as a marketing tool some company always uses that rating as a marketing tool because they always feel that my company is a triple A rated company or my company is a double A rated company. So, it is A rated company so, that basically always they can use to market themselves in the financial system or to attract the investors that this company is a good company and this company is better for the investment in the future.

Reduces cost of borrowing, because of good reputation because of the good brand value because of less probability of default; the borrowing cost of those companies basically reduces. And another one is easy to raise the resources, if the company wants to raise the money from the market and they want to raise the money from the public and if it is a good rated company then always it motivates the people to invest.

And as well as whatever bonds this company will issue and it is easily described in the financial market or the investors will be ready to buy those kind of bonds whatever thing are issued by these particular companies; the bond issuance will be relatively easier and this company basically gets the good price for that particular bond and it will be easy for them to raise the resources from the system.

And it also helps in growth and expansion, because the companies rating is good what can happen in that process it is then easy for raising the capital, say it is easy for raising the capital particularly where referring to the financial capital because the financial capital increases relatively better than the company can grow and they can expand in a better way because the announcement of the financial capital lead to the announcement of the physical capital. They can create the infrastructure, they can create the machines and all these things to growth themselves or to make some expansion plan for that particular company so that is why it also helps in the growth and expansion. So, these are the major advantages what we can realize, we can observe from the company's prospective that why the company needs the credit rating.

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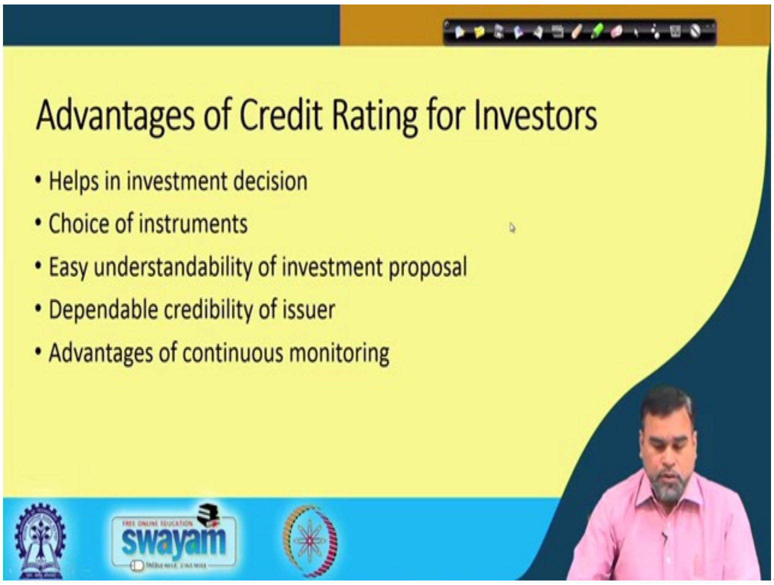

From the investor prospective it helps in the investment decision it helps that which company they should choose, they can easily understand the investment proposal and they can always find out what is the credibility of the issuer. The qualitative credibility whether the issuer is really able to pay the coupons and principal in the end or not and because the credit rating companies or credit rating agencies rate this companies periodically whatever rating the company gets there is a valid period of this particular rating.

So, whatever rating the company gets may be that is valid for 1 year or 6 months and after that again the rating will be done and the same process will be followed and the rating may sustained, rating may increase, rating may decrease that is why what this investors always feel that if the companies rating is consistent or the rating is getting better and better than maybe it is good for them or; that means, it is continuously monitor on the company's performance is going to be better off.

So, if they are going to take part in the investment processes with respect to that company maybe it is better for them or profitable for them to maximize their returns.

That is why it basically act as a continuous monitoring process because credit rating is a continuous monitoring process; the investor can rely that whatever on the basis of the rating they can charge that whatever company it is whether it is a good company or it is a bad company.

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Then which are those credit rating agencies in India and abroad if you see; we have 5 major rating agencies, one is CRISIL already I was just telling about this thing Credit Rating and Information Services India Limited. There we have Investment information and Credit Rating Agency Limited that is called ICRA. Then Credit Analysis and Research Limited that is called CARE, then you have the Brickwork Ratings India Private Limited that is another rating agency, then SME Rating Agency of India Limited that is called SMERA; S M E R A.

There are some global players we have Moody's already I told you we have standard and poor, we have the Fitch ratings these are the companies or these are the rating agencies who give the ratings across the globe to the companies and as well as to the country. The country governance and all these things or the rating of the company for the investment all kind of things are done by the global players and they also do the rating for the corporates for their bond is ones, these are the different kind of agency.

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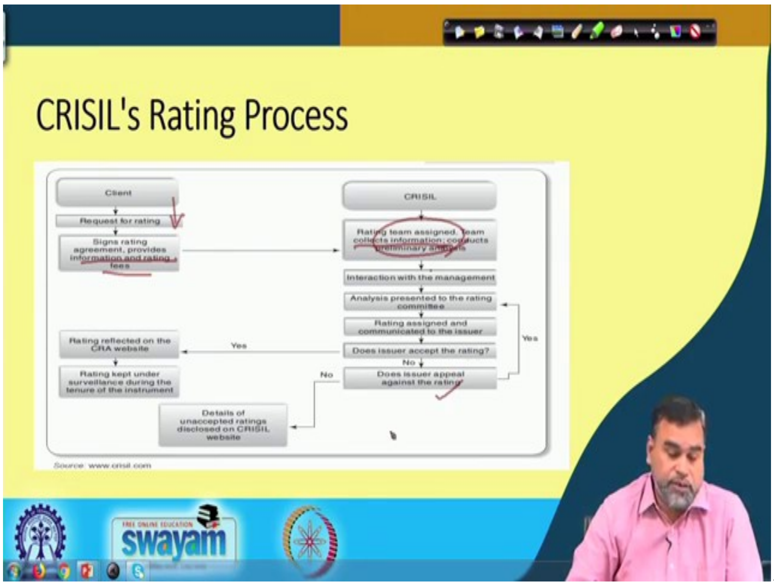

So, if you see that rating process, how this rating process basically works. The rating process means any company who wanted to be rated. So, let any company bonds that I should get some credit rating for the credit rating agency, then what they do the client basically who wants the rating or the company who wants the rating they send a request to the rating agency for the rating. And the rating agency what they do they sign an agreement all those with the all those information rating fees because they will give the rating to the company that is why some rating fees they will charge and one agreement will be sign.

Then once those things got over then what will happen that the rating agency in this case we are talking about CRISIL, the CRISIL basically assigned a team and the team basically collects the information from the company. Whatever product the companies producing and whatever financial strength the company has all those preliminary analysis basically they will do. Then after getting all those information by this team they can interact with their top management people with the rating agency and as well as the company. Then after that all those analysis whatever they will make that will be presented in a rating committee.

And they finally, on the basis of the different parameters that we will discuss the rating parameters one rating will be assigned and that particular rating will be given to the issuer. If issuer will accept this rating then that will be published in the website that this is the rating what the company has. If the issuer does not accept this then what will happen? The issuer or the particular company can appeal against this rating and then what will happen again this rating agency may look at those things, but still the details of unaccepted ratings disclosed on the website. And what about rating the company got that also will be reflected in the website, but this rating basically kept under surveillance during the tenure of the instrument.

Because the rating has been given for 1 year or so, the rating agencies also always monitor the situation of that particular company the look at because the company's performance and everything should be under surveillance to ensure that whatever factors or the parameters they considered to provide is rating those parameters affect us everything should not be changed frequently at this should not be deviate from the target level by a larger extent. So, because of that the regular monitoring also happens true that. So, finally, one rating was being has will be given to that company and the rating will be always shown in the website.

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Then how the company is basically give the rating, the ratings are basically given to the company using the different analysis different factors they consider, what are those? They do a business analysis, they do a financial analysis, they go for analyzing the management, geographical analysis also they do, regulatory and competitive environment of that particular company, then some of the other fundamentals. So, these are all type of analysis the rating companies always do, whenever the ratings are provided ratings are given to the different entities or the different type of companies.

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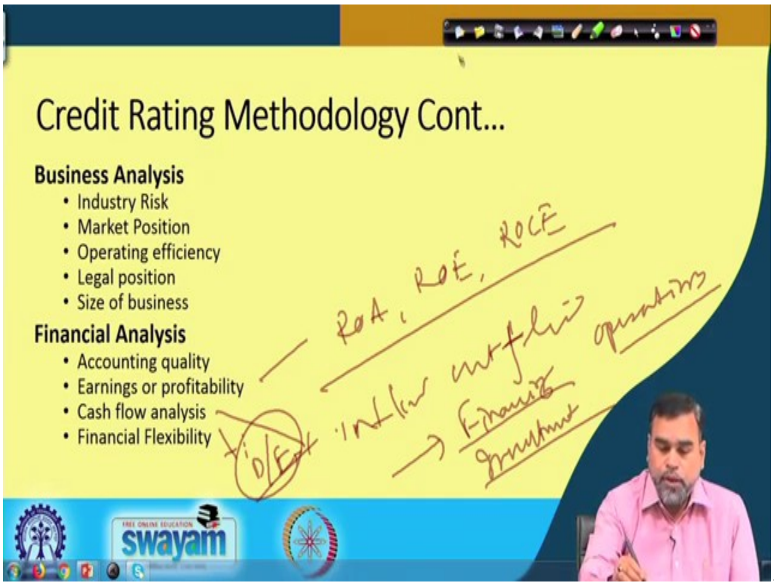

Then how it is basically done one by one if you see, in the business analysis what they do. All of you know that the business means what all of you know that the business means what how they sell the business risk if you consider the business risk is nothing, but how the sales as sales figure of that particular company or sales income of that particular company is going to be affected.

So, if this is the sales is the parameter through which the business risk of that particular company can measure then which are those factors which affecting the sales? One is the industry risk of that particular company under which the particular company belongs. The market position; the market share and all these things whatever the company's position is now and how the company is going to grow in the future.

What is the operating efficiency of the company, is there any kind of legal battle the company has or is there any kind of bigger cases in terms of fraud or in terms of other activities which is already going on with the company that is legal positions. What about the legal position the company has? Size of the business, what about business the companies doing, then what kind of business, what is the turnover in all these things, that also has to be looked upon in terms of the business analysis.

So, they look at the risk aspect in terms of industry risk, they look at the market share, they look at the efficiency of the company, operating efficiency of the company, they look at the legal aspect whether the company is busy with or may be involved any kind of fraud or any kind of legal cases are going on for that particular company that thing basically look at. And finally, the size of the business also obvious looked upon which are the part of the business analysis.

Then we go for the financial analysis, in the financial analysis mostly the look at the different ratios, what are those different factors or different ratios which measure this financial performance of the company that also has to be looked upon. They look at the accounting quality, profitability ratios means we are referring the ROA or ROE, ROCE all these things they look at what is the profitability.

They look at the cash inflow and outflow and you know that there cash flow are many times, cash flow from the financing, cash flow from the investment and cash flow from the operations, operating cash flow, financing cash flow and investment cash flow. These are the different type of cash flow; they do the cash flow analysis of the company.

Financial flexibility that is basically measured through your debt equity ratio, mostly if debt equity ratio is more and flexibility of the companies relatively less, if the debt equity ratio is low then the flexibility of the companies high. So, these are the different mostly I already told you these are the ratio analysis the companies do sorry the credit rating agencies do in terms of the financial analysis.

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Then we can see that what are the other things evaluation of the management, what is the goal of the management, what are the strategies management is going to adopt in the future or whatever strategies they are now adopting, is there any kind of capacity they have to overcome the unfavorable conditions. There is any business cyclic fluctuations, any kind of recession or any other thing which can happen in the market, whether they have capacity to overcome back.

Planning and controlling system, whatever planning plants their making and what is the control system they have. Then in terms of geographical analysis they look at whether it is a domestic company or a multinational company, even if it is a multinational company whether the geographical advantage; the company is enjoying or not or they have chosen a particular region whether the region is basically providing good subsidy for the business in that particular place or particular domestic path so, these are basically a part of the geographical analysis.

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Then we have the look at the competitive environment of the particular country regulatory environment of that particular country like structure, the regulatory framework, licensing policy, taxes on policy and all these things has to be looked upon. Then the fundamental analysis the always look at the manage look at the liquidity management, asset quality, what is the quality of the asset most latest the applicable for the finance companies, profitability and financial position, interest and tax sensitivity. How the interest and tax that will change how the profitability and other things of the companies are going to be affected so, that sensitivity also they tried to check.

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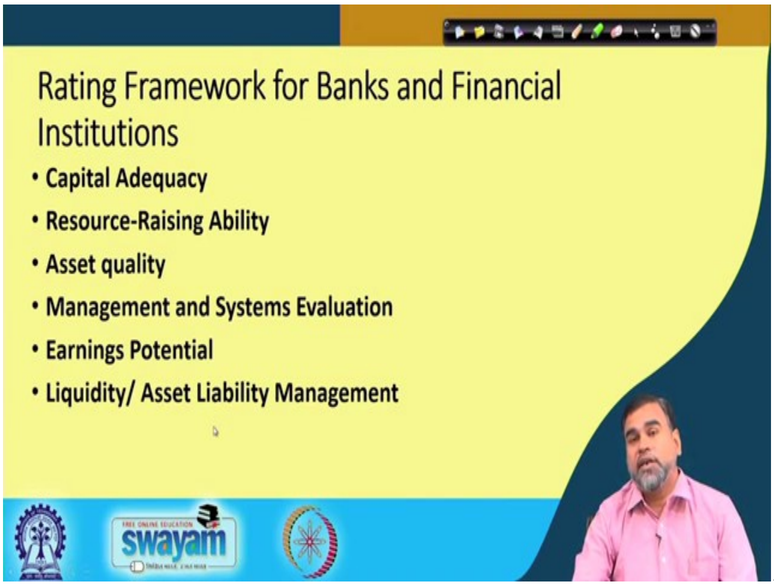

Then if you divide this kind of thing into two part; one is rating for the financial institutions and another one is for the manufacturing and other companies. If they are going for the banks and financial institutions rating the rating agencies, look at the capital adequacy ratio that already you know capital upon total risk asset, whatever resources raising ability the company has or the bank has, asset quality; that means, already we have discussed that, whether the asset as standard, substandard, how much NPA and all this things.

Management and systems evolution the look at earnings potential in the future how much cash flow the particular banks and all these things can generate and how their asset liquid or asset liability management they are basically making. These are the part of the banks or financial institutions; these are the parameters they look at whenever they give the rating to banks and financial institutions.

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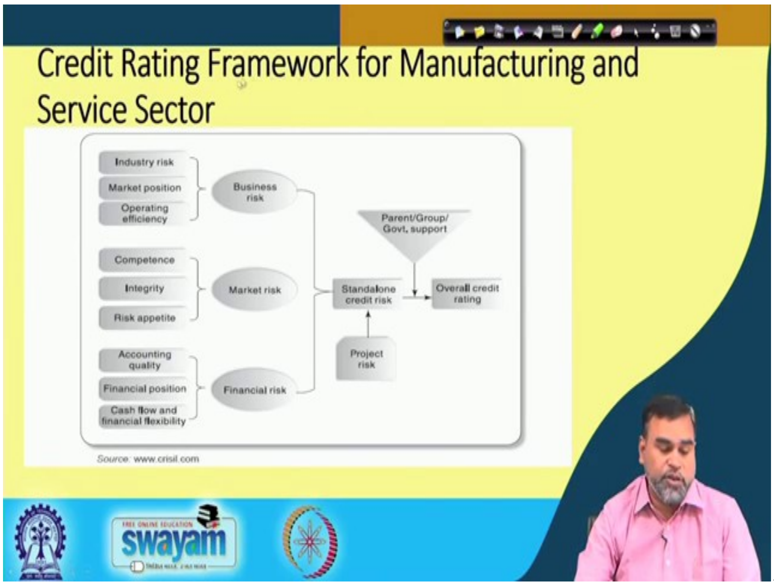

But while coming to the manufacturing companies, the whole process has to be followed, industry, market position, operating efficiency look at it is business risk, competency, integrity, risk appetite it is a part of the market risk, accounting quality, financial position, cash flow and financial flexibility these are comes under the financial risk.

So, once you have add up everything then considering all those factors then they look at how the company is going to perform or how their performing now, the overall rating will be given accordingly.

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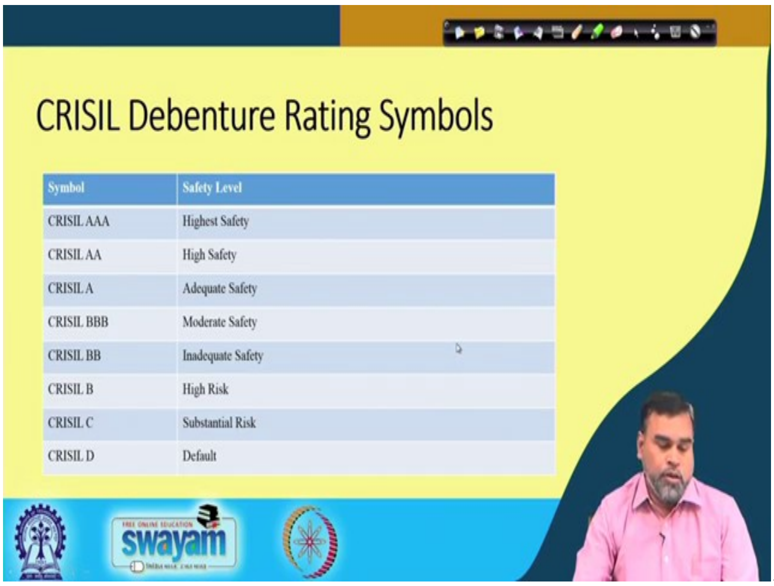

So, if you see some of the example the CRISIL is giving the CRISIL AAA; that means, it is the highest safety, AA high safety like that then, if you go by the CRISIL D it is a default bond which is the most of sell bond which is available in the market. So, this is the way the ratings are given by the different companies or different rating agencies give the different symbols.

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So, then if you want to know more about this, then you can go through these references and the website of the CRISIL for the better idea about the utility of the credit rating.

Thank you.