Credit Rating and Credit Cards

Credit Rating

- Credit rating is the assessment of the borrower's credit quality.
- Credit rating is the function of credit risk evaluation where it computes the borrower's expected capability to repay the debt as per terms of the issue.
- Credit rating is not a recommendation to buy hold or sell.
- It is a well-informed opinion made available to the public which might influence their investment decision.
- So credit rating agencies have come into existence to assist the investors in their investment decisions by assessing the credit worthiness of the borrower.
- **Importance** of credit rating:
    - Credit rating helps in development of financial markets.
    - Credit rating agencies play a key role in infrastructure of the financial system.
    - It saves the investor time and enables them to make a better choice among available investment opportunities.
    - Credit rating helps the market regulators to promote stability and efficiency in the securities market.
    - Credit ratings make market more efficient and transparent.
    - Credit ratings have also assumed a much larger role in global financial markets.
    - Fund managers, international banks, and foreign investors look at the ratings in portfolios of the company to assess the overall health of the country's economy.
- The **most prominent rating agencies** in India are:
    - CRISIL Limited
    - ICRA Limited
    - CARE Ratings
    - Fitch Ratings India Private Limited
- **Benefits** of credit rating to **investors**:
    - **Safeguards against bankruptcy**
        - Highly rated instrument of a company gives assurance to the investor about the safety of his investment and the return on their investment with least risk of bankruptcy.
    - **Recognition of risk**
        - Credit rating agencies provide the investors with rating symbols that carry information in the most simply and understandable manner.
        - This information reflects the risk involved in the investment.
        - The investors without any knowledge of financial analysis can easily use the rating symbols to understand the risk involved in the investment, and search for better options.
    - **Credibility of the issuer**
        - The rating symbol also reflects on the credibility of the issuer company.
    - **Rating facilitates quick investment decisions**
        - There is no need for the investors to do fundamental analysis of the credit worthiness of the company.
        - The rating symbols help make investors quick decisions about investing money in various instruments since every instrument has its own credit rating.
    - **No need to depend on investment advisors or professionals**
        - Investors with no knowledge of how and where to invest money have to seek help from brokers, or financial intermediaries.
        - Using credit rating, the investors need not seek their advice about investing funds in debt instruments.
        - Thus, investors can make direct investment decisions.

- **Choice of investment**
  - The investors can make their own choice about various debt instruments and companies based on the risk they are willing to take and their diversification plan.

- **Benefits** of credit rating to **issuers**:
  - **Wider audience for borrowing**
    - A company with a high credit rating for its debt instrument can approach different sections of the society on the basis of their credibility.
  - **Rating as a marketing tool**
    - Companies who have high rated instruments use the same as a marketing tool.
    - They can keep up their reputation and attract more customers, lenders and other creditors.
    - Even the consumers feel confident about using and investing in products by these companies.
  - **Reduction of cost in public issues**
    - A company whose debt instrument is highly rated does not have to spend more time, money or efforts on raising capital because customers are attracted to invest only by seeing the credit rating.
    - The saved expenses can be utilised on media coverage, conferences and other marketing activities.
  - **Motivation for growth**
    - Rating provides motivation for the company to grow.
    - The promoters of the company feel confident in their own efforts and plan to expand their business.
- **Process of rating a company:**
  - 1. Receipt of the request
  - 2. Assignment to analytical teams
  - 3. Obtaining information
  - 4. Plant visits and meeting with management
  - 5. Presentation of findings
  - 6. Rating committee meeting
  - 7. Communication of decision
  - 8. Dissemination to the public
  - 9. Monitoring for possible change
- **Rating Symbols:**

Rating	Risk Level
AAA, AA+, AA, AA-	Negligible
A+, A, A-, BBB+, BBB, BBB-	Very low to low
BB+, BB, BB-	Low to moderate
B+, B, B-	Moderate to high
CCC+, CCC, CCC-	Very high
CC, C, D	Extremely high

- **Limitations of credit rating:**
  - The credibility of rating is questionable. There are times where the institutions whose instruments were given the highest rating haven't performed well.
  - A frequent revision of grading by credit rating agencies that is frequent upgrading and downgrading creates confusion among investors hence, questioning the credibility and expertise of the credit rating agency.
  - The rating agencies do not perform an audit, they only rely on the information by the issuer. If this information is inaccurate and incomplete, then the rating process and the credit rating itself is compromised.

- Often a credit rating agency gives high rating to one instrument of the company and frequently downgrades another instrument of the same company. Such a rating looks biased and creates confusion in investors. Due to this, sometimes the investors also lose their investments.
- Rating agencies often fail to correctly predict the borrower's financial health in short term. The investor who depends on these ratings is not given any warning by rating agencies to wind down his investments.
- Rating agencies offer consultancy and financial advice to the clients who papers they rate. This leads to conflict of interest and many times, credit rating agencies compromise on their rating process by giving their client a high credit rating to gain its favour.

- **Different kinds of securities that need credit rating:**
  - Bond rating
  - Equity rating
  - Preference share rating
  - Commercial paper rating
  - Fixed deposits rating
  - Borrowers' ratings
  - Individual ratings
  - Sovereign rating

Credit Cards

- **Short note on credit cards**
  - A credit card is a payment card issued to users to enable the cardholder to pay a merchant for goods and services based on the cardholder's promise to the card issuer to pay them for the same purchase amount + some agreed charges.
  - Credit cards are also called as plastic money.
  - The issuer sets up a credit limit on its card holders to ensure the cardholder purchases items in his limits and does not spend so much that he is not able to return.
  - These cards are only accepted at establishments who have consented to entertain them, and are called **merchant establishments**.
  - **Concept**:
    - It is similar to taking a loan to pay for something you want or need.
    - Later, you are responsible for paying that money back.
    - So, after purchase, the user gets a statement at the end of every month stating the total amount due, minimum amount due and when his payment is due.
    - Either the person pays full amount due before or on the due date.
    - Or he can pay the minimum amount due before or on the due date.
    - There is no interest charged if the total amount due is paid off.
    - If person only pays minimum amount due, then he has to pay off the remaining amount + interest.
    - It is better to pay off total amount due since the interest rates are very high, and it will take forever to settle the debt.
- **Types of credit cards**
  - **Based on status of credit card**
    - Standard cards – limited privileges, normal cards
    - Business cards – enjoys more credit limit, given to executives by the firm to make their business trips more comfortable
    - Gold cards – high value for elite, offers cardholders with additional benefits and facilities that aren't provided in standard, or business cards

- **Based on geographical validity**
    - Domestic card – all transaction in local currency
    - International card – for people who travel abroad frequently, cardholder can make purchases in many currencies
- **Based on franchise**
    - VISA card – issued by a bank having tied up with Visa International Corp., USA
    - MasterCard – issued by a bank having tied up with Master Card Corp., USA
- **Based on user category**
    - Individual cards – issued for individuals
    - Corporate cards – issued to corporate companies and business firms only, the cards bear the name of the firm; the firm pays purchase amounts back to bank

- **Advantages of credit cards**
    - It is buy now, pay later concept – hence, encouraging people to buy more without tension
    - It is like getting an interest free loan – only if the total amount is paid before or on due date
    - Getting benefits and rewards – discounts on movie tickets, or dining etc.
    - Boosting your credit rating – when all amounts are always paid on time, the credit rating of the cardholder increases
- **Disadvantages of credit cards**
    - The possibility of debt – if the amount isn't paid in full, then the cardholder keeps drowning in debt due to high interest charged
    - Credit rating – if the above happens, then consequently the credit rating of the cardholder also goes down
    - Fees and charges – if the total amount isn't paid on time, then the card issuers levies heavy fees and charges on the cardholder
    - Limited usage – unless the cardholder has a gold card, they are restricted to spend some particular amount of money only as the card issuer has set up a credit limit on credit issuer