Research Paper Commerce

Demystifying Credit Rating

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ABSTRACT

The paper intends to provide view about the concept of credit rating, rating terminologies, how rating action is initiated in the form of rating process and how ratings are assigned. The paper also covers the role of rating agency and the concerns particularly in India and recommendation to improve the efficacy of CRA's in India.

KEYWORDS | Credit Rating, CRA, Rating process, Rating Criteria

1. Understanding Credit Rating

According to Standards & Poor's(S&P) "Ratings express the agency's opinion about the ability and willingness of an issuer to meet its financial obligation in full and on time".

the above definition highlights the following aspect:

- Credit ratings are not a guarantee that investment will pay out and not default, it is an opinion expressed by the agency based on the information available and factoring in the foreseeable future events
- It also assesses the full and timely repayment i.e with respect to repayment amount and repayment date
- Credit ratings do not indicate investment merit; it only talk about the Credit Quality
- Credit ratings are forward looking wherein the current and historical information is ascertained and the potential impact of foreseeable future event is evaluated

Credit ratings typically are expressed on a scale of alpha and/or numeric symbols, and these symbols are defined by the particular credit rating agency (CRA) issuing those ratings which vary amongst the agency. However in India The Securities and Exchange Board of India (SEBI) has, vide circular CIR/MIRSD/4/2011 dated June 15, 2011, standardised the rating symbols and their definitions for all credit rating agencies in India. This stipulation makes for uniform meaning and interpretation of a particular rating, easier identification of symbols with the agencies and better comparability of ratings across rating agencies.

Also another point to be noted is that credit rating is assigned to debt alone and not equity instruments. Typically instruments like bonds, fixed deposits, commercial paper, structured obligations, debentures, partially convertible debentures etc. Are rated Entities issuing these instruments can also be rated on their capacity to service debt obligation .Thus rating can be either Issue based or Issuer Based Credit Rating.

For instruments with an original maturity of one year or less short term rating is assigned else long term. Different scale and symbols are used for defining short term or long term rating. Plus and minus (+/-) modifier may be appended to a rating (long/short) to denote relative status within major rating category.

Once rating is assigned and accepted, the agency continuously monitors the credit quality of the rated instrument or entity and reflects the same periodically through upgrade, downgrade or reaffirmation.

Select Rating Terminologies:

The following terminologies are defined as per the CRISIL's definition

Structured Obligation Rating:

is assigned to structured finance securities backed by receivables or other financial assets . These ratings are typically assigned to individual security or tranche in a transaction and not to the issuer. CRISIL assigns structured obligation rating on the long term scale with suffix 'so' in parentheses

Bank Loan Rating:

indicates the degree of risk regarding timely payment of the bank facility being rated; the facility includes principal and interest, if any, on the principal.

The concept in India emerged post the Reserve Bank of India's guideline on capital adequacy for banks under Basel II norms wherein banks are required to provide capital on the credit exposure as per the credit rating assigned by the External Credit assessment institutions.

Rating Outlook:

defines the direction in which rating may move over medium term horizon of one-to-two years. A rating outlook may be positive, negative or stable. Positive outlook indicates rating may be upgraded ;stable outlook indicate the rating is likely to remain unchanged while negative outlook indicate that rating may be downgraded

Rating Watch:

Rating is placed on watch when events occur that may affect the credit quality of the issuer/issue, the impact of which cannot be accurately assessed at the point of time

Recovery Rating:

focus solely on expected recovery in the event of a payment default of a specific issue, The recovery rating is not linked to, or limited by, the Issuer Credit Rating or any other rating, and provides a specific opinion about the expected recovery.

Not Meaningful 'NM' rating:

CRISIL assign Not Meaningful 'NM' rating to outstanding rating of companies where the existing rating on the instrument has been rendered meaningless for instance a company has been declared sick or has been referred to BIFR(Board of Industrial and Financial Reconstruction)

2. Rating Process

Rating is a multi layered decision making process. The following illustration captures the rating process followed by S&P

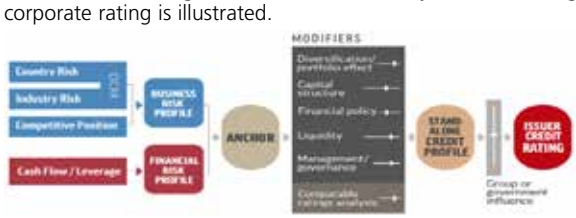


3. Rating Criteria

Rating Criteria includes all fundamental quantitative and qualitative elements, analytical methodologies and the assumptions that are used in the rating process. The criteria may differ from the industry or subject area, type of the instrument, or type of issuer.

The analytical framework involves the analysis of business risk, technology risk, operational risk, industry risk, market risk, financial risk and management risk. Business risk analysis covers industry analysis, operating efficiency, market position of the company whereas financial risk covers accounting quality, existing financial position, cash flows and financial flexibility. Under management risk analysis an assessment is made of the competence and risk appetite of the management

The paper does provide detailed clarification on the different rating criteria used by different agencies in different types of instruments etc. A gist of the criteria used by S&P in deriving corporate rating is illustrated.



4.Role of Credit Rating Agencies and Concerns

Credit Ratings can help reduce the knowledge gap, or "information asymmetry," between borrowers (issuers) and lenders (investors). The essential subject matter of this information asymmetry is a borrower's creditworthiness. By using ratings as an independent, unbiased "second opinion," and combining it with his own investment analysis the lender may be able to more accurately form his investment decision. This can widen market participation and contribute to deeper, more liquid markets.

Post sub prime crisis debate over the role of credit rating agencies in financial regulation has focused primarily on issues such as conflict of interest and adequacy of performance. Among the questions are how the rating agencies assign ratings, what they rate, and whether ratings fuelled the pre crisis lending boom and resulting asset bubbles and provoked an opposite and pernicious effect after the crisis

Misuse of rating in the form of "rating shopping" may happen when an issuer chooses the rating agency that will assign the highest rating or that has the most lax criteria for achieving a desired rating, which hinders the ability of ratings to fulfil role of reducing information asymmetry

Also as independent private entity CRA aim to maximize profits and shareholder value, a basic conflict of interest which is partly inherent, since the sponsor or issuer of new instruments pays the CRA for being rated.

Another concern pertain to Multiplicity of regulators in India where CRAs operate in domains regulated by different entities. SEBI recognises CRAs, who rate instruments that are purchased in the capital markets (regulated by SEBI), and a diverse community of investors including banks (regulated by RBI), insurance companies (regulated by IRDA), pension funds (regulated by PFRDA).

Oligopolistic nature of the rating industry, At present there are six eligible CRA's in India: Credit Analysis and Research Ltd(-CARE), CRISIL Ltd. India Ratings and Research Pvt. Ltd(formerly FITCH India), ICRA Ltd. , Brickwork Ratings India Pvt Ltd. , SMERA Ratings Ltd because of natural barriers or propriety barriers of entry leading to lack of competition

General lack of accountability as CRAs do not have a legal duty of accuracy and are often protected from liability in case of in accurate ratings puts serious question on the working methodologies of the agency.

5.The way forward

Globally, the need for strong regulations governing CRAs has come into focus post subprime crisis. Pursuant to their findings in 2009, SEBI has taken multiple steps to strengthen the regulatory framework for CRA's :

- CRAs has to document the rating process in detail enlisting the various underlying factors affecting the rating, summary of discussions with all stakeholders, decisions of the rating committee including any dissent note, and rationale for any material difference with the quantitative model used (if any). The records needs to be kept for five years after maturity of the instrument
- Standardised the default rate calculations with definitions and calculation formula
- Remedial measures for reducing conflict of interest of CRAs through restricting analysts to do marketing and business development including negotiations of fees with the issues and also restricting their family members to hold any ownership of shares of the issuer. SEBI has also mandated that every CRA to formulate the policies and internal code for dealing with the conflict of interest
- CRAs to conduct an internal audit twice a year covering operations and procedures including investor grievance redressal mechanism and compliance with the SEBI Act

CRAs typically opine on the credit risk of issuers of securities and their financial obligations and not guarantee against default of the rated instrument, it is also not recommendation to buy, sell or hold the rated instrument nor a comment on the market price or suitability of rated instrument for a particular investors. Investors can use the information provided by the CRA in framing their investment decision but not solely depend on them.

REFERENCES

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