

Credit Rating

Nidhi Bothra
Vinod Kothari & Company

Definition: Credit Rating is the symbolic indication of the current opinion regarding the relative capability of a corporate entity to service its debt obligations in time with reference to the instrument being rated.

Keywords: credible, independent, objective and well researched, risk assessment

Credit Rating is an alphabetical or alphanumerical representation of the credit worthiness of the individual, business or instrument of a business. However Ratings merely express an opinion on the credibility of the entity and cannot be considered to be a recommendation. The evaluation of the credit worthiness of the anything is based on several premises, most important of them being:

- Ability to pay
- Willingness to pay

History:


First Credit Rating Agency was the Mercantile Credit Rating Agency, established in 1841 in New York. First rating guide was published by Robert Dun in 1859 and another rating agency was set up by John Bradstreet, which is popularly known as Dun & Bradstreet today. Some of the renowned rating agencies are:

- Standard & Poor's
- Moody's Investor Service
- Fitch Rating Agency

In India

- CRISIL (Credit Rating and Information Services (India) Limited) – first in India
- ICRA Limited (Investment information and Credit Rating Agency of India Limited)
- CARE (Credit Analysis and Research Limited)
- Fitch Rating India Pvt Ltd

What can be rated?

- Financial Instruments
 - Customer Rating
 - Borrower Rating
- Sovereign Rating
- 

Benefits of Credit Rating:

- Numerical indicator of the ability of an entity to meet its financial obligations
- Establishes a link between risk and return
- Helps in making investment decision

- Plays an investor protection role and acts like a marketing tool on behalf of the company
- Encourages corporates to maintain discipline, improve their financial structure and operating risks to get a better rating
- Credit rating is important from the regulatory point of view as well, for determining the margin requirements, entry levels, category of investors etc.

Factors for successful credit rating systems:

- Credible and independently determined
- Independence and unbiased opinion
- Analytical research, consistency is crucial
- Industry related expertise
- Confidentiality
- Timeliness of ratings and changes in ratings
- Wide reach and coverage

Process of rating:

1. Credit Rating Agency enters into an agreement with the client whose securities are to be rated
 - a. Rights and liabilities of the parties are defined
 - b. Fees charged is specified
 - c. Tenure for periodic review of the rating is specified
 - d. The client shall disclose the credit rating received for its listed securities and disclosed the same in its offer document whether or not it is accepted by him
 - e. Ensure confidentiality of all the information disseminated by the client
 - f. The rating agency shall exercise due diligence to ensure that the rating assigned is fair and appropriate
2. Rating agencies on the basis of several premises assign the credit rating and communicate to the client/ issuer.
3. The issuer can make one request for review of the rating based on fresh facts and clarifications.
4. Then the final rating is assigned and the same is published along with the definition of the concerned rating along with the symbol.
5. A copy of the rating is filed with the Board along with any modifications and additions made thereafter
6. The rating agency will also publish the rationale behind the rating assigned and the justification to the premises considered, favorable assessment and factors constituting risk
7. Once accepted, it is disclosed and put in the *surveillance* process thereafter
8. **Surveillance:** Continuous review of the ratings assigned to the rating agency. Frequency of the reviews may vary from quarterly to annually as per the agreement
9. **Credit Watch:** In case of any event taking place, that may result in major deviations from the expected trends and which are likely to impact the credibility, rating of the entity, such instruments are put on credit watch, until the impact of the event is not evident or clear
10. **Investments in investment grade:** Investors are advised to invest in securities upto investment grade level, which is BBB (S&P) and Baa (Moody's). Securities rated below the investment grade are referred to as speculative grade or junk bonds

Setting up a Credit Rating Agency: As per the SEBI (Credit Rating Agencies) Regulations, 1999

Application for grant of certificate of registration:

- Application is to be made to SEBI in **Form A** along with non-refundable application fee for grant of certificate of registration to carry out activity of credit rating agency and shall be granted certificate of registration in **Form B** by the Board.
- The Applicant must comply with the Eligibility Criteria laid down by SEBI
- Credit Rating Agency **must** be promoted only by persons belonging to the following categories:
 - Public Financial Institution, as defined in Section 4A of the Companies Act, 1956
 - Scheduled Commercial Bank
 - Foreign Bank operating in India with the approval of Reserve Bank
 - Foreign credit rating agency having 5 years experience in rating securities
 - Company/ Body Corporate having continuous net worth of Rupees 100 crore as per the annual audited accounts for the previous 5 years
- Credit Rating Agency would appoint a compliance officer who shall be responsible for compliances with the various acts, rules, regulations, notifications, circulars and guidelines concerning them as may be issued by the Board or Central Government
- Credit Rating Agency shall maintain its books of accounts and records for a minimum period of 5 years

Obligations of Credit Rating Agencies: Code of Conduct

- They shall observe high standards of **integrity** and **fairness** in all their dealings
- Fulfill all its obligations in a **prompt, ethical and professional** manner
- Protect the **interest of the investors**
- Render at all times
 - **High standards of service**
 - **Exercise due diligence**
 - **Exercise independent professional judgment**
 - **Provide unbiased services**
- Any **conflict of interest** in the rating analysis shall be avoided and disclosed if any
- Shall **NOT** indulge in **unfair competition**
- Shall maintain confidentiality of the information disclosed by the client during the process of rating or pass any **price sensitive information**
- Shall **not** make **false statements** about its **capability to render services** or its qualifications and achievements
- Shall **NOT** make an **untrue statement** or **suppress material facts** while rating a security