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RESEARCH ARTICLE

CONVERGENCE AND REGULATION OF CREDIT RATING INSTRUMENTS WITH SPECIAL REFERENCE TO CRISIL, ICRA AND CARE

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ABSTRACT

In the post-reforms era, with increasing market orientation in the Indian financial sector both existing and new companies are opting for finance from the capital market, money market, foreign exchange markets. The competition among firms for a slice of the savings cake has increased. The market is flooded with a variety of new instruments and complex financial products, such as asset-backed securities and credit derivatives to attract ordinary investors for subscription of their issues. These new instruments are embodied with complex features very difficult for an ordinary investor to understand and analyse. Besides this, investors no longer evaluate the creditworthiness of the borrowers by their names or size. Credit rating agencies have come into existence to assist the investors in their investment decisions, by assessing the creditworthiness of the borrowers. It is one of the supporting services and positive tool for the development of capital market in developing countries like India. Basic philosophy of credit rating is to assess the risk associated with and assign the rating to the debt instrument. The main purpose of the study is to know the Credit rating process that are adopted by Credit Rating Agencies in general and also to have a close observation on various ratings given by CRISIL, ICRA and CARE on specified instruments. The study also highlights the regulations and mandatory controls issued by SEBI from time to time in controlloing the operations of Credit Rating Agencies.

Objectives

1. To understand the conceptual procedure of rating a credit instrument in Indian financial system.
2. To analyse long term and short term credit rating instruments that CRISIL, ICRA and CARE adopt for credit rating evaluation.
3. To frame out the various regulations propounded by SEBI from time to time in monitoring the Credit Rating Agencies.

Research Methodology

The study is based on the secondary data. The secondary data was collected from various text books, company websites, other websites, Journals and Articles.

Scope of Study

1. The study is limited up to 3 rating agencies namely, CRISIL, ICRA and CARE.
   The study does not reflect the entire credit rating agencies all over the world.
2. The study is carried on long term and short term instruments rather on specifying them.
3. Credit rating symbols were analysed based on key criteria but not the entire structure.

INTRODUCTION

Traditionally Indian corporate borrowers were depending on banks and financial institutions for the purpose of mobilizing the requisite fund to establish new business activities and to expand the existing businesses. But with the integration of national economy with the global stream, due to the growth of business and economy the environment has changed gradually. The industrial environment has become more and more competitive demanding the funds for the supply of funds. As a result, the corporate borrowers steadily started approaching the market for the necessary funds at the competitive prices. The investors expectations are different, the companies needs are different, the financial institution’s environment is different for making the investment decisions. At the present situation, the investors need an independent and credible agency which judges impartially and gives a better direction in this regard. This is a difficult task as it involves the analysis of voluminous data which consists of quantum of work involved, expertise one should possess knowledge to evaluate the creditworthiness, costs involved etc. On the basis of this aspects, there is a need for an expert and independent agency to take this assignment which gave rise to credit rating. It is a process of evaluating risk associated with the credit instrument. India was first among the developing world to set up a credit rating agency. In India CRISIL (Credit Rating Information Services of India Limited) was set up in 1988. Then come ICRA (Investment Information and Credit Rating Agency of India Limited) in 1990, followed by CARE (Credit Analysis and Research Limited) in 1993, Fitch Ratings India Private Limited and SMERA (Small and Medium Enterprises Rating Agency).

Definition

A credit rating is an evaluation of a potential borrower’s ability to repay debt, prepared by a credit bureau at the request of the lender. Credit ratings are calculated from financial history and current assets and liabilities which are usually expressed in alphabetical or alphanumeric symbols. In brief, a credit rating tells a lender or investor the probability of the subject being able to pay back a debt. It should be noted that a credit rating is assigned to the investment instrument and not to the company issuing it as a whole. Standard and

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Poor defined the Credit Rating, “A SandP’s corporate or municipal debt ranging is a current assessment of the credit worthiness of an obligator with respect to specific obligation”.

Need for Credit Rating

- As credit ratings establish a link between risk and return, it is a yardstick against which to measure the risk inherent in any instrument.
- Credit rating is only aguidance to the investors and not a recommendation to a particular debt instrument.
- It saves the investor’s time and enables him to take a quick decision and provides him better choices among available investment opportunities.
- Credit rating enhances company’s reputation and recognition by rating the instrument.
- Credit rating is an evergreen tool for banks and financial institutions in taking decisions relating to lending and investments.

CREDIT RATING PROCESS

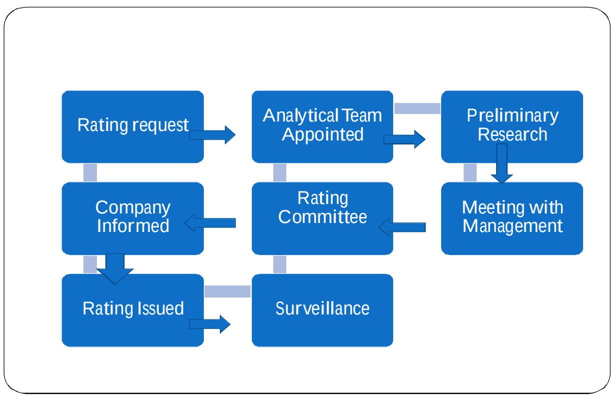


Figure 1. Credit Rating Process followed by CRA

Rating request

The preliminary step in the rating process is to get the request for rating from a Co. which is an agreement entered into between rating agency and the issuer co. The agreement revolves towards following aspects.

- To keep the information confidential given by CRA (Credit Rating Agency).
- Right to accept or not to accept the rating of the issuer co.
- Whether the issuer co. is providing all relevant information to the CRA for rating and subsequent surveillance.

Analytical team appointed

On receipt of the request CRA appoints the analytical team which comprises of two members/analysts who have expertise in the relevant business area to carry out the rating assignments.

Preliminary research

The analytical teamgo for research on obtaining the requisite information from the client co. The analytical team analyses on all aspects i.e. financial statements, cash flow projections and other relevant information which have a bearing on the rating.

Meeting with management

The team interacts with the company’s executives to evaluate the quality of technical personnel and finally form an opinion on all the key variables that influence level, quality, cost of production, financial policies, historical performance, risk profile etc.

Rating committee

After completing the analysis the findings of the team are discussed with senior analysts of the CRA and finally presented to Rating Committee who go for complete assessment of all the factors and the key issues concerning the issuer.

Company informed

The assigned rating grade by the rating committee is communicated to the issuer along with rationale supporting the rating and rejected ratings are not disclosed provided complete confidentiality is also maintained.

Rating issued

The credit rating agencies disseminate the rating through printed reports to the public on the acceptance of the issuer.

Surveillance

Once the co. has decided to use the rating, it is an obligation for credit rating agencies to monitor the accepted ratings over the life of the instrument, if any changes have been taken place, the possible change through published reports by CRAs are made to the public.

Credit Rating methodology

The rating methodology involves an in-depth analysis of both objective and subjective factors affecting the creditworthiness of an issuer co. The analytical framework for rating the instruments consists of following broad areas

Business Analysis

An analysis of industry risk, market position, operating efficiency and legal position of the co. come under the purview of business analysis.

a. The rating agencies evaluates the industry risk by these factors viz, demand and supply position, strength of the industry prospect, Government policies relating to the industry, its future potentiality. Industries stand in stronger position with stable growth in demand and therefore enjoy better credit rating.
b. Rating agencies evaluates market position through the study of marketing strengths and weaknesses of the firm, vis-à-vis its competitors, selling and distribution channel, diversity of products, customers base, marketing infrastructure etc.
c. Rating agencies evaluates the firm’s operating efficiency through production processes of the firm, cost structure, management and labour relationships, local benefits, input availability, level of capital employed and technological advantages etc.
d. Legal position of an instrument is assessed by study of prospectus, letter of offer, filing of forms, returns etc with proper regulatory authorities.

Financial Analysis

This includes an analysis of four areas, accounting quality, earnings potential, cash flow analysis and financial flexibility.

a. Accounting Quality is the study of income recognition, valuation of inventory, auditor’s remarks, overstatement/ understatement of profits, depreciation policies etc.
b. Earnings potential is analyzed with reference to profitability ratios, earnings growth, projected earnings, as rating is a

forward-looking exercise, more emphasis is geared on the future rather than the past earning capacity of the issuer.

c. Cash flow Analysis is an analysis of the application of cash which includes working capital requirements, capital budgets, future cash flows and the extent of cash available for meeting fixed interest obligations.
d. Financial flexibility is examined in terms of debt/equity ratio, whether alternative financing plans have been used to raise funds, feasibility of such plans etc.

Management Evaluation

Rating of a debt instrument requires evaluation of the management strengths and weaknesses which includes a study of the track record of management goals, plans and strategies, philosophy, staff's own experience and skills, the management's capacity to overcome adverse situations etc.

Geographical Analysis

A company located in backward area may enjoy the benefit of lower cost through subsidies from Government. On the other hand if an issuer co. having its business spread over through various geographical areas enjoys the benefits of diversification and gets better credit rating. Therefore, geographical analysis is undertaken by the credit rating agencies to determine the location benefits enjoyed by the issuer co.

Fundamental Analysis

This analysis covers liquidity management, asset quality, profitability and financial position, interest and tax sensitivity.

a. Liquidity Management of the co. can be known by the study of capital structure, matching of assets and liabilities, liquid assets corresponding to financing commitments and maturing deposits.
b. Asset Quality covers factors like quality of company's credit risk management, composition of assets, sector risk, policies for monitoring credit.
c. Profitability and Financial position is examined through a study of profitability ratios, past profits, reserves, revenues on non-fund based activities and so on.
d. Interest and Tax Sensitivity reflects sensitivity of company in terms of exposure to interest rate changes, impact of tax law changes, tax provisions.

CRISIL (Credit Rating Information Services of India Ltd)

Until the establishment of CRISIL, Rating was not known to Indian investors. In this sense, CRISIL has created history in India. It was the first one to develop the methodology to rate instruments in the light of India's financial, monetary, economic, and regulatory environment. CRISIL was promoted by Industrial Credit and Investment Corporation of India Ltd (ICICI) along with Unit Trust of India Ltd (UTI) as a public limited company with its headquarters at Mumbai. It was incorporated in 1987 and commenced operation on January 1, 1988. CRISIL has launched innovative rating products for entities like banks, financial institutions, green field projects and new instruments such as asset-backed securities and other structured obligations. CRISIL publishes a journal 'Rating Scan', containing reviews, news and articles related to ratings. The CRISIL provides not only the credit rating but also renders services to the corporate sector covering the topics like structure of the industry, degree of competition, and business situations. It also prepares CRISIL 500 Index which will be very useful to the corporate sector. The principal objective of CRISIL is to rate the instruments of Indian companies.

CRISIL gives rating in respect to following instruments

- Debentures
- Fixed deposits
- Short-term instruments(commercial paper)
- Credit assessment
- Structured obligations
- Real estate developers/builders
- Bond funds

ICRA (Investment Information and Credit Rating Agency of India)

The ICRA is the second rating agency in India. It is established as a competitor to the CRISIL. The ICRA Ltd has been promoted by (IFCI) Industrial Finance Corporation of India as its main promoter to meet the requirements of the companies based on the northern parts of the country with its headquarters at New Delhi. It was incorporated on January 16, 1991, as an independent and professional credit rating agency providing investment information and credit rating services. The agency commenced its commercial activities from August 31, 1991. The primary objective of ICRA was to provide information and guidance to investors/creditors for determining the credit risk associated with the credit obligation. ICRA's rating is based on an objective analysis of the information provided by the client company.
ICRA gives rating in respect to following instruments

- Long-term instruments, including debentures/ bonds/ preference shares
- Medium-term instruments comprising fixed/certificate of deposits
- Short-term instruments, including commercial papers
- Equity
- Bank line of credit
- Credit assessment scale
- Insurance companies

CARE (Credit Analysis and Research Limited)

The CARE is the third credit rating agency in India. The CARE Ltd is a credit rating and information services company promoted by the Industrial Development Bank of India (IDBI).These ratings are accepted by the SEBI, the RBI, and the Government of India. It is incorporated as a Public Limited company under the Indian companies Act. It was promoted in 1993 jointly with investment companies, banks and finance companies. It has commenced its credit rating operations in October 1993 and announced its first rating in 1993. The company is an autonomous body and enjoys full freedom in its operations and the ratings are also accepted by the market. It maintains its integrity, independence and credibility. It offers a wide range of products and services in the field of credit information and equity research. It also undertakes general credit analysis rating of parallel markets of LPG and SKO (Superior Kerosene Oil) and collective investment schemes of plantation companies. It prepares credit reports of Indian companies on request and undertakes credit assessment of companies for use by banks and financial institutions.

CARE gives rating in respect to following instruments

- Fixed deposits
- Debentures
- Bonds
- Commercial paper
- Inter-corporate deposits
- Certificate of deposits
- Convertible bonds
- Structured obligations

SEBI Guidelines for Credit Rating Agencies

The regulator's support played an important role in the development of the credit rating industry. In 1992, for the first time, the Reserve

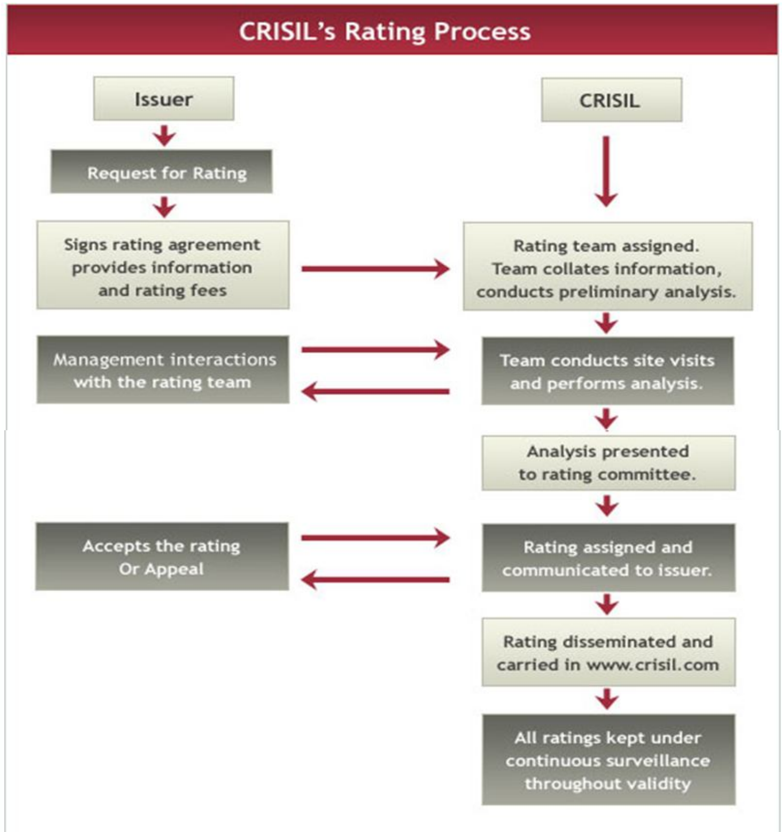


Figure 2. CRISIL Rating Process

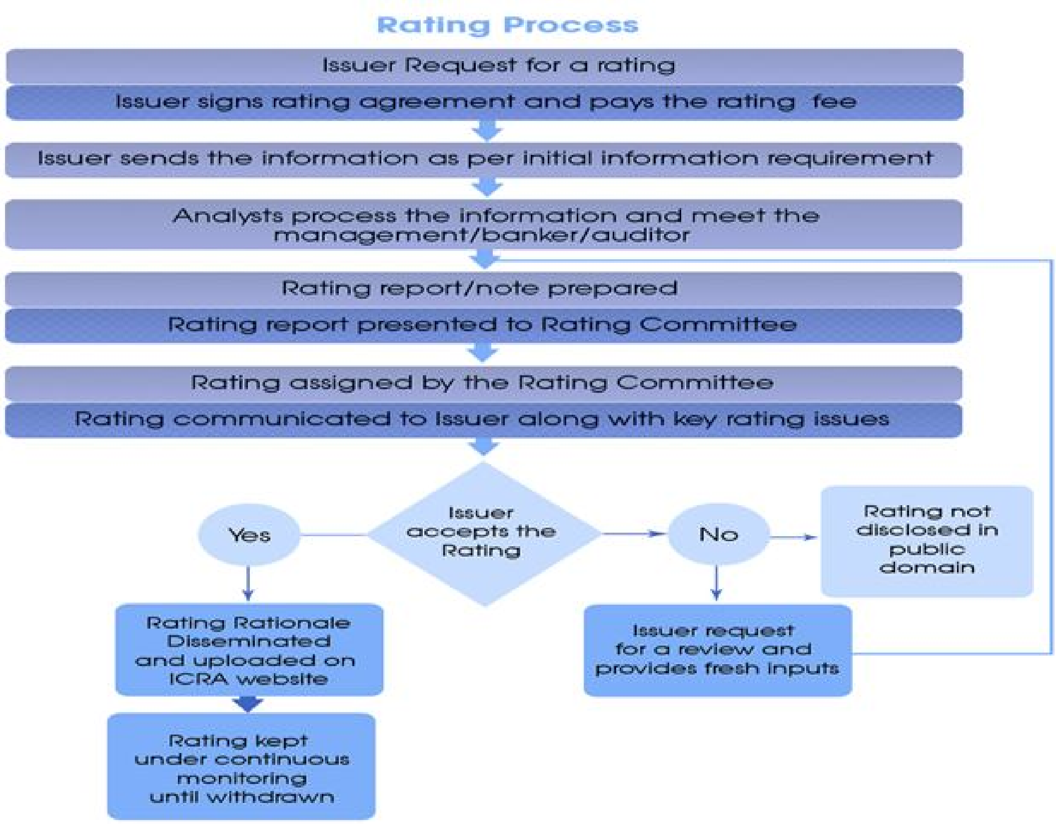
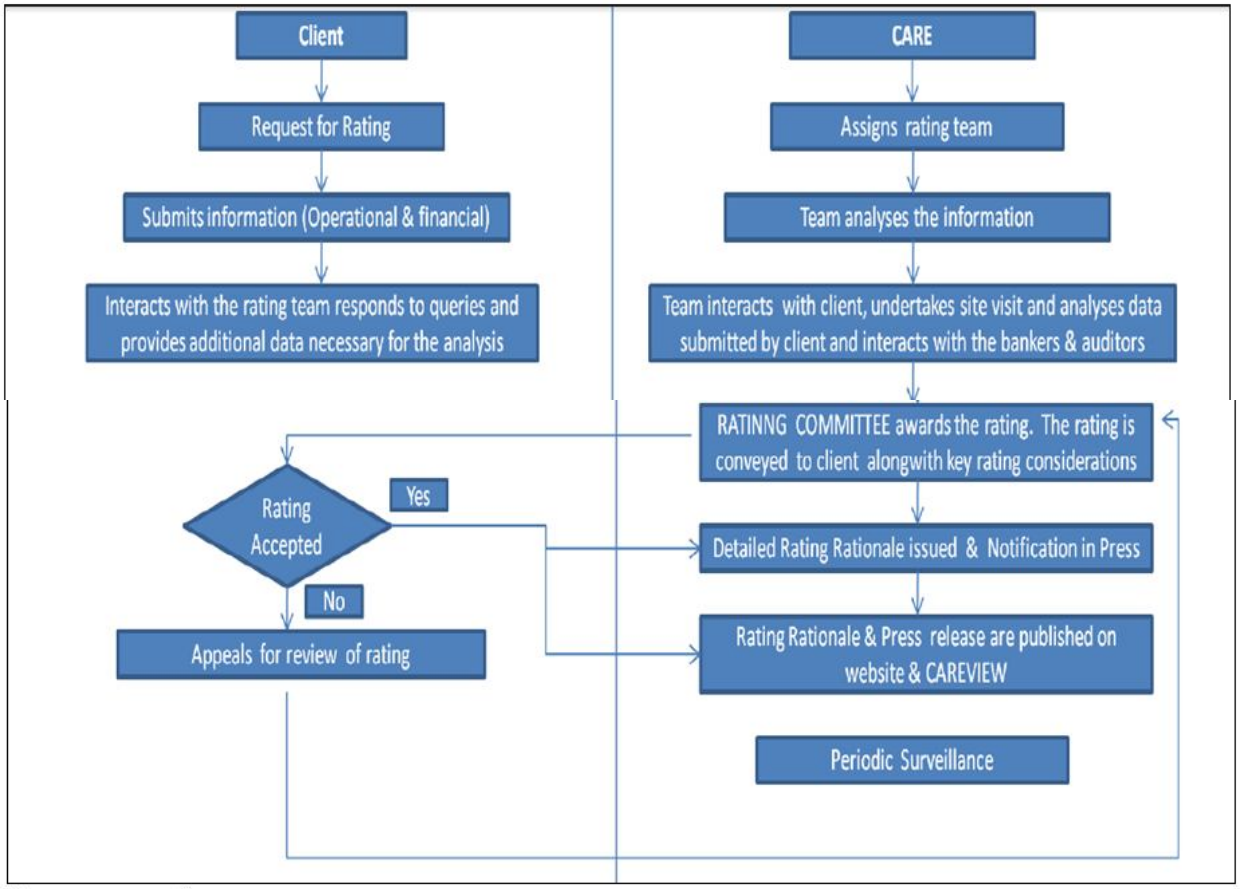


Figure 3. ICRA Rating Process



Source: careratings.com

Figure4: CARE Rating Process

Analysis of Credit Rating for Long term Instruments

Terminology	Symbol	CRISIL Description	Symbol	ICRA Description	Symbol	CARE Description
Highest safety	AAA	It indicates highest safety of timely payment of interest & principal	LAAA	It indicates fundamentally strong position with no risk factors, & does not affect timely payment of interest & principal in any adverse situation	CARE AAA	It is considered to be the best quality, carrying no investment risk, which are protected by stable cash flows with good margin & strong payment signal even in adverse situation
Adequate safety	A	It indicates to offer adequate safety of timely payment of interest & principal, provided changes in circumstances adversely affect such issues	LA	Risk factors are greater during economic stress. The protective factors are average & adverse situation may alter the fundamental strength & affect the timely payment of interest & principal	CARE A	It has many favorable investment attributes. Adequate safety is available for principal & interest. Adverse situation of the business /economic conditions may not show an impact on this issue
High risk	B	It indicates to have greater susceptibility of default. Though currently interest & principal payments are met adverse business/ economic conditions would lead to lack of ability or willingness to pay interest or principal amounts	LB	It indicates that the protective factors are narrow & obligations may not be fulfilled. Adverse business/economic conditions results in inability/unwillingness to service debts on time	CARE B	It indicates that this ratings are generally classified as susceptible to default. Though interest & principal payments are met, adverse business/economic conditions lead to default
Default	D	Indicates that the instruments are in default & in arrears of interest or principal payments or are expected to default on maturity. These are more speculative & the interest may be received only on liquidation or reorganization	LD	Extremely speculative. Either already in default or expected to default. Recovery is likely only on liquidation or reorganization	CARE D	These categories of investments are in the least safety position. They are either in default or likely to be in default soon

Analysis of Credit Rating for short term instruments

Terminology	Symbol	CRISIL Description	Symbol	ICRA Description	Symbol	Care Description
Highest safety	P1	The ratings reveals that interest & principal amount will be made on time. The investment in this instrument is very safe	A1	The rating indicates that the prospect of timely payment of debt/obligation is the best	PR-1	It indicates issuing company has superior capacity for repayment of short term promissory obligation & issuers are characterized by leading market positions in established industries with high rate of return on funds employed
Adequate safety	P3	This rating reveals the degree of safety for timely payment of the interest & principal amount	A3	The prospect of timely payment of interest & installment is adequate, but adverse changes in business/economic conditions affect fundamental strength	PR-3	The instruments have an adequate capacity for repayment of short term obligations. The affect of the industry characteristics & market composition may be more pronounced. Variability in earnings profitability results in changes in the level of debt protection
Default	P5	This rating indicates that the co. is unable to refund the amount on the maturity	A5	The rating indicates the default position or the position which is expected to default (inadequate capacity)	PR-5	Instruments with this rating are in default or expected to be in default on maturity

Bank introduced the requirement of rating for commercial paper. SEBI followed up by introducing mandatory rating of bonds. Declining interest rates, a shift towards market borrowings from bank loans and a tremendous increase in the State Government borrowings through special purpose vehicles are some of the growth drivers of the credit rating industry. SEBI vide CIR/MIRSD/CRA/6/2010 dated May 3, 2010 has provided for certain transparency and disclosure norms for the Credit Rating Agencies ("CRAs"). The major measures taken in this regard are sumnmarized below.

1. CRAs should maintain records of the rating committee, including voting details and notes of dissent for a period of five years.
2. It has been made mandatory for CRAs to publish information about the historical default rates of their rating categories and whether the default rates of these categories have changed over time.
3. CRAs should ensure that its analysts do not participate in any kind of marketing and business development, including negotiations of fees with the issuer whose securities are being rated. Also, the employees involved in the credit rating process and their dependants cannot own shares of the issuer.
4. CRAs while rating structured finance products, are barred from providing consultancy or advisory services regarding the design of the structured finance instrument. This prohibition would apply to the subsidiaries of CRAs too. While publishing the ratings of structured finance products and their movements, CRAs apart from following all the applicable requirements in case of non-structured ratings should also disclose the track record of the originator and details of nature of underlying assets while assigning the credit rating.
5. CRAs should also disclose (i) the policies, methodology and procedures in detail followed by them regarding solicited and unsolicited credit ratings, (ii) the history of credit rating of all outstanding securities, (iii) the general nature of its compensation arrangements with the issuers and (iii) the details of any relationship it has with the issuer whose securities are being rated and any of its associate of such issuer and the CRAs or its subsidiaries.

Observations/Findings

1. It is found that, there is a highest safety towards principal and interest amount over all 3 rating agencies in case of long term and short term instruments and by seeing ICRA and CARE it indicates a fundamentally strong payment position even in adverse situations and it is considered to be the best form of investment as it is very safe with no risk and results in high rate of return there by leading good market position.
2. Though 3 rating agencies offers adequate safety of timely payment of principal and interest amount in case of long term and short term instruments, it has been found that changes in ircumstances may affect debt obligations in CRISIL and ICRA but doesn't have any impact in CARE in case of long term instruments and variability in earnings potential may affect obligations and fundamental strength of ICRA and CARE in case of short term instruments.
3. Though principal and interest amounts are met during high risk, but business/economic conditions results in lack of willingness and ability to service debts or obligations on time.
4. It has been found that during default the investments are extremely speculative and are in the least safety position and recovery is only on liquidation in case of ICRA and only interest may be received on liquidation in case of CRISIL towards long term instruments, where as in case of short term instruments the company is unable to refund the amount or expected to be default on maturity

Conclusion

Credit Rating by an authorized competent authority gives a birds-eye view of financial strength of an organization and its instruments. It is a simple global measure of credit risk and serves as an information and reference point. It is an independent benchmark which provides opinions on the creditworthiness of an entity, a debt or financial obligation, or financial instrument based on objective and subjective analysis. The analysis and assessments provided by various credit rating agencies provide investors with information and insight that facilitates their ability to examine and understand the risks and opportunities associated with various investment environments. Investors may utilize information from a single agency or from multiple rating agencies. By facilitating investment decisions they can help investors in achieving a balance in the risk return profile and at the same time assist firms in accessing the capital at low cost. CRAs can thus potentially help to allocate capital efficiently across all sectors of the economy by pricing risk appropriately. There are a number of areas where rating agencies will have to cover new ground in the coming years. The rating of municipal bonds, State government borrowings, commercial banks and public sector undertakings etc will be covered in the near future, So, the outlook for the credit rating industry is positive. Credit Rating Agencies should be made accountable for any faulty rating by penalizing them or even de-recognizing them, if needed.

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