A Study on the Process of Credit Rating Agencies and its relevance in India

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A B S T R A C T

In current scenario, every person wants to get safe or wants to have security when they are investing and bank also wants to be assuring while lending loan that which company deserves loan. Credit Rating Agencies are established to provide valid and relevant information about the financial, market, solvency position of a company. They are regulated by SEBI so there are fewer chances to get fraud and if these agencies work effectively then it is beneficial to everyone as it gives report about company telling the whole position of a company. They analyze every part from management to financial statement, they consider each and every information and then give their rationale about the company. Financial Ratios play a major role in analysis of financial statement as it is the simplest and effective tool to represent company position in an understandable and readable manner.At last, credit rating agencies play a very important role in handling financial crisis and also in providing report describing about creditworthiness of the company. It is also useful for investors as from these reports they make their decision to buy or sell the securities.

Keywords:Credit Rating Agencies,CRA Rating,SEBI.

1. Introduction

Credit Rating is an effective way to know about the creditworthiness and the ability of any organization, company, government, or any entity to pay its debts or loans. The scale of rating is AAA – D. AAA is the highest rating that every company wants to achieve and D signifies that the company is default. The higher the rating, the lesser risk in it and also they get debt on lower interest rates. Now the question comes who will rate the organizations? There are 7 agencies established in India which are regulated by SEBI.These agencies follow a deep process to find relevant rating and also provide reasoning in the reports. The process is itself self-explanatory and also they cover all the areas from operations to profitability.They also gives a person an overview of the risk any company holds and then person can think about how much return he wants and how much risk he can take it accordingly. As risk and return go hand in hand, and CRA tells about the risk any company or bond holds.

2. Literature Review

KuljeetKaur, Dr. RajinderKaur (2011),They talked about what is credit rating consistency. They said that the objective of their research is to know about the rating methodology of different agencies and consistency between them while rating different bonds and they concluded that there is no significant difference between the agencies, almost every agency got same rating whether they follow same methodology or not.

Vandana Gupta, R.k. Mittal and V.K. Bhalla (2010), They threw light on the crisis happened named subprime crisis and the role of these agencies and also suggested some norms to deal with such crisis in future. They concluded that the ratings estimated by CRA has been failed to give right picture about credit worthiness and hence the gap between rating quality and rating standard , such market crisis happen and thus they have suggested some regulatory frameworks so that CRA improve their rating methodology.

Kumar, K. V., & RAO, S. H. (2012), They have given their view on the importance of Credit Rating Agencies that these agencies act as a bridge between investors and lenders as company having investment grading will be consider by investors and they also said that CRAs analyze company completetly by covering all the factors and then made their decision regarding its creditworthiness.

Ekins, E. E., Calabria, M. A., & Brown, C. O. (2011), they discussed about the oligopoly market of CRA and about the industry and how they came into marketplace with less competition as these agencies are highly consider serving investor's interest.

Ryan, J. (2013), In his research paper, he talked about the relevance of CRAs and their credible role in Euro financial market that how much an investor should be rely on the results of these agencies. In particular the market has 3 firms globally with their dominance all over the world. So this paper analyzes the credibleness of agencies and their working system that how much they have to improve.

Mittal, R. K., &Bhalla, V. K. (2010), when India faced a sub prime's crisis; the CRAs have played a major role in this crisis. So this paper talks about the crisis and the role played by these agencies and then also suggested some improvements for the better working of these agenci es so that in future if any crisis happen, they can help with their full potential. In their paper, they have used secondary data.

Ferri, G., & Liu, L. G. (2002), they have worked on the sovereign ratings relevance according to develop and developing countries and also analyze the firm's rating that is arrived by these agencies. They reached to findings: first, developed countries have higher sovereign rating than developing countries.

Smith, R. C., & Walter, I. (2002), they collectively worked on the conflicts that can arise in CRA business. They also consider that How CRA is providing relevant trading information which is useful to every investor and also bank while investing their money in a particular company.

3. Research Objectives

a) To know the concept of credit rating and its different types.
b) To know the relevance of credit rating for the investors while investing.
c) To know the process of Credit Rating.

4. Research Methodology

4.1 Concept

Credit Rating Industry consists of 7 agencies. There are 7 major players in this industry and other than this; there are several local companies which are providing services of how to improve the rating. For example, if a company directly goes to any of the 7 agencies and get rated then whatever rating is estimated, the particular agency will going to show that rating on their website which can be harmful for that company if the rating estimated is low. So, these local advisory companies do the same work as rating agencies, the only different thing is they are not legally eligible to rate the companies, they only provide suggestion or areas of improvement so that when they go for rating their firm, they get high rating.

4.2 Business Model

These agencies generate their revenue by providing service about variety of products. The main source is by the issuer of securities. They broadly have two models:

- **Issuer pay Model**: In this model, the company or any institution who want to get rated will pay these agencies to get ratings. This is the main source of income as company will register itself then pay a fee and then they will start their process of rating. the reports which are made is provided free on their website to investors or to anybody whosoever wants to read that report.
- **Subscription Pay Model**: In this model, agency will get paid with every user or investor who wants to get report. In simple words, to read reports, one has to get subscription to the agency and then only can read the report, reports are not freely available.

4.3 Types of Rating and their symbol

Credit Rating Agencies have given a symbol from AAA-D. This is a rating range. In which, AAA is the highest rating signifying lowest level of risk and D is the lowest rating that signifies Default and this means the particular corporate or bond will come in default and investing in these type of bonds is not advisable.

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AAA	Instruments having this rating are classified as the safest instrument regarding timely servicing of financial obligations and have lowest credit risk.
AA	Instruments having this rating are classified as the safe instrument regarding timely servicing of financial obligations and have very low credit risk.
A	Instruments having this rating are classified as having adequate safety regarding timely servicing of financial obligations and have low credit risk.
BBB	Instruments with this rating are considered to have moderate degree of safety regarding timely servicing of financial obligations. Such instruments carry moderate credit risk.
BB	Instruments with this rating are considered to have moderate risk of default regardingtimely servicing of financial obligations.
B	Instruments with this rating are considered to have high risk of default regarding timelyservicing of financial obligations.
C	Instruments with this rating are considered to have very high risk of default regarding timely servicing of financial obligations.
D	Instruments with this rating are in default or are expected to be in default soon

4.3 Relevance of CRA for investors while investing

Credit Rating Agencies suggests investors about the particular bond or a company about the risk in investing in that. The higher the rating, the lower risk in it, and the lower the rating, the high risk in it. CRA evaluate a particular company or bond by considering every factor and then give a particular rating with proper reasoning. An investor can go to the CRA website and download the report of the particular company and can read a bout its profitability, solvency, liquidity, and leverage position and then accordingly can make decision.

For example, person who is risk averse in nature will invest in high rated bond and will be happy in getting low returns as compare to others because high rating means low risk and risk and return go hand in hand, so person will get low return with low risk.

Table 1- CRA Rating

	Risk	**Return**
AAA	0.5	0.7
B	1.2	1.6
A	1	1.1
BB	1.7	2.1

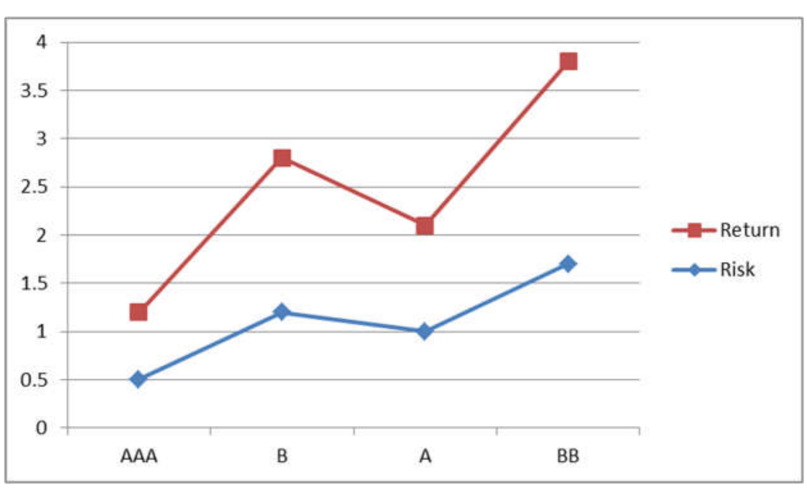


Fig 1 : Risk and return with CRA

5. Process of analyzing company's performance

a) Business Profile: The first step to do is to understand their business that how they operate, how many subsidiaries they have, how many competitors they have, their core product, who are the target market, how many employees are there, is it a major player in its industry or not.

b) Operating Segment and Industry Standing: Now, analysts will analyze its operating segments that how much it has been diversified, which branch gives major contribution and then analysts will see where it stands in industry, how much contribution it has in industry, what is its market position, how it works.

c) Business Risk: Now, analysts are responsible to consider all the risks that can be there like operational risk that how much there is a product acceptance, is it harmful, and then will also analyze future portfolio that a company makes to cover its loss if any, so what are their strategies, and it also includes to analyze cash blockage if any.

d) Historical Performance Analysis: Now, analyst will consider all the historical data like cash flow statement, balance sheet, income statement to know about the past financial performance and stability and to take all the information about debt, assets and working capital utilization. It gives them a broad perspective to make a general view point about company so that they can give proper rating to instruments.

e) Scale and Margins compare to its Peers: Now, it is a time to make comparison between peers. It is an important view point to arrive at rating as it gives the information that how many major players are in the industry and how a particular company is performing in its sector, is it doing its operation with full efficiency or more can it do.

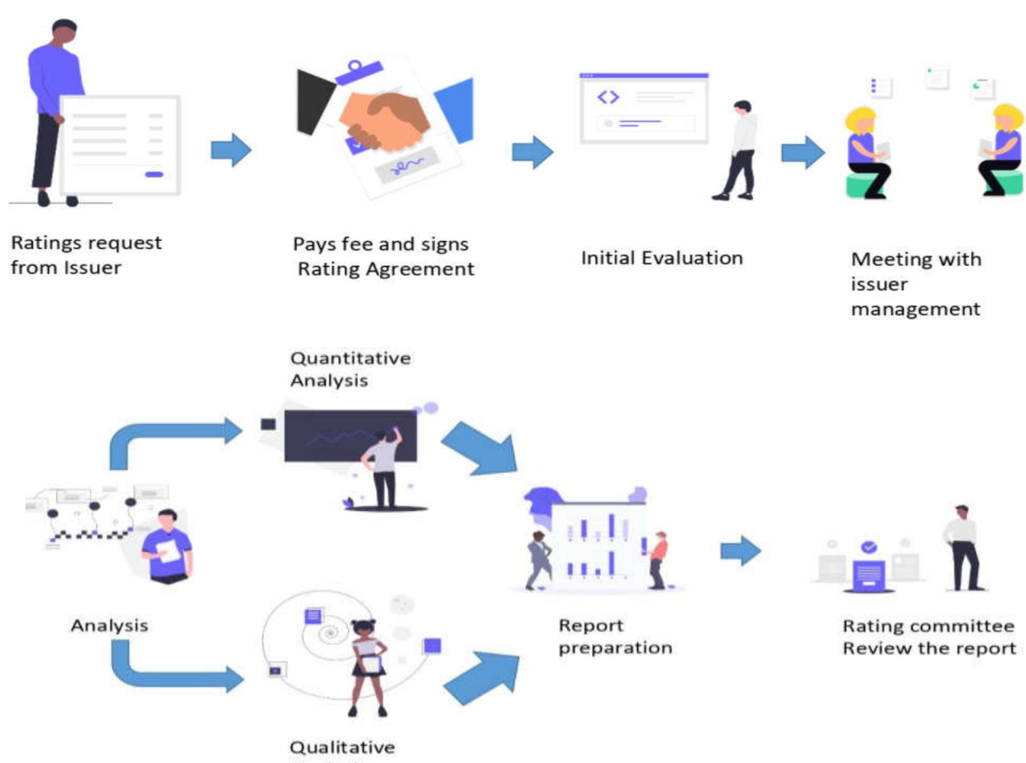
f) Revenue and margin drivers in the past, and their sustainability: Revenue is the important factor to know the company's performance as every company establish to earn revenue, so it is important to analyze revenue that what is their operating revenue and is it a growing company or declining company.

g) Cash flow generation capability: Cash Flow Statement depicts true picture of company's cash inflow and outflow, so it gives a real picture of company's transaction and tells about the liquidity position of the company.

h) Balance sheet analysis and liquidity profile: Now, analyst will analyze balance sheet of current year and previous year and also current year balance sheet of peers to get a broader view point about the performance of that company like what is the dividend payout ratio, how often they pay dividend, from where they raise money, is there any unsecured loan or which type of loans they mostly go for.

i) Financial ratios and peer analysis: Ratio Analysis is the most effective and easy way to make comparison between companies operating in same industry. ratios like EBIDTA, DSCR,ROCE, etc, they all provide the information about financial, liquidity and solvency position of a business and also tells about which company is performing better.

6. Process of assigning Rating



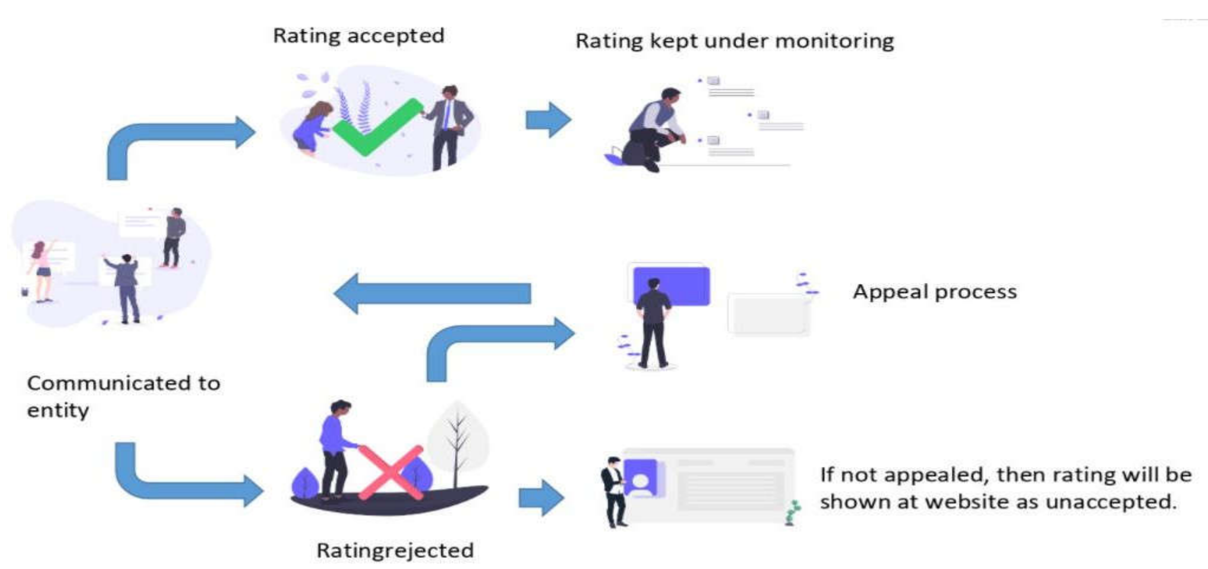


Fig 2 - Process of assigning Rating

Steps followed are:

a) **Ratings request from issuer**: Company makes request to the agency to get rating, they submit RRF (Rating Request Form). And then the rated entity makes payment to the agency as a fee of getting rating and signs rating agreement (RA).

b) **Initial evaluation:** Now, case is taken forward and given to the analyst and rated entity provides all the relevant information to arrive at rating. Analysts process the information and also do plant or site visit to get brief understanding of working and also have a discussion with management/banker/auditor/suppliers.

c) **Meeting with issuer management**: They make a questionnaire to ask some pre decided questions which would guide them towards understanding of company's working.

d) **Analysis:** Now after gathering all the information, analysts will do all the types of analysis: Quantitative and Qualitative.

   i. **Quantitative analysis**: Analysts consider financial statements and calculate ratio and also do peer comparison, history of equity expansion, dividend and earning history.

   ii. **Qualitative Analysis**: Analysts analyze business model, SWOT analysis, Competitive advantage of a company, pricing power, organization structure, risks in the business.

e) **Rating committee review and vote:** Rating report is prepared after analyzing all the information provided by the rated entity.

f) **Notification to issuer:** Now rating agency provides report to the rated entity and demand fees. Rated entity is free to accept or reject the rating.

g) **Publication & dissemination of public rating opinions**: If rating is accepted then it will be shown at their website as accepted. And if it is unaccepted and appeals for re-estimation, then agency will consider and estimate again and then also if they reject, the agency will show rating as unaccepted on their website.

h) **Surveillance of rated issuers and issues:** Now, analysts are responsible to analyze the rated instrument continuously until it get its maturity date. It is done because there might be occurrence of change in environmental factors which could affect the rated instrument and to always have right rating, it is under taken by agencies.

7. Conclusion

In India, people have risk averse nature and hence CRA play an important role as they provide all the investors full information about the company's or bond's performance. This gives investors a safe side to invest. and also by understanding the full process of analyzing the rating, we can have clear picture that CRA provides quality and transparent information, so that a normal person can also excess these information. There are rating symbols that helps a person in understanding about what company wants to convey about the company or bond.

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