Credit Rating & IPO Grading

Credit Rating - It is the evaluation of the credit worthiness
- of an individual or
- of a business concern or
- of an instrument of a business

about the ability and willingness to pay obligations.

2011 Dec – Credit rating establishes a link between risk and return. Discuss?
Features –

1. It is an assessment of borrower's compliance and ability to repay the obligation in accordance with terms and conditions.
2. It is **only an opinion** and not a recommendation to purchase, sell or hold the securities.
3. The ratings keep on changing subject to the changes in company's financial and operating performance.
4. It is about rating the securities only and not the companies.
5. **It establishes a link between risk and return.**
6. It is expressed in the form of Standard Symbols such as AAA, LAAA etc.

Credit Rating Agency
- The credit rating agency (CRA) is one of the capital market intermediaries.
- It is a body corporate which is engaged in the business of rating the securities.

Following the important CRAs in India:-

1. Credit Rating and Information Services (India) Ltd (**CRISIL**) formed in 1987.
2. Investment Information and Credit Rating Agency of India Ltd (**ICRA**) formed in 1991.
3. Credit Analysis and Research Limited (**CARE**) formed in 1994.
4. **Fitch** Credit Rating India Pvt Ltd formed in 1999.
5. **Brickworks** Rating Pvt Ltd formed in 2008.
6. SME Rating Agency of India Ltd (**SMERA**) formed in 2011.

International Credit Rating Agencies (CRAs)
1. Standard and Poors
2. Moody's Investor Services.

2010 Dec, 2014 June – Credit rating is a marketing tool for the companies. Explain?
2012 Dec – Credit rating is useful to investors and issuers.

Benefits of Credit Rating

1. **For Investors** –
- To communicate the relative ranking of the default loss probability.
- To compare between various instruments.
- To access and compares the offered rate of return with expected rate of return.

2. **For issuers –**
- To generate investors faith in the securities issued by the company.
- To enables the issuers of highly rated instruments to access the market even during the adverse market conditions.

3. **For Intermediaries –**
- It is useful to intermediaries such as merchant bankers for planning, pricing, underwriting and placement of the issues.
- Brokers and analysts use credit rating as an input for monitoring risk.

4. For Regulators –
- RBI requires that the NBFC must have a minimum investment grade, if it intends to accept public deposit.
- Commercial Paper [Money Market instrument] shall have a minimum rating for issuance.
- This strengthens the market and the mechanism which creates trust amongst people in the market.

SEBI (Credit Rating Agencies) Regulations 1999

1. It covers the rating of securities only and not the rating of fixed deposits, foreign exchange, country ratings etc.
2. CRA must have a minimum net worth of 5 crore.
3. A CRA cannot rate any security issued by its promoters.
4. A CRA cannot rate the security issued by the company or its associate co. or subsidiary co., if there are common Chairman, Director, Promoter, Manager or employee between the CRA and the Company.
5. CRA are regulated under these Regulations.
6. Practising CS is authorized to undertake Internal Audit of CRAs.

Promoters of Credit Rating Agencies

1. A public financial institution
2. Scheduled Commercial Banks
3. A Foreign Bank operating in India
4. A Foreign CRA having minimum 5 years of experience.
5. Any company or body corporate having minimum net worth of Rs 100 crore for the previous 5 years.

Eligibility criteria for CRA – An application is to be made to SEBI along with prescribed non refundable fee.

1. An applicant must incorporate a company under Companies Act, 2013.
2. An applicant must be fit & proper person.
3. Minimum Net Worth – Rs 5 crore.
4. An applicant must specify rating activity as one of its main object in its MOA.
5. An applicant must have adequate infrastructure facilities.
6. An applicant or promoter or director must not have convicted of any offence involving moral turpitude or any economic offence under securities laws.
7. The grant of certificate is in the interest of investors.

2007 Dec – Discuss briefly the Code of Conduct for CRA?
Code of Conduct – Every CRA is required to abide by the code of conduct as per SEBI Regulations.

1. Should observe high standards of integrity & fairness in all its dealing with its clients.
2. Should fulfill its obligations in an ethical manner.
3. Should render high standards of service, exercise due diligence, ensure proper care and exercise independent professional judgment.
4. Should discharge all professional dealings in a prompt and efficient manner.
5. Should abide by the provisions of the act, rules & regulations.
6. Should not indulge in unfair competition.
7. Should not make any exaggerated statement.
8. Should not make any untrue statement or suppress any material fact in any documents, reports etc.
9. Should not disclose any confidential information of their client to other person.

Appointment of Compliance Officer
- A CS shall be appointed as a compliance officer.
- CS shall be responsible for the compliance of the Act, Rules, Regulations, Notifications, Guidelines, Circulars, Instructions issued by SEBI or CG.

Maintenance of Books of Accounts
Every CRA shall keep and maintain books of accounts, records & documents for a period of 5 years.
Intimation is to be send to SEBI about the place where such Books of Accounts are kept.

- Copy of Balance sheet
- Copy of Profit & loss account
- Copy of Auditor`s Report.
- Copy of Agreement entered into with the clients.
- Ratings assigned to various securities.
- Particulars of fees charged for rating.
- Any other particulars specified by SEBI.

2008 Dec, 2014 June - Explain the procedure of IPO Grading?
Procedure of Credit Rating or IPO Grading

1. CRA shall obtain the required information for the rating from the company.
2. Discuss such information with the company's management.
3. Visit the company's operating locations, if required.
4. Prepare an analytical assessment report.
5. Present the analysis to a committee comprises of senior executives of the concerned rating/grading agency.
6. The committee after considering the analytical assessment report and all relevant issue shall assign a rating.
7. Communicate the rating to the company along with an assessment report outlining the reason for the rating assigned.

2010 June – Discuss the factors generally considered by CRA for the rating of Manufacturing companies?
2013 June – Discuss the factors considered by CRA for rating of an instruments?

The Rating methodology – Factors to be considered by CRA for rating of an instrument.
Every CRA develops its own rating parameters / models / standards for rating the instruments.

A. For rating of Manufacturing companies

- Industry risk in which the firm operates.
- Company`s sales position and market position.
- Operating efficiency.
- Capital structure.
- Long term earning capability of the firm.
- Financial leverage.
- Cash flow adequacy.
- Management efficiency & effectiveness.
- Working capital.

B. For NBFC – it is based on CAMEL model.

C – Capital Adequacy
A – Assets Quality
M – Management
E – Earnings
L – Liquidity

2007 June – State the requirements for monitoring of ratings by a CRA. ?
Monitoring of Rating - Credit rating is not a one time job on the part of CRA.

- CRA should continuously monitor the rating of such securities which are rated by it, throughout the life time of securities.

- CRA should disseminate information regarding newly assigned ratings and should call a press release or put it on the website as well as inform the stock exchange in case of listed securities.
- The frequency of Surveillance may be quarterly or half yearly or yearly.

Disclosures made by Credit rating Agencies

For the listed companies, the CRA shall make the necessary disclosures to the stock exchanges as mentioned by SEBI.

- For ratings assigned and periodic reviews, the CRA shall issue press release which shall also be update on their websites.

A CRA shall make all the disclosures stipulated below on their websites:

- Disclose its policies, methods and procedures in details regarding the ratings.
- Shall disclose in the format prescribed about the details of new credit rating assigned.
- Movement of each credit rating.
- Movement of each credit rating from investment grade to non investment grade and vice versa.
- The history of credit rating of all the securities.
- A CRA shall disclose the annual receipt from rating services and non rating services.
- A CRA shall disclose the compliance status of each provision of IOSCO Code of Conduct.

2008 Dec, 2011 June, 2013 June, 2014 June – What is IPO Grading?
2010 June – "IPO Grading is a service aimed at facilitating the assessment of the equity issue offered to the public". Discuss.
2013 Dec – Priyanka Ltd is planning to come out with an IPO. For this purpose, it has to be obtained IPO grading from these agencies which are: IPO 3, IPO 4 & IPO 5. Explain the meaning of IPO Grading. Advise which IPO Grading should be reported by the company in its prospectus.

IPO Grading – It is a service aimed at facilitating the assessment of equity issues offered to public.
It means grading or rating of IPO by CRA.
IPO grading is mandatory for Public issue, but with effect from 4th Feb 2014, it becomes optional.
The issuer has to obtain the grading for IPO from at least 1 CRA registered with SEBI.
As per SEBI (ICDR) regulations 2009, the issuing company has to disclose all the Grading obtained from different CRA in the prospectus, advertisements and all other places where the issuing company is advertising for IPO.

IPO Grade 5	**Strong Fundamentals**
IPO Grade 4	**Above Average Fundamentals**
IPO Grade 3	**Average Fundamentals**
IPO Grade 2	**Below Average Fundamentals**
IPO Grade 1	**Poor Fundamentals**

Note:
If a company makes a public issue of convertible debentures then it has to obtain credit rating from 1 or more CRAs.