

FAQs on Credit Ratings

What is credit rating?

Credit rating is, essentially, the opinion of the rating agency on the relative ability and willingness of the issuer of a debt instrument to meet the debt service obligations as and when they arise.

Why do rating agencies use symbols like AAA, AA, rather than give marks or descriptive credit opinion?

The great advantage of rating symbols is their simplicity, which facilitates universal understanding. Rating companies also publish explanations for their symbols used as well as the rationale for the ratings assigned by them, to facilitate deeper understanding.

Why is credit rating necessary at all?

Credit rating is an opinion expressed by an independent professional organization, after making a detailed study of all relevant factors. Such an opinion will be of great assistance to investors in making investment decisions. It also helps the issuers of debt instruments to price their issues correctly and to reach out to new investors. Regulators like Reserve Bank of India (RBI) and Securities & Exchange Board of India (SEBI) often use credit rating to determine eligibility criteria for some instruments. For example, the RBI has stipulated a minimum credit rating by an approved agency for issue of Commercial Paper. In general, credit rating is expected to improve quality consciousness in the market and establish, over a period of time, a more meaningful relationship between the quality of debt and the yield from it. Credit Rating is also a valuable input in establishing business relationships of various types.

Does credit rating constitute an advice to the investors to buy?

It does not. The reason is that some factors, which are of significance to an investor in arriving at an investment decision, are not taken into account by rating agencies. These include reasonableness of the issue price or the coupon rate, secondary market liquidity and pre-payment risk. Further, different investors have different views regarding the level of risk to be taken and rating agencies can only express their views on the relative credit risk.

What kind of responsibility or accountability will attach to a rating agency if an investor, who makes his investment decision on the basis of its rating, incurs a loss on the investment?

A credit rating is a professional opinion given after studying all available information at a particular point of time. Nevertheless, such opinions may prove wrong in the context of subsequent events. Further, there is no privity of contract between an investor and a rating agency and the investor is free to accept or reject the opinion of the agency. Nevertheless, rating is essentially an investor service and a rating agency is expected to maintain the highest possible level of analytical competence and integrity. In the long run, the credibility of a rating agency has to be built, brick by brick, on the quality of its services.

Do rating companies undertake unsolicited ratings?

Not in India, at least not yet. There is however, a good case for undertaking unsolicited ratings. It will be relevant to mention here that any rating based entirely on published information has serious limitations and the success of a rating agency will depend, to a great extent, on its ability to access privileged information. Co-operation from the issuers as well as their willingness to share even

confidential information are important pre-requisites. On its part, the rating agency has a great responsibility to ensure confidentiality of the sensitive information that comes into its possession during the rating process.

How reliable and consistent is the rating process? How do rating agencies eliminate the subjective element in rating?

To answer the second question first, it is neither possible nor even desirable, to totally eliminate the subjective element. Rating does not come out of a pre-determined mathematical formula, which fixes the relevant variables as well as the weights attached to each one of them. Rating agencies do a great amount of number crunching, but the final outcome also takes into account factors like quality of management, corporate strategy, economic outlook and international environment. To ensure consistency and reliability, a number of qualified professionals are involved in the rating process. The Rating Committee, which assigns the final rating, consists of professionals with impeccable credentials. Rating agencies also ensure that the rating process is insulated from any possible conflicts of interest.

Is it customary to have the same issue rated by more than one rating agency? Do the ratings for the same instrument vary from agency to agency?

The answer to both the questions is yes. In the well-developed capital markets, debt issues are, more often than not, rated by more than one agency. And, it is only natural that the opinions given by two or more agencies will vary, in some cases. But it will be very unusual if such differences are very wide. For example, a debt issue may be rated DOUBLE A PLUS by one agency and DOUBLE A or DOUBLE A MINUS by another. It will indeed be unusual if one agency assigns a rating of DOUBLE A while another gives a TRIPLE B.

Why do rating agencies monitor the issues already rated?

A rating is an opinion given on the basis of information available at a particular point of time. As time goes by, many things change, affecting the debt servicing capabilities of the issuer, one way or the other. It is, therefore, essential that as a part of their investor service, rating agencies monitor all outstanding debt issues rated by them. In the context of emerging developments, the rating agencies often put issues under credit watch and upgrade or downgrade the ratings as and when necessary. Normally, such action is taken after intensive interaction with the issuers.

Do issuers have a right of appeal against a rating assigned?

Yes. In a situation where an issuer is unhappy with the rating assigned, he may request for a review, furnishing additional information, if any, considered relevant. The rating agency will, then, undertake a review and thereafter indicate its final decision. Unless the rating agency had overlooked critical information at the first stage, (which is unlikely), chances of the rating being changed on appeal are rare.

How much time does rating take?

The rating process is a fairly detailed exercise. It involves, among other things, analysis of published financial information, visits to the issuer's office and works, intensive discussion with the senior executives of issuer, discussions with auditors, bankers, etc. It also involves an in-depth study of the industry itself and a degree of environment scanning. All this takes time and a rating agency may take three to four weeks or more to arrive at a decision, subject to availability of all the solicited information. It is of paramount importance to rating companies to ensure that they do not, in any way, compromise on the quality of their analysis, under pressure from issuers for quick results.

Issuers would also be well advised to approach the rating agencies sufficiently in advance so that issue schedules can be adhered to.

Is it possible that not satisfied with the rating assigned by one rating agency, an issuer approaches another, in the hope of getting a better result?

It is possible, but rating companies do not and should not indulge in competitive generosity. Any attempt by issuers to play one agency against another will have to be discouraged by all the rating companies. It may, however, be pointed out here that two rating companies may, and often do, arrive at different conclusions on the same issue. This is only natural, as perceptions differ.

Who rates the rating companies?

Informed public opinion will be the touchstone on which the rating companies have to be assessed and the success of a rating agency should be measured by the quality of the services offered, consistency and integrity.

Is the rating assigned for an instrument or for the Issuer Company?

Both. Rating of instruments would consider instruments' specific characteristics like maturity, credit reinforcements specific to the issue etc. Issuer ratings consider the overall debt management capability of an issuer on a medium term perspective, typically three to five years. While issuer ratings are more often than not, one time assessments of credit quality, instrument ratings are monitored over the life of the instrument.

Why are equity shares not rated?

By definition, credit rating is an opinion on the issuers capacity to service debt. In the case of equity, there is no pre-determined servicing obligation, as equity is in the nature of venture capital. So, credit rating in the conventional sense does not apply to equity shares. However, of late, credit rating agencies offer grading of IPOs which take into account the fundamentals of the issuer.

If a rating is downgraded, how would it "benefit" (or compensate) the investor?

A credit rating is a professional opinion on the ability and willingness of an issuer to meet debt-servicing obligations. It is an opinion on future debt servicing capabilities given on the basis, inter-alia, of past performance and all available information (from audited financial statements, interaction with company management, banks and financial institutions, statutory auditors, etc.) at a particular time. While rating agencies make all possible efforts to project corporate business prospects, industry trends and management capabilities, many events are unpredictable. Hence, such opinions may prove wrong in the context of subsequent events. On the occurrence of such an event, a rating agency can only review and make appropriate changes in the rating. Moreover, when there are recessionary trends in certain segments of the economy, companies in such segments or with large exposures to such segments are adversely affected and their credit ratings get downgraded. Such down gradations are a natural consequence of the recessionary trends. In other words, credit quality (and credit rating) is dynamic, not static and all rating agencies review their ratings periodically and make changes, wherever considered appropriate. Such changes are reported widely through the media. It is the experience of all rating agencies that some instruments initially rated as investment grade fall below investment grade or go into default, over a period of time.

Further, it must be noted that there is no privity of contract between an investor or a lender and a rating agency and the investor is free to accept or reject the opinion of the agency. A credit rating is not an advice to buy, sell or hold securities or investments and investors are expected to take their

investment decisions after considering all relevant factors and their own policies and priorities. A credit rating is not a guarantee against future losses. Please also note that credit ratings do not take into account many aspects which influence investment decisions. They do not, for example, evaluate the reasonableness of the issue price, possibilities for capital gains or take into account the liquidity in the secondary market. Ratings also do not take into account the risk of prepayment by issuer, or interest or exchange risks. Although these are often related to the credit risk, the rating essentially is an opinion on the relative quality of the credit risk, based on the information available at a given point of time.

CA Prakash Somani (A Helping Hand)
