Rating & Grading in India: The Road Beyond

Credit, Corporate Governance & Other Institutions like Hospitals

By

Priya Chinda
priyachinda@yahoo.co.in

Assisted by
Zaheer Zaidi
zazaidi@yahoo.com

Department of Financial Studies

University of Delhi

TABLE OF CONTENTS

- Credit Rating: The concept
- Rating Rationale
- Rating Process and Framework
- The Rating Agencies operating in India
- New areas of operation
    - Advisory Services
    - Information Services
    - EPRA
- New areas in Rating & Grading
- Grading of Healthcare Institutions
- Corporate Governance Grading
- Annexure
    1. Highlights of the Round table conference on Rating issues
    2. ICRA's Project Finance Ratings
    3. ICRA's Methodology for Municipal Corporation's ratings
    4. ICRA's Rating feature: Securitisation of CDO's
    5. Performance of ICRA Ratings: Transition study and update till July, 2003
    6. ICRA's Indian Structured Finance Market Review
    7. Corporate Governance Rating Services from ICRA
    8. CGR Case Study

Credit Rating: The Concept

A rating is an opinion on the future ability and legal obligation of the issuer to make timely payments of principal and interest on a specific fixed income security. The rating measures the probability that the issuer will default on the security over its life, which depending on the instrument may be a matter of days to 30 years or more.

In addition, long term ratings incorporate an assessment of the expected monetary loss should a default occur.

They help investors by providing an easily recognizable, simple tool that couples a possibly unknown issuer with an informative and meaningful symbol of credit quality.

Ratings, usually expressed in alphabetical or alphanumeric symbols, are a simple and easily understood tool enabling the investor to differentiate between debt instruments on the basis of their underlying credit quality. The credit rating is thus a symbolic indicator of the current opinion of the relative capability of the issuer to service its debt obligation in a timely fashion, with specific reference to the instrument being rated.

It is focused on communicating to the investors, the relative ranking of the default loss probability for a given fixed income investment, in comparison with other rated instruments. A rating is specific to a debt instrument and is intended as a grade, an analysis of the credit risk associated with the particular instrument.

It is based upon the relative capability and willingness of the issuer of the instrument to service the debt obligations (both principal and interest) as per the terms of the contract. Thus a rating is neither a general-purpose evaluation of the issuer, nor an overall assessment of the credit risk likely to be involved in all the debts contracted or to be contracted by such entity.

In determining a rating, both quantitative and qualitative analyses are employed. The judgment is qualitative in nature and the role of the quantitative analysis is to help make the best possible overall qualitative judgment because, ultimately, a rating is an opinion.

Rating Process:

Rating is an interactive process with a prospective approach. It involves series of steps. The main points are described as below

(a) Rating request: Ratings in India are initiated by a formal request (or mandate) from the prospective issuer. This mandate spells out the terms of the rating assignment. Important issues that are covered include: binding the credit rating agency to maintain confidentiality, the right to the issuer to accept or not to accept the rating and binds the issuer to provide information required by the credit rating agency for rating and subsequent surveillance.

(b) Rating team: The team usually comprises two members. The composition of the team is based on the expertise and skills required for evaluating the business of the issuer.

(c) Information requirements: Issuers are provided a list of information requirements and the broad framework for discussions. These requirements are derived from the experience of the issuers business and broadly conform to all the aspects, which have a bearing on the rating. These factors have been discussed in detail under rating framework.

(d) Secondary information: The credit rating agency also draws on the secondary sources of information including its own research division. The credit rating agency also has a panel of industry experts who provide guidance on specific issues to the rating team. The secondary sources generally provide data and trends including policies about the industry.

(e) Management meetings and plant visits: Rating involves assessment of number of qualitative factors with a view to estimate the future earnings of the issuer. This requires intensive interactions with the issuer’s management specifically relating to plans, future outlook, and competitive position and funding policies. Plan visits facilitate understanding of the production process, assess the state of equipment and main facilities, evaluate the quality of technical personnel and form an opinion on the key variables that influence level, quality and cost of production. These visits also help in assessing the progress of projects under implementation.

(f) Preview meeting: After completing the analysis, the findings are discussed at length in the internal committee, comprising senior analysts of the credit rating agency. All the issues having a bearing on the rating are identified. At this stage, an opinion on the rating is also formed.

(g) Rating Committee meeting: This is the final authority for assigning ratings. The rating team makes a brief presentation about the issuers business and the management. All the issues identified during discussions in the internal committee are discussed. The rating committee also considers the recommendation of the internal committee for the rating. Finally, a rating is assigned and all the issues, which influence the rating, are clearly spelt out.

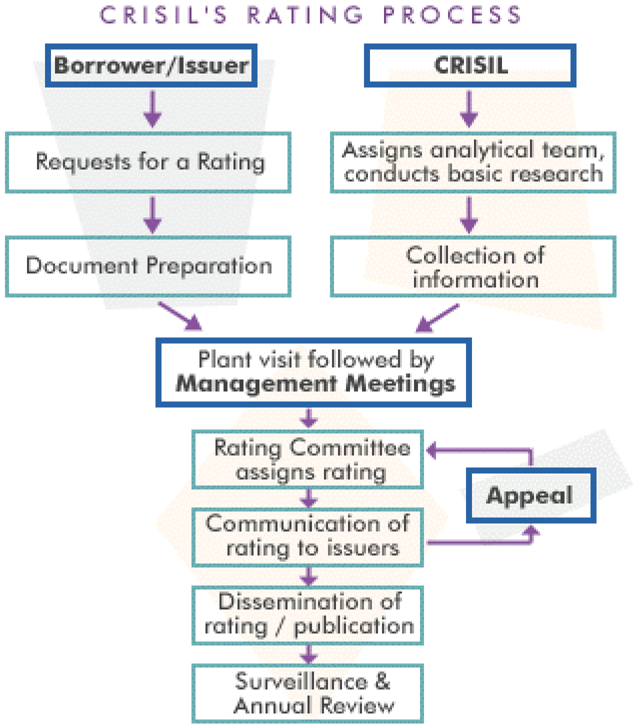
(h) Rating communication: The assigned rating along with the key issues is communicated to the issuer’s top management for acceptance. The ratings, which are not accepted, are either rejected or reviewed. The rejected ratings are not disclosed and complete confidentiality is maintained.

(I) Rating Reviews: If the rating is not acceptable to the issuer, he has a right to appeal for a review of the rating. These reviews are usually taken up only if the issuer provides fresh inputs on the issues that were considered for assigning the rating. Issuers’ response is presented to the Rating Committee. If the inputs are convincing, the Committee can revise the initial rating decision.

(j) Surveillance: It is obligatory on the part of the credit rating agency to monitor the accepted ratings over the tenure of the rated instrument. As has been mentioned earlier, the issuer is bound by the mandate letter to provide information to the credit rating agency. The ratings are generally reviewed every year, unless the circumstances of the case warrant an early review. In surveillance review the initial rating could be retained or revised (upgrade or downgrade).

The various factors that are evaluated in assigning the ratings have been explained under rating framework.

The primary objective of rating is to provide guidance to investors\creditors in determining a credit risk associated with a debt instrument\credit obligation. It does not amount to a recommendation to buy, hold or sell an instrument, as it does not take into consideration factors such as market prices, personal risks preferences and other considerations, which may influence an investment decision.



The rating process is itself based on certain 'givens'. The agency, for instance, does not perform an audit. Instead, it is required to rely on information provided by the issuer and collected by analysts from different sources, including interactions in-person with various entities. Consequently, the agency does not guarantee the completeness or accuracy of the information on which the rating is based.

Rating Framework

The basic objective of rating is to provide an opinion on the relative credit risk (or default risk) associated with the instrument being rated. This in a nutshell includes, estimating the cash generation capacity of the issuer through operations (primary cash flows) Vis a Vis its requirements for servicing obligations over the tenure of the instrument. Additionally, an assessment is also made of the available marketable securities (secondary cash flows), which can be liquidated if required, to supplement the primary cash flows. It may be noted that secondary cash flows have a greater bearing in the short-term ratings, while the long-term ratings are generally entirely based on the adequacy of primary cash flows. All the factors, which have a bearing on future cash generation and claims that require servicing, are considered to assign ratings. These factors can be conceptually classified into business risk and financial risk drivers.

Business risk drivers	**Financial risk drivers**
Industry characteristics	Funding policies
Market position	Financial flexibility
Operational efficiency	
New projects	
Management quality	

Industry characteristics: This is the most important factor in the credit risk assessment. It is a key determinant of the level and volatility in earnings of any business. Other factors remaining the same, industry risk determines the cap for ratings. Some of the factors that are analysed include:

Demand factors	**State of competition**
Drivers & potential	Existing & expected capacities
Nature of product	Intensity of competition
Nature of demand - seasonal, cyclical	Entry barriers for new entrants
Bargaining position of customers	Exit barriers
	Threat of substitutes

Environmental factors	**Bargaining position of suppliers**
Role of the industry in the economy	Availability of raw material
Extent of government regulation	Dependence on a particular supplier
Government policies - current and future	Threat of forward integration
	Switching costs

For credit risk evaluation, stable businesses (low industry risk) with lower level of cash generation are viewed more favorably compared to businesses with higher cash generation potential but relatively higher degree of volatility (higher industry risk). It needs to be mentioned that with the opening up of the Indian economy, it is also critical to establish international competitiveness both at the industry and the unit level.

Market position: All the factors influencing the relative competitive position of the issuer are examined in detail. Some of these factors include positioning of the products, perceived quality of products or brand equity, proximity to the markets , distribution network and relationship with the customers. In markets where competitiveness is largely determined by costs, the market position is determined by the unit's operational efficiency. The result of these factors is reflected in the ability of the issuer to maintain /improve its market share and command differential in pricing. It may be mentioned that the issuers, whose market share is declining, generally do not get favorable long-term ratings.

Operational efficiency: In a competitive market, it is critical for any business unit to control its costs at all levels. Cost of production to a large extent is influenced by: Location of the production unit(s) Access to raw materials Scale of operations Quality of technology Level of integration Experience and last but not the least the ability of the unit to efficiently use its resources. A comparison with the peers is done to determine the relative efficiency of the unit. Some of the indicators for measuring production efficiency are: resource productivity (both assets and manpower), material usage (or input-output ratios) and energy consumption. Collection efficiency and inventory levels are important indicators of both the market position and operational efficiency.

New project risks: The scale and nature of new projects can significantly influence the risk profile of any issuer. Unrelated diversifications into new products are invariably assessed in greater detail. The main risks from the new projects are: Time and cost overruns, even non-completion in an extreme case, during construction phase; financing tie-up; operational risks; and market risk. Besides clearly establishing the rationale of new projects, the protective factors that are assessed include: track record of the management in project implementation, experience and quality of the project implementation team, experience and track record of technology supplier, implementation schedule, status of the project, project cost comparisons, financing arrangements, tie-up of raw material sources, composition of operations team and market outlook and plans. Besides on the assessment of various project risks, assumptions about completion and contribution to/from these projects are incorporated in the issuer's overall projections. It needs to be emphasised that the impact of the project risk on the rating depends on the scale of projects in relation to the size of assets and cash flows of the existing operations.

Management quality: The importance of this factor cannot be overemphasized. When the business conditions are adverse, it is the strength of management that provides resilience. A detailed discussion is held with the management to understand its objectives, plans & strategies, competitive position and views about the last performance and future outlook of the business. These discussions provide insights into the quality of the management. It also helps in establishing management's priorities. A review of the organisation structure and information system is done to assess whether it aligns with the management's plans and priorities. The interactions with key operating personnel help in determining the quality of the management. Issues like dependence on a particular individual and succession planning are also addressed. Other important factors are: labor relations, track record of meeting promises specifically relating to returns and project implementation, performance of "group" companies, transactions with the "group" companies etc.

Funding policies: This determines the level of financial risk. Management's views on its funding policies are discussed in detail. These discussions are generally focused on the following issues: Future funding requirements Level of leveraging Views on retaining shareholding control Target returns for shareholders Views on interest rates Currency exposures including policies to control the currency risk Asset-liability tenure matching.

Financial flexibility: While the primary source for servicing obligations is the cash generated from operations, an assessment is also made of the ability of the issuer to draw on other sources, both internal (secondary cash flows) and external, during periods of stress. These sources include: availability of liquid investments, unutilised lines of credit, financial strength of group companies, market reputation, relationship with financial institutions and banks, investor's perceptions and experience of tapping funds from different sources. Generally financial flexibility factor facilitates determination of the relative strength within a rating category (i.e., + or - prefix with the rating) and has a greater bearing on the short-term ratings.

Past financial performance: The impact of the various risk drivers is reflected in the actual performance of the issuer. Thus while the focus of rating exercise is to be determined the future cash flow adequacy for servicing debt obligations, a detailed review of the past financial statements is critical for better understanding of the influence of all the business and financial risk factors. Evaluation of the existing financial position is also important for determining the sources of secondary cash flows and claims that may have to be serviced in future.

Accounting quality: Consistent and fair accounting policies are a pre-requisite for financial evaluation and peer group comparisons. It may be mentioned that accounting quality is also an important indicator of the management quality. Rating analysts review the accounting policies, notes to the accounts and auditors comments in detail. Where necessary, rating analysts adjust the financial statements to reflect the correct position. Over a period of time the focus of financial analysis at the credit rating agency has shifted towards evaluation of cash flow statements as cash flows to a large extent offset the impact of "financial engineering".

Indicators of financial performance: Financial indicators over the last few years (typically five years) are analysed and performance of the issuer is compared with its peers. Comparison with peers is important for better understanding of the industry trends and determining the relative position of the issuer. Some of the important indicators that are analysed are presented below:

- **Profitability:** A traditional indicator of success or failure of any business endeavour has been its ability to add value to its wealth or generate profits. A few important indicators are, trends in: Return on capital employed Return on net worth Gross operating margins higher profitability implies greater cushion to debt holders. Profitability also determines the market perception, which has a bearing on the support of shareholders and other lenders. This support can be an important factor during stress.

- **Gearing or level of leveraging:** This is an important determinant of the financial risk. Some important indicators are: Total debt as a % of networth Long term debt as a % of networth Total outside liabilities as a % of total assets It needs to be emphasized that business risk is a prime driver, while gearing has a secondary role in determining the overall rating (especially long term). To illustrate, an issuer whose gearing level is favorable but relative business fundamentals are weak is unlikely to get a favorable long-term rating. This is so because gearing is considered to be a "controllable" factor while business factors are relatively difficult to alter significantly.

- **Coverage ratios:** Considered to be of primary importance to the debt holders. The important ratios are: Interest coverage ratio (OPBDIT/Interest) Debt service coverage ratio Net cash accruals as a % of total debt The level of these ratios reflect the result of business risk drivers and the funding policies. Generally speaking, higher the level of coverage, higher is the rating. However as mentioned earlier, business with lower level of coverage can get higher ratings if the earnings are steady (i.e., business with low industry risk).

- **Liquidity position:** The indicators of liquidity position are, the levels of: Inventory Receivables Payables The state of competition, issuer's market position & policies, relationship with customers and suppliers are the important factors that impact the above levels. Comparison with peers on these indicators help to determine the relative position of the issuer in the industry. The funding profile with respect to matching of assets -liability tenures also has an important bearing on the liquidity position.

- **Cash flow analysis:** Cash is required to service obligations. Thus, any financial evaluation would be incomplete if cash flow analysis is not carried out. Cash flows reflect the sources from which cash is generated and its deployment. As has been mentioned earlier, cash flows also to a very large extent offset the impact of diverse accounting policies and hence facilitate peer comparisons. The coverage ratios enumerated above can be modified to factor the impact of actual cash flows only. Issuers which are not able to generate sufficient cash to service obligations do not normally get favorable ratings.

- **Future cash flow adequacy:** The ultimate objective of the rating is to determine the adequacy of cash generation to service obligations. Number of assumptions based on the future outlook of the business is made to draw projections of financial statements. Invariably, the financial projections are carried out for a number of scenarios incorporating a range of possibilities in the set of assumptions for the key cash flow drivers. A few important drivers are expectations of growth, selling prices, input costs, working capital requirements, value of currencies etc.

Limitations of Credit Ratings

A Credit Rating is an assessment carried out from the limited standpoint of credit risk evaluation. A Credit Rating therefore constitutes a current opinion on the credit quality of a specific issue of debt, in terms of the issuer's ability and willingness to meet principal and interest payments on rated debt instruments in a timely manner.

<u>A Credit Rating is NOT:</u>

1. A general-purpose credit or performance evaluation of the rated entity: CRISIL Credit Ratings are always issue-specific.
2. A recommendation to invest in, or not to invest in, any shares, debentures or other instruments issued by the rated entity, or derivatives thereof.
3. An opinion on associate, affiliate or group companies of the rated entity, or on promoters, directors or officers of the rated entity.
4. A statutory or non-statutory audit of the rated entity.
5. An indication of compliance or otherwise with legal or statutory requirements.

Credit Ratings are arrived at based on information obtained in the rating process. In addition to management meetings and information provided by rated entities, the rated entity's audited accounts, regulatory filings, and information provided by trustees form an important source of information. A credit rating agency does not verify and validate all the information that it uses for its ratings. However, reasonable due diligence is carried out on all information used to the extent feasible to ensure that a meaningful and accurate rating exercise is done (for instance, financial accounts are extensively 'adjusted' to ensure that they present a relevant picture of the financial position of an entity from a debt servicing perspective, to the extent feasible).

RATING AGENCIES IN INDIA

CRISIL

The Credit Rating Information Services of India Limited (CRISIL), was incorporated on January 29,1987,as a Public Limited Company, was promoted by leading financial institutions, and a host of nationalised Banks, foreign Banks and private sector Banks, with the main promoters being The Industrial Credit and Investment Corporation of India Limited (ICICI), Unit Trust of India (UTI) and Housing Development Finance Corporation Limited (HDFC). The unit was set up with the objective of analysing, rating and evaluating various securities and instruments such as loans, debentures, shares etc. - Three new centres of excellence headed by senior executives were created to cover financial sector, infrastructure sector and manufacturing sector. It is also the fourth largest credit rating agency in the world

ICRA LTD

ICRA was incorporated on January 16, 1991 and launched its services on August 31, 1991. ICRA is an **independent and professional** company providing investment information and credit rating services. ICRA's major shareholders include Moody's Investors Service and leading Indian financial institutions and banks. As the growth and globalisation of Indian Capital markets have led to an exponential surge in demand for professional credit risk analysis, ICRA has actively responded to this need by executing assignments including credit ratings, equity gradings, and mandated studies spanning diverse industrial sectors. In addition to being a leading credit rating agency with expertise in virtually every sector of the Indian economy, ICRA has broad-based its services to the corporate and financial sectors, both in India and overseas, and presently offers its services under three banners namely

- Rating Services
- Information Services
- Advisory Services

FITCH INDIA

Fitch Ratings is an international rating agency that provides global capital market investors with the highest quality ratings and research. Dual headquartered in New York and London, Fitch rates entities in 75 countries and has some 1,100 employees in more than 40 local offices worldwide. Fitch Ratings provides ratings for Financial Institutions, Insurance, Corporates, Structured Finance, Sovereigns and Public Finance Markets worldwide. Recently, three well-known rating agencies were integrated into Fitch – IBCA, Duff & Phelps and Thomson BankWatch -which expanded our capabilities, coverage and markets.

Fitch India is a 100% subsidiary of the Fitch Group. It is the only international rating agency with a presence on the ground in India. Fitch India is fully geared to extend the expertise and commitment of its foreign parent to Indian companies. Fitch India analysts have access to Fitch International's large global information network. Interacting with other areas of Fitch Ratings, such as the Sovereign, Structured Finance, Public Finance groups, enhances our analysts' insights into a global marketplace that is vast and evolving. We arrive at rating decisions in committees comprising senior management from Fitch International as well as sectoral specialists from Fitch India. This collaboration ensures a more comprehensive assessment as we profile an entity's strategic initiatives, competitive position, financial performance and the overall dynamics of the industry in which it operates.

In a market that is highly sensitive to economic change and that continually devises new types of debt structures, Fitch India's Structured Finance Group has developed forward-thinking rating criteria and investor services that have made us a leader in deal and performance analytics. Fitch's Structured Finance Group covers a wide variety of increasingly complex transactions that are backed by various assets. Our rating process evaluates three fundamental aspects of the transaction: the credit quality of the collateral, the financial structure of the security; and the legal separateness of the issuer. In addition, Fitch performs originator and loan file reviews, legal document review and extensive ongoing surveillance of each rated transaction.

CARE

Credit Analysis & Research Ltd. (CARE), incorporated in April 1993, is a credit rating, information and advisory services company promoted by Industrial Development Bank of India (IDBI), Canara Bank, Unit Trust of India (UTI) and other leading banks and financial services companies. In all CARE has 15 shareholders.

CARE assigned its first rating in November 1993, and upto August 31, 2003, had completed 2339 rating assignments for an aggregate value of about Rs 3572 billion. CARE's ratings are recognised by the Government of India and all regulatory authorities including the Reserve Bank of India (RBI), and the Securities and Exchange Board of India (SEBI). CARE has been granted registration by SEBI under the Securities & Exchange Board of India (Credit Rating Agencies) Regulations,1999.

The rating coverage has extended beyond industrial companies, to include public utilities, financial institutions, infrastructure projects, special purpose vehicles, state governments and municipal bodies. CARE's clients include some of the largest private sector manufacturing and financial services companies as well financial institutions of India. CARE is well equipped to rate all types of debt instruments like Commercial Paper, Fixed Deposit, Bonds, Debentures and Structured Obligations.

CARE's Information and Advisory services group prepares credit reports on specific requests from banks or business partners, conducts sector studies and provides advisory services in the areas of financial restructuring, valuation and credit appraisal systems. CARE was retained by the Disinvestment Commission, Government of India, for assistance in equity valuation of a number of state owned companies and for suggesting divestment strategies for these companies.

NEW AREAS OF OPERATION

INFORMATION SERVICES

Under these the rating agencies undertake mandate-based exercises, which are customised to address the unique needs and requirements of individual clients. Need based information solutions are ratified by a thorough verification of facts thus providing an information advantage to the investor. They have conducted mandate-based studies for clients across a wide spectrum of industries, including power, ports, automobiles, information technology and textiles.

For e.g. ICRA Information Services has undertaken the following types of mandate-based assignments:

- **Credit Assessment**
- **Due Diligence Studies**
- **Equity Assessment / Valuation**
- **Brand Valuation**
- **Group Assesment**

- **Industry Analysis**
- **Market Study**

Other Information Services include:

- **Corporate Reports**
- **Industry and Sector Research**
- **Bulletin on Money & Finance**
- **Rating Profile**
- **Customised Research**
- **Grading Services**

Corporate Reports

To facilitate investment decisions of large investors and information requirements of others, agencies offer reports on Indian corporates. These reports provide exhaustive and reliable information and analysis by Research Analysts on an ever-growing universe of corporate, with the critique covering all areas of business, industry, market, financial and operational analysis.

Corporate Reports broadly follow the following structure,

Executive Summary provides details of the company background, incorporation, history and promoter / sponsor profile. It also includes information pertaining to its products, services, capacities, location, industry and subsidiaries.

Industry background provides an over view of the industry in which the company operates. The various aspects covered include, industry structure, key trends and characteristics, consumer segments, competitive environment, regulatory framework and policy issues.

Operational Performance provides an in depth insight into the operational parameters of the company including discussion on growth in volumes, values and realisations; capacity utilization, operating efficiency, market shares and competitive positioning vis-a-vis other players in the industry. This section also includes a discussion on raw material position, industrial relations, brand strength, distribution and environmental concerns, wherever applicable. It also discusses any new projects undertaken or under consideration by the company and their status including any mergers, acquisitions, collaborations, joint ventures in the offing; major orders or contracts in hand or acquired recently ; any legal issues /

regulatory action awaiting decision or recently settled; any management changes / organizational restructuring. This section also includes a note on interim results declared and their comparison with corresponding period in previous years along with reasons for deviations.

Financial Performance provides an analysis of the financial health of the company addressing factors such as size of sales, growth, margins, returns, cash flows and working capital management. This section also discusses effects of currency depreciation, cost structures, significant concerns about accounting policies, capital structure and financial flexibility. Interim results are factored into the financial analysis wherever available. This section also examines the likely impact of planned projects on the future financial health of the corporate.

Prospects looks into the performance expectations for the company based on underlying fundamentals. This section summarises factors and issues internal to the company that are likely to affect the earnings of the company. It also includes the impact of external factors including budget / credit policy / regulatory announcements which may be expected.

Industry & Sector Research

Industry research is leveraged on the extensive sectoral knowledge, which covers a diverse spectrum of industries. Existing products include,

Industry Watch

Industry Watch Series, present an in-depth analysis of different sectors / industries, providing an insight into industry competitiveness, the imperatives of succeeding in a global scenario and the relative positions of industry participants. The studies are tailored to meet the requirements of all those who have an interest in contemporary developments in the Indian economy and in the specific industries covered. The Industry Watch Series would be useful to researchers, academics, practitioners in the financial services world and corporate managers. These studies have a distinct corporate orientation and are designed to be a useful information and analytical tool for investment and portfolio managers. The key elements that govern the business environment of the industry, the likely future direction, and the performance of the major corporate entities, form the substance of the series. Select the **'Industry Watch'** link on the left hand section of the screen to access the updated listing of available titles in this series.

Industry Comment

Industry Comment is designed to give a reader an overview of the industries covered. It presents a snapshot of the business environment of the industry, its structure, competitiveness and likely future direction. It would be useful for anyone interested in obtaining a continuous coverage of major sectors in India including updates on significant developments in the industry, changes in policy framework, and major corporate developments in a concise

Industry Flash

These are topical reports providing insights and analysis of the specific developments that take place in the industries being tracked by the Information services.

Money & Finance

With the Indian economy undergoing fundamental changes, rating agencies have built up a research programme to analyse contemporary developments that characterise Indian money and finance world. The ultimate objective is to develop analytical models, which can explain the inter-related movements of the principal macro-variables that define the monetary and fiscal sector of the Indian economy. Money & Finance is a quarterly publication.

Rating Profile

This is a unique source of reference from ICRA Limited, essential to all players in the credit markets –

Rating Profile features :

Ratings in use

Rationales for Ratings assigned

Rating Symbols & Implications

Rating Profile is useful to:

- **Investors** and lenders Fund managers and financial analysts of investing institutions; Also lending officers at commercial banks, and sovereign lending institutions.
- **Borrowers,Treasurers, finance directors and other senior executives** at issuing corporations, institutions and sovereign entities.
- **Intermediaries,** Merchant and investment banks, security houses, brokers and marketmakers.

Customised Research

The increasing magnitude and scale of cross border investments, and the rising level of complexity and volatility in the corporate environment are globally witnessed phenomena today. A multitude of seemingly lucrative investment opportunities have become available to investors, as the wave of liberalization sweeps across previously insulated economies of the world, such as India. However, the investor community is increasingly recognizing the merits of gaining a thorough understanding of the business environment and key investment related issues which could have a far reaching impact on the returns that they can expect. It is, therefore, not surprising that investors are dedicating increasing amounts of time and resources to a thorough assessment of their investment options before making commitments of magnitude. This has given rise to an increasing demand for need based solutions among investors.To address such needs,

Grading services

In line with perceived market needs, these agencies have developed highly specialised evaluation methodologies, which address unique, domain specific requirements under the umbrella of our Grading services. These methodologies are designed to provide an objective, credible and independent opinion on the quality of entities being examined with specific reference to parameters and issues unique to the domain. The approach for offering specialised grading products of this nature has included strategic association with reputable and specialised bodies associated with the domain to develop a useful grading system, which may be implemented. For e.g. ICRA has pioneered the following grading methodologies,

- **ICRA-CIDC grading for Construction Entities (**Contractors, Consultants, Project Owner & Project)

- **ICRA-NAREDCO grading for Real Estate Entities (**Real Estate Developers & Projects)

- **ICRA-HSCC grading for Health Care Entities**

- **Grading of Mutual Funds**

- **EPRA grading for Equity Grading**

ADVISORY SERVICES

Transport & Urban Infrastructure The Infrastructure Ratings Group specialises in the rating of borrowing programmes of State Governments, Municipal Corporations, Water and Sewerage Boards, Housing Boards, Urban Transport Bodies, Urban Infrastructure Financing Institutions and other bodies providing or financing urban infrastructure as well as mobile telephony service providers, value added services providers, e.g. paging, telecommunication equipment manufacturers and other bodies providing or financing telecommunication services. The division also provides credit-assessment reports on these entities to the financiers to telecommunication services projects.

Transport & Infrastructure Expertise: Rating agencies have carried out various assignments, which combine financial expertise with an intimate knowledge of local business environment and the Indian capital and debt markets. The range of services and capabilities offered by the advisory services draws on the ability to identify and assess risks.

For e.g. in infrastructure, CRISIL Advisory Services (CAS) is currently focused on sectors such as roads, ports, energy, industrial parks, and urban infrastructure. In these sectors, CAS provides advisory services at both, the policy and transactional levels. The advisory services offered by CAS in infrastructure, support the efforts of the governments at the centre and the state in managing privatisation processes in a transparent, objective and a time bound manner.

CAS has the distinction of having been appointed Consultant to various State Governments and State Government enterprises in facilitating private sector participation in infrastructure development. CAS's services complement the efforts of the key participants - State governments / Government undertakings / Major ports / State Electricity Boards / Private sector developers - in implementing the privatisation processes.

EARNINGS PROSPECTS AND RISK ANALYSIS (EPRA)

EPRA range of services are structured with a view to providing authentic information on the relative quality of equity in diverse corporates. The relative quality of equity of a company, the growth, stability and composition of its earnings are assessed by analysing the underlying fundamentals that will affect the company's future performance over the medium term. A complex combination of variables is examined including, industrial outlook, management quality, financial strength, corporate operations, competitive strength and outlook. EPRA range of services includes:

Equity Grading

Equity Grading is designed to comment upon the relative inherent quality of equity reflected by the earnings prospects, risk and financial strength associated with the specific company. Equity Grading does not predict the future market price of the stock of a company, rather it grades the fundamentals of a company, which ultimately act as important inputs in the price behaviour of the stock of such a company over the medium term and long term. Over the short term, equity grading helps in reconciling the market sentiment with respect to the stock of a company to the long term fundamentals as reflected by the equity grade. The Equity Grading process commences at the request of the prospective issuer and culminates in an opinion from the agency expressed symbolically as an equity grade.

Equity Assessment process commences at the request of an investor and the consent of the company being assessed. The agency may or may not disclose the investor's identity to the company depending upon the investor's preference. The rest of the assessment process is similar to the Equity Grading process, except that the end result is not in form of a symbol but an assessment report specific to the investor's need and intended to be used by investor only.

As an early entrant in the credit rating business, ICRA is one of the most experienced credit rating agencies in India today. ICRA rates rupee denominated debt instruments such as,

- Bonds and Debentures (Long Term)
- Fixed Deposit Programmes (Medium Term)
- Commercial Paper and Certificates of Deposit (Short Term)
- Structured Obligations and sector specific debt obligations (Issued by Infrastructure companies)

The ICRA rating is a symbolic indicator of the current opinion of the relative capability of timely servicing of debts and obligations by the corporate entity with reference to the instrument rated. The rating is based on an objective analysis of the information and clarifications obtained from the concerns as also other sources, which are considered by

ICRA to be reliable. The independence and professional approach of ICRA ensure reliable, consistent and unbiased ratings. Ratings facilitate investors to factor credit risk in their investment decision. ICRA rates long term, medium term, and short term debt instruments.
ICRA offers its rating services to a wide range of issuers including:

- **Manufacturing companies**
- **Banks and financial institutions**
- **Power companies**
- **Service companies**
- **Construction companies**
- **Insurance Companies**
- **Municipal and other local bodies**
- **Non-banking financial service companies**
- **Telecom Companies**
- **Company's involved in infrastructure such as ports, dams, roads, and highways.**

NEW AREAS IN RATING AND GRADING

Rating Criteria for Asset Backed Securitisation (ABS) transactions

The rating methodology for ABS broadly consists of evaluation the following:

· Credit Risk

· Structural/Payment Risk

· Credit Enhancement

· Legal Risk

Unlike in plain vanilla instruments, in securitisation transactions it is possible work towards a target credit rating, which could be much higher than the originators own credit rating. This is possible through a mechanism called ‘Credit enhancement’. The purpose of credit enhancement is to ensure timely payment to the investors, if the actual collection from the pool of receivables for a given period are short of the contractual payouts on ABS. ABS are normally non-recourse instruments and therefore, the repayment on ABS would have to come from the underlying assets and the credit enhancement. Therefore, the rating criteria centrally focus on the quality of the underlying assets.

Credit risk

The principal credit risk in asset backed financing is the potential impairment of cash flows resulting from delinquency or loss on securitised assets. Agencies use a qualitative and quantitative approach supported by on-site management meetings for evaluating credit risk. The following factors need to be looked into:

Originator analysis

If the originator is not a rated company, the rater takes an implicit view of the rating. This is because, of, inter alia, the continued dependence on the originator for servicing.

Portfolio analysis

In portfolio analysis, the emphasis is on that segment of business of the originator from which assets are drawn for securitisation. Factors considered include length of experience, size, market position and reach, competitive advantages of the originator, origination systems, underwriting standards, decision-making process, documentation process, monitoring and collection mechanism, and Management Information Systems.

Other factors include analysis of the of the types of the physical asset that has been financed i.e., whether the asset financed is a car or a truck or machinery, etc., ease of repossession, availability of resale market and resale value, whether the assets financed are new or old. The portfolio is also analysed over several parameters like geographical location, borrower profile, type of vehicle, size of loan, etc. in order to gain an understanding into the relative performance of the different segments. Historical repossessions, credit loss and prepayments are studied in detail. Historical collection efficiency for at least 5 years is analysed with the help of a sophisticated model in order to get a clear idea of the collection pattern.

Pool analysis

In pool analysis, the focus is on the pool being securitised. CRISIL normally specifies the criteria for pool selection like minimum seasoning, zero delinquency at the time of selection, maximum loan to value ratios, etc. For e.g. CRISIL studies the size of the pool in relation to the overall portfolio of the originator, the pool is also analysed over geographical location, borrower-profile, type or model of the vehicle, tenure, etc. to gain insights into the risk profile of the pool vis-à-vis the portfolio.

Structural / Payment Risk

In the analysis of the structural/payment risk the flow of cash from the underlying obligors to the investors is studied. The factors considered are the structure of the transaction, the mode of collection from the underlying borrowers, payment schedules to investors, etc.

Evaluation of servicer / trustee

The ability and willingness of the servicer and the trustee to manage and maintain control on the assets and the payment stream from the assets are analysed. The servicer or trustee should not be allowed to resign until a suitable successor is appointed. They should be paid a fee for their services and it should be attractive enough for others to get interested in acting as the servicer/trustee if a need arises to replace the existing servicer/trustee.

Commingling Risk

The risk that the cash flows from the securitised pool would get mixed with those of the originator is referred to as co-mingling risk. In transactions where separate collection accounts are not opened for the pool assets, the pool cash flows get mixed with that originator, if the originator performs the function of servicing. Analysis of this risk includes an estimation of the quantum of funds commingled considering the time period for which the funds are retained by the originator before passing on to the investors. Depending on the originator's short term rating, the level of credit enhancement is adjusted to address the risk of commingling.

Credit Enhancement

Rating Agencies have developed a sophisticated model to determine the extent and form of credit enhancement necessary for the desired level of rating. The rating is a function of the asset quality and the quantum of credit enhancement. Higher the rating sought, higher would be the credit enhancement required for a given pool of assets. Similarly, for a given rating, better the asset quality of the pool, lower would be the quantum of credit enhancement.

Quantum of credit enhancement

The quantum of credit enhancement required is arrived at by subjecting the pool cash flows to various stress tests. This involves analysis of the projected investor payouts on the securitised instrument, expected cash flows from the pool, the historical performance of the portfolio from which the pool has been drawn, quality of the pool vis-à-vis the portfolio, outlook for the asset class during the tenure of the instrument, etc. Thereafter, an appropriate stress multiple is used to arrive at the level of credit enhancement required for the desired rating.

Form of credit enhancement

Credit enhancements come in various forms viz. cash collateral, letter of credit, guarantees, over collateralisation, subordinate securities, etc. In case of third party credit enhancements like guarantee or line of credit, the rating of the instrument would be equated to the rating of the third party extending the credit enhancement. Therefore, when the rating of the concerned third party changes, there will be a corresponding change in the rating of the ABS. Cash collateral is used to meet the shortfall in the pool collections for the purpose of making the investor payout for a given period. Later, when the pool collections are in excess of investor payouts, the excess is used to top up the cash collateral to the stipulated level. Guarantees and Line of Credit would also function in the same way.

Overcollateralisation and subordination are credit enhancement mechanisms, which are built into the pool itself. Here the credit enhancement is achieved is by according higher payment priority to the rated senior paper. Repayment on lower rated or unrated subordinate paper is made only after meeting full obligations on the senior paper.

Legal Risk

Legal analysis is at the very core of the process of rating ABS. While the overall objective is to ensure that there is a true sale of assets to the investors and that the cash flows to the investors are not impaired in the event of the bankruptcy of the originator and the issuer, it involves a fairly detailed study of the legal documents to ensure that the investors' interest is not compromised. Besides, the securitisation transaction should comply with the local laws.

In securitisation transactions, the rating is based on the strength of assets and the credit enhancement mechanism backing the instrument. Due to this, often the rating on ABS is higher than the stand-alone rating of the originator. Therefore it is important to ensure that legally the assets and the credit enhancement mechanism are bankruptcy remote i.e., the bankruptcy of the originator will not impact the investors' claim on the pools cash flows. Bankruptcy remoteness is achieved when there is a true sale of the pool assets to the SPV. While evaluating the legal integrity, for e.g. CRISIL, in addition to studying the documents, relies on legal opinion obtained from legal counsels.

RATING OF SEB's

Pursuing power sector reforms aggressively, the government felt the need for state electricity boards (SEBs) to be rated for the purpose of future investment and selection of locations for putting up plants by the power utilities.

The ratings would be changed every six months incorporating the impact of steps taken by states during the period.

There are 15 parameters including investment, corporatisation of SEBs, functioning of regulatory commissions and steps to keep tariff fixation away from political interference, among others.

It is expected that by December the first rating s would be out.

ICRA-CIDC GRADING FOR CONSTRUCTION ENTITIES

The Concept

ICRA Limited (ICRA) and Construction Industry Development Council (CIDC) have perceived the need of enhancing efficiency in the construction sector and facilitating credit flow to it. The sector assumes considerable importance as it consumes a big chunk of national plan outlays, generates vast business activities, and provides employment to millions. However, the Indian construction industry faces several problems. The unique risk features of the sector have acted as an impediment to the flow of institutional financing to it.

With a view to enhancing the lenders' confidence in decision making for financing the construction sector and ultimately stepping up banks' participation in construction financing, ICRA and CIDC have evolved a methodology for grading all the entities in a construction project: the contractor, the consultant, the project owner, and the project itself. The aim is to develop an objective system of grading these agencies. The entity that wants to be graded can approach ICRA/CIDC with a grading request.

The grading of construction agencies is designed to provide lenders with an independent opinion on the quality of the entity being examined. It is not a recommendation to lend or not to lend to the entity concerned.

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment and credit rating agency.

The Construction Industry Development Council (CIDC) was set up by the Planning Commission along with several leading organisations in the field. The objectives of CIDC include providing a forum for all parties involved in construction to express their concerns and study various problems of the sector.

BENEFITS

As construction is a highly capital intensive activity, with long gestation periods, assessing the quality of agencies involved assumes great importance in facilitating decisions that may not result in vast infructuous expenditure of resources causing an unwanted strain on the nation.

With this in mind, the grading of construction agencies is designed to benefit the various entities involved in the following manner.

A. The Project Owner: Provide a fair picture of completion of the project as per terms and provide the level of comfort of the investment yielding planned returns.

B The Contractor: Facilitates acceptance while highlighting his competence and eliminating unhealthy undercutting or unrealistic bidding.

C The Consultant: Barriers to entry in the consultancy industry are low. Grading enables the consultant to stand out in the crowd.

D The Project: Forewarned of the risks and deficiencies in the enabling infrastructure and financing. Benefits from lower cost of indemnities and easier access to funds.

The assessment process for the contractor, the consultant, and project owner commences at the request of the respective entity. Once the mandate letter is received, ICRA-CIDC require, inter alia, the entity’s financial statements, and details regarding its organisational structure and project experience. Once the information is received, a team of analysts takes up the task of preparing a report on that entity, highlighting its business and financial risks. The support of in-house research facilities and database of ICRA and CIDC are availed of. A report prepared to the Grading Committee for assessing the entity. The whole process is highly interactive and includes inputs from sector experts including the Committee of Elders.

ICRA-CIDC ensure strict confidentiality of all information collected during the assessment process.

Methodology

The Contractor, Consultant and Owner are graded under two broad risk categories-business risk and financial risk. The indicative criteria, among other factors, include:

Criteria to assess contractor

- Business risk determinants
- Market position
- Sector of operation
- Ability to be an integrator
- Project quality track record
- Client category and diversity
- Management quality
- Quality of design systems
- Contract evaluation
- Ability to provide project finance
- Project composition
- Labour relation track record
- Financial risk determinants
- Leverage
- Financial flexibility
- Accounting quality
- Credit-worthiness of clients
- Customer advances
- Receivable management
- Liquidated damages exposure
- Contigent liabilities
- Bank guarantee rates

- Cost structure
- Contract composition
- Insurance cover

Criteria to assess consultant

- Business risk determinants
- Market reputation
- Sector of operation
- Project quality track record
- Human resources quality
- Quality of design systems
- Project composition and size
- Financial risk determinants
- Financial flexibility
- Liquidated damages exposure
- Insurance cover

Criteria to assess project owner

- Business risk determinants
- Industry characteristics
- Market position
- Operational efficiency
- New projects
- Management quality
- Financial risk determinants
- Funding policies
- Financial flexibility
- Accounting quality

Criteria to assess project risks include an analysis of the following factors among others:

- Completion risk
- Price risk
- Resource risk
- Technology risk

- Political risk
- Casualty risk
- Environmental risk
- Permitting risk
- Exchange rate risk
- Interest rate risk
- Insolvency risk
- Project development risk
- Site risk
- Financial closure risk

GRADING OF REAL ESTATE DEVELOPERS & PROJECTS

The Concept

The real estate sector assumes considerable importance as it generates vast business activities and provides a multiplier effect to the economy. Organised development of the real estate and housing sector is thus critical to the economic development of a country. Following the liberalisation of the Indian economy and the economic reform programmes, the sector has been witnessing rapid changes. With the government's increased focus on real estate and housing in terms of policy initiatives, large investments are likely to flow into the sector over the coming years.

The real estate sector has traditionally been associated with inadequate information and lack of agreed standards. The ICRA-NAREDCO grading, which is an independent opinion on the relative performance capability of the real estate entity concerned aims to serve as a tool for identifying and managing risks associated with the concerned entity.

Besides benefiting the sector participants and end users (investors/customers), the grading is designed to provide objective opinions as inputs in the pricing and credit decisions of banks/financial institutions. It is not a recommendation to lend/do business with or not to lend/not to do business with a certain entity.

The National Real Estate Development Council (NAREDCO) is the apex national body of Real Estate Developers for self-regulation of industry and bringing ethics & code of conduct in the profession. The body includes Hon'ble Minister of Urban Development and Food & Consumer Affairs, Public Sector Organisations and all practitioners of real estate sector. The mission is to improve the confidence level of lenders, investors and consumers by bringing in professional practices through self regulation and ultimately catalysing the growth of this sector. As a nodal agency NAREDCO has been invited by the Government of India to be the nodal agency for development of the concept of grading projects and developers in the Housing & Real Estate sectors.

Benefits

The grading of the real estate developers is designed to make the investors (end user/buyer of property) aware of the risks involved in the developer's ability to deliver as per specified terms and quality parameters and transfer of ownership on time. Moreover, grading would facilitate the overall growth of the real estate sector by providing the developers with incentives to conform to fair trade practices and legal requirements.

A scientifically graded project would lend itself to a more accurate and reliable estimation of risks associated with the real estate project/project promoter. This is expected to enhance the confidence of the end users and augment the interest of the lenders in these projects, thereby facilitating the flow of institutional funds to the project/project owner.

The Grade Assessment Process

The assessment process for the real estate developer or the real estate project commences at the request of the respective entity. Once the mandate letter is received, ICRA-NAREDCO require, interalia, the developer's financial statements, organisational structure and project experience. Once the information is received, a team of analysts takes up the task of preparing a report on that entity, highlighting its business and financial risks. The support of in-house research and database of ICRA and NAREDCO is availed of. A report prepared by the analysts is presented to the Grading Committee for assessing the entity. The whole process is highly interactive and includes inputs from sector experts including the Committee of Experts.

Raters ensure strict confidentiality of all information collected during the assessment process.

Methodology

The Developer and the Real Estate Project are graded under two broad risk categories - business risk and financial risk. Indicative criteria among other factors include:

Criteria to assess Developers

Business Risk Determinants:

Sector specific risk: A complete overview of the state of the economy and its near and medium term prospects. Sectoral presence of the developer/builder enterprise and consequent revenue generation capacity.

Market Position: The position of the developer vis-à-vis other players and the developer's general reputation in the market.

Project Composition: Project mix in terms of number and value of projects in hand.

Adherence to project time schedules: Present state of all the projects undertaken by the developer and the extent of adherence to milestones indicates the chances of any time overruns.

Project Quality track record: The quality of the completed projects has a vital bearing on the developer's business risk. The quality consciousness of the developer refers to the quality procedures adopted at the various project sites, material procurement and inspection systems adopted by the developer.

Project Management and Systems for timely completion: The internal planning and project management systems adopted, extent of review meetings at the on going project sites, nature of construction agencies deployed and construction techniques adopted can significantly affect the progress at the worksites.

Management Quality: Organisation structure, commitment of the management, management policies and resources deployed.

Extent of legal compliance and documentation: Conformity with building bye laws and regulations and trade practices followed. Extent of documentation also has an important bearing.

Contract Composition: Indicates the nature of contracts entered into by the developer with the construction agencies which influences the risk sharing in case of any delay or deviation.

Past projects track record: Track record of the developer in terms of quality, timely completion and transfer of ownership to the customers.

Dispute and litigation track record: Nature and extent of litigation against the developer by government/semi government/public sector agencies and the general public.

Transfer of ownership track record: Track record of the developer in terms of effective transfer of title in the past/completed projects.

Customer satisfaction: Extent of satisfaction of the customers/investors and redressal of grievances of the purchaser/investor.
Financial Risk Determinants:

Profitability: Important indicator of developer's financial strength.

Leverage: Developers that are highly leveraged face bigger problems during economic downturns.

Financial Flexibility: Financial flexibility refers to the company's ability to arrange funds in case of a liquidity crunch and erratic cash inflows.

Working Capital Management: Control of receivables and advances from customers aid working capital management thereby requiring less working capital support from external sources which require interest payments.

Insurance Cover: Insurance cover taken by the developer for its various projects reduces the risk in case of any contingencies.

Accounting Quality: Includes accounting practices and standards followed.

Contingent Liability: Any contingent liability that may significantly affect the risk profile of the developer.

Criteria to assess Real Estate Project Risks includes an analysis of the following factors among others:

Completion risk: This is the risk that the project may not be completed in time or at all due to faulty planning, cost overruns, wrong choice of construction agencies, force majeure etc.

Price risk: Price quoted should be reasonable and any risk of volatile prices due to supply-demand factors increases the price risk.
Resource risk: The risk includes the non-availability or a possibility of an adverse price movement of raw materials

Quality and non-conformance risk: This is the risk of non-conformance of laid down quality standards for construction processes and raw materials.
Political risk: This risk relates to matters such as increased taxes and any policies that may have a bearing on the project.

Project development risk: This is a risk that the project development may not take place in an orderly manner if the agreement between the landowner and developer is not clear and faulty contractual arrangements with agencies involved.

Permitting Risk: This is the risk that official clearances like approved building plans, licences from competent authorities may not be forthcoming or subject to expensive conditions.
Exchange Rate Risk: This indicates the risk of any currency fluctuation if any foreign currency liabilities are present.

Interest Rate Risk: This is the risk that the floating interest rate of the project, if any, would increase beyond the levels assumed for preparing projected cash flows.
Insolvency Risk: This is the risk of insolvency of the Developer.

Site Risk: This is the risk that the project site might have legal encumbrances.
Transfer of ownership risk: This is the risk that the ownership title may not be transferred effectively.

Penalty clause: Presence of a penalty clause in case of delay in handing over possession in time can act as a source of comfort to the investor.

In addition to the project specific risks the past track record of the developer and its financial position have an important bearing on the grading of the project.

GRADING FOR HEALTHCARE INSTITUTIONS

On the supply side, there is increasing polarisation in terms of availability of healthcare services: while the population living in urban India is enjoying increasing access to healthcare services and options, that in rural India remains under-served. The Government, traditionally the largest healthcare provider, is under pressure to meet the evolving and rising demand for healthcare services across the country. This demand-supply interaction has created the conditions for increasing private/voluntary sector participation in the delivery of healthcare services. Thus, the private/voluntary sector has been seeing its share of bed-capacity increase significantly over the decades. The health insurance industry, which hitherto accounted for only a small share of the total expenditure on health, may also be poised for a big leap, with private insurance products just round the corner.

The transformation-taking place in the healthcare sector has several implications. For users of healthcare services (patients), the choice is increasing. For healthcare entities, there is need to differentiate, and establish a favourable price-value equation. For regulators, the provision and quality of healthcare offered must be monitored. For insurers, healthcare entities with which they can associate themselves have to be identified. For lenders, the viability of healthcare entities must be ascertained. All these needs call for a system that can provide a credible, objective and unbiased opinion on the quality of care that healthcare entities are providing.

Grading for Healthcare Institutions is an opinion on the relative quality of healthcare delivered by the institution to its patients. Healthcare institutions graded higher would have better facilities, superior quality levels, and greater consistency in service delivery compared to healthcare facilities in lower grades.
The grade assigned to a Healthcare institution is applicable for a specific healthcare facility (i.e. single hospital, generally in a single location) and is not applicable to the entire healthcare organisation.

The grade assigned to a Healthcare Institution should, however, not be construed to be:

- A comment on the probability of outcome of any particular treatment, procedure or surgery
- A comment on the suitability of a particular healthcare organisation for any specific ailment(s)
- A certification that the healthcare institution is complying with all applicable regulations of the State Government and Government of India.
- A recommendation to buy / sell or invest in the financial instruments issued by the healthcare institution.
- A recommendation to provide funds through grants, loans, or donations to the hospital.

Grading Scale And Definition:

The grading scale will have two components. The first will be the hospital classification such as:

· Nursing home

· General Secondary care

· Specialty secondary care

· Multi-specialty tertiary care

· Single-specialty tertiary care

The second component of the grading scale will be the hospital's grading within that classification on a four-point scale. Thus, a typical grading could read – General Secondary care hospital assigned Grade C or Nursing Home assigned Grade B. The hospital classification will be based on the number of specialties offered by the hospital. The definition for various grades, as envisaged currently, is given below:

Grade A:

Reflects Very Good Quality of delivered patient care. A healthcare institution graded in this category has facilities, equipment, manpower and service quality levels which are consistent with the highest standards in the Indian healthcare industry.

Grade B:

Reflects Good Quality of delivered patient care. A healthcare institution graded in this category has facilities, equipment, manpower and service quality levels which are consistent with high standards in the Indian healthcare industry, although these would be lower than healthcare quality levels in Grade A hospitals.

Grade C:

Reflects an Average Quality of delivered patient care. A healthcare institution graded in this category has facilities, equipment, manpower and service quality levels which are consistent with adequate standards in the Indian healthcare industry. Improvements in specific areas would be required for such hospitals to be eligible for a higher grade.

Grade D:

Reflects Poor Quality of delivered patient care. The healthcare institution graded in this category has facilities, equipment, manpower and service quality levels which are below the average standards in the Indian healthcare industry. The grading indicates that quality standards would need to be set up in the institution and substantial improvements in patient care would be needed to obtain a higher grade.

A typical definition would read as follows:

"The Agency has classified the XYZ Hospital as a 'Specialty Secondary Care Hospital' and assigned a 'Grade B'. The grading reflects a Good Quality of delivered patient care. The healthcare institution graded in this category has facilities, equipment, manpower and service quality levels which are consistent with high standards in the Indian healthcare industry.."

Grading Process

It is a multi-layered decision making process in assigning a grading. This results in thoroughness and transparency in the grading process.

A team of at least two suitably qualified analysts is assigned to interact with the Healthcare institution's management. CRISIL strongly believes that a direct dialogue with the management allows the incorporation of non-public information in a grading decision and enables the grading to be forward looking. The topics discussed during the management meeting are wide-ranging, including Mission and Policy, regulatory compliance, medical specialties, support services, management evaluation, patient rights, nursing care and financial performance.

The process from the initial management meeting to the final assignment of the grade normally takes around three to four weeks for a multi-specialty tertiary care hospital and around one to two weeks for a nursing home.

Confidentiality

The grading process ensures complete confidentiality of information that is provided by the healthcare organisation. A substantial portion of the information provided to the agencies is only for the purpose of arriving at gradings. Such information is kept strictly confidential and is not used for any other purpose, or by any third party.

Grading Committee and Assignment of the Grading

After meeting with the management, a report is prepared, analysing the medical facilities available, support services, procedures undertaken, clinical parameters, quality and adequacy of personnel, financial performance, functioning of various review committees etc. This report is then presented to the Grading Committee that comprises of eminent people drawn from the healthcare industry. Individual grades are assigned drawing on the knowledge, experience and expertise of the committee members. The grading is a composite assessment of all the factors concerning the healthcare organisation, with key issues getting greater attention.

The Grading Committee process ensures objectivity in grading, as the decision results from the collective thinking of a group. The process also ensures a consistent level of analytical quality, as reports and discussions are focused on critical grading factors that are relevant to a particular healthcare organisation. The grading philosophy is based on rigour of analysis, transparency of grading methodology, objectivity and impartiality.

Publication

Once a final grade is assigned and accepted, it is disseminated to the agency’s subscriber clientele, as well as to the news media. In addition, CRISIL publishes detailed analytical reports in its range of information products.

Surveillance and Annual Review

After a grade has been assigned, the agency monitors the on-going performance of the organisation. Surveillance also enables analysts to stay abreast of current developments and discuss potential problem areas with the management. The primary analyst maintains periodic contact and ensures regular surveillance information is shared on a timely basis. All gradings are under continuous surveillance and even where there is no obvious reason to change the grade, CRISIL conducts a formal annual review, which involves a meeting with the company.

GRADING METHODOLOGY FOR HEALTHCARE ORGANISATIONS

The eight broad parameters, assessed for grading a healthcare institution are:

Medical Specialties:

The medical and diagnostic specialties are evaluated based on essential and desirable equipment available, qualification and adequacy of medical and other personnel, availability of requisite support services, number and nature of procedures or surgeries performed by the concerned departments, process efficiency and clinical parameters.

Quality of Support Services:

The hospital support services are evaluated based on the quality of service and degree of support provided to the medical specialties. These include:

· Billing

· Hospital Information System

· Central Sterile Supplies Department (CSSD)

· Front Office

· House Keeping

· Medical Records

· Out-Patient Department (OPD)

· Biomedical Engineering

· Maintenance

· Pharmacy

Regulatory Compliance:

The agency assesses the degree of compliance with various regulations stipulated by the Government of India, respective state governments and other independent bodies while grading a healthcare institution. Some of the key regulations include:

· Bio Medical Waste Management & Handling Rules, 1998

· Transplantation of Human Organs Act

· Nursing Home Regulation Act (wherever applicable)

· Drugs & Cosmetics Act

· BARC standards for Radiology

Financial Performance:

The financial performance of the hospital is evaluated based on the financial benchmarks developed by the agency for credit rating of hospitals. The financial performance is only evaluated to check whether the hospital is generating sufficient cash flows from operations to upgrade the essential equipment and retain qualified professionals. In case of not-for-profit organisations, the evaluation is also based on the adequacy of grants and donations to the hospitals for maintaining the existing quality of patient care.

Management Evaluation:

The management philosophies and strategies are evaluated and the agency compares the hospital business strategies and financial plans to provide insight into the management's ability with respect to forecasting and implementing plans. Specific areas reviewed include goals and strategies of the management, track record of the management in planning and control systems, ability to retain key consultants, depth of managerial talent, succession plans and quality improvement plans.

Hospital Mission & Policy:

All healthcare facilities must have clearly defined mission and policy for providing quality healthcare to the patients. The implementation of the mission throughout the hospital, in policies and procedure is a pre-requisite. The established quality improvement process throughout the organisation and diligent functioning of various review committees in the hospital are carefully assessed in the grading process.

Patient Rights:

The patient rights followed by the hospital are evaluated based on the patient feedback and the basic rights followed by the hospital. This parameter reflects an evaluation of the planning and providing of care, treatment and rehabilitation. It also considers how the organization sets care goals for each patient, and selects qualified personnel to provide and evaluate the care. However, CRISIL does not directly evaluate the nature of care provided to any individual patient. Rather, the assessment process is based on the willingness of the organization to monitor the results of care processes. The feedback of patients during the course of treatment and after discharge is observed to assess this parameter. Policies and procedures of the hospital and the individual departments will also be assessed in this module.

Nursing Care:

Nursing care provided to the patients in critical care, emergency care, private and general wards, etc., is evaluated based on the nurses to bed ratio, experience and ability of the nurses, training programs for nurses, etc. The documented and practiced nursing procedures in the hospital for admitting and nursing the patients in emergency care, operation theater, Intensive Care units, labour wards, in-patient wards, etc., are also evaluated. The ability of the hospital management to retain qualified and experienced nurses is assessed.

Based on the evaluation of the parameters mentioned above the agency arrives at the final grade for the healthcare institution. Broadly, the degree of importance of these parameters will be in the order mentioned above. However, the relative importance of these parameters in any particular grade may vary depending on the facts of the case.

Benefits Of Healthcare Institution Grading

Grading of Healthcare institutions would be a useful tool for inter-institution comparison for all constituents associated with the healthcare industry, viz., hospitals, patients, healthcare insurance companies, government and third party administrators. The specific benefits to each of these constituents is outlined below:

Hospitals

- Improved credibility which enhances the potential business revenues through increased patient flow from insurance companies / Third party administrators.
- Improved visibility for the graded healthcare facilities as the rationale is disseminated by the agency in its publication.
- Unbiased assessment by an external agency and can provide valuable inputs to the management on relative benchmarks vis-à-vis other hospitals.

Patients

- Ability to choose healthcare institutions on the basis of unbiased assessment of an independent agency instead of word of mouth.
- Improved access to in-depth information on the healthcare institution.

Healthcare Insurance Companies

- Useful input for developing sophisticated products linking level of premium with the grades assigned to the healthcare institutions, thereby providing a host of choice to prospective clients.
- Facilitates introduction of pre-approved treatment mechanism as opposed to ‘post-payment claims’, which eliminates the risk of false claims.

Government

- Improved transparency on healthcare institutions
- Useful input for policy decision and improvement of healthcare delivery standards.

Third Party Administrators (TPA)

- Provides objective criteria to selection of hospitals to be included in their network.
- Can help curtail fraudulent claims and achieve optimum claims to premium ratio from the insured population.

Grading Symbols

H1	The institution has resources and processes consistent with those required for delivering the highest quality of care.
H2	The institution has resources and processes consistent with those required for delivering high quality of care.
H3	The institution has resources and processes that can deliver moderate quality of care.
H4	The institution has resources and processes delivering low quality of care.

CORPORATE GOVERNANCE RATING

In India till the very recent past Standard And Poor was doing International corporate Governance rating. Due to the high cost being charged for this service, Rating agencies devised their own Corporate Governance rating model. CGR would indicate ICRA's current opinion on the relative level to which an organisation accepts and follows the codes and guidelines of corporate governance practices.

Corporate Governance is defined as the distribution of rights and responsibilities among different participants in the organization, such as, the board, managers, shareholders and other stake holders, and spells out rules and procedures for making decisions on corporate affairs. The focus of CGR will be on corporate's business practices and quality of disclosure standards with respect to the requirements of regulators and interests of its financial stakeholders i.e. its shareholders, lenders and creditors.

CGR is based on the core principles of corporate governance practices laid down by the business sector advisory group of OECD. These are: Fairness, Transparency, Accountability and Responsibility. The codes and standards, which are applicable, have been defined in details in the various committees constituted by the SEBI and RBI. The agency would consider these requirements and various parameters including amongst others a) the ownership structure, b) Management Structure including board level issues, c) Quality of financial reporting and other disclosures and d) fulfillment of interests of the financial stakeholders. Besides these broad parameters, it would then evaluate number of sub parameters for assigning CGRs.

CGR will not have any direct linkage with its conventional Credit Ratings. A credit rating is a current opinion on the relative ability of an issuer to meet its debt obligations as per terms. Whereas, a CGR is a current assessment of various company practices and procedures relative to the codes and standards of corporate governance. While a CGR can affect the attractiveness of a company to potential investors (debt or equity), CGR is not intended to be an opinion on specific financial obligation, credit quality, capital market valuation or operational performance. CGR is not an audit, a rating or a financial advice nor is it a recommendation to take any financial decision. Also CGR is not to be interpreted as an indicator of statutory compliance.

For the CGR exercise, the agency would have detailed interactions with the senior management of the company, its board of directors including nominee & independent directors, key shareholders, auditors and other financial stakeholders. The information which the agency will peruse and collect copies of the same would include Annual reports, intra-year financial reports, MIS reports, memorandum and articles of association of the company, documents filed with the statutory authorities, records of AGM/EGM, minutes of the board meetings, records of penalties, fines or other violations relating to abuse of shareholder rights and other relevant documents which would be case specific.

Agencies believe that this rating service would assist the corporates to develop a credible opinion on its management quality and responsiveness towards the interest of all its financial stakeholders. Improved perception of investors may in turn influence its valuation and facilitate raising of funds at favourable terms. Though CGR is not an indicator of statutory compliance, a higher CGR rating may also improve the comfort level of the statutory authorities and regulators. It can also be used as a check to determine the relative standing of the company with respect to the benchmarks of best corporate practices in the industry and country.

Agencies will provide its CGR ratings on a formal request of corporates. A CGR rating once accepted will be subject to regular periodic reviews. During these reviews the agencies would incorporate the changes in corporate's position on various parameters in the assigned CGR. For withdrawal of the CGR rating, the corporate would have to provide a written request to the agency giving a notice period of one year for withdrawal.

RATING PROCESS

In brief the key variables that are analysed while arriving at the CGR for a corporate entity are as follows:

1. Shareholding structure
2. Governance structure and management processes
3. Board structure and processes
4. Stakeholder relationship
5. Transparency and disclosures
6. Financial Discipline

The starting point of rating process is assessment is the corporate's compliance with statutory regulations as laid down in Clause 49 of the Listing Agreement. The focus of the exercise, however, is on substance over form, and to that extent, compliance with regulations is only the starting point. Besides the regulatory compliance, the CGR exercise involves perusal of various corporate documents like Board notes, Agenda Papers, Minutes of Meeting, Statutory returns submitted to the registrar of companies, the Stock Exchanges, and the SEBI, Annual Reports, disclosures in websites, etc. Additionally, the GR process involves meeting key officials of the corporate being rated, its statutory auditors, Directors (including independent directors) on the Board, and some institutional investors.

Each of these variables is scored on a set of parameters and a composite score using a proprietary model developed by the agency. The thrust of the analysis is highlighted in the following sections. Under each one of these variables, compliance with statutory requirements is also studies, but as mentioned, the same is only the starting point.

Shareholding Structure

The agency analyses an organisation's shareholding structure to understand its ownership pattern, identify the dominant shareholders, evaluate the extent of cross-holdings, and identify the extent of shares held by its promoter/promoter groups. A transparent ownership structure where the key shareholders are easily identifiable, the absence of opaque cross-holdings are considered positives from the CGR perspective.

The analysis is based primarily on the study of distribution schedule furnished to the Stock Exchanges and offer documents relating to any public/rights issues that a company made in the recent past.

Governance Structure and Management Processes

The key focus of the analyses here is on the internal decision making process followed in the company being rated and the quality and nature of information that is presented to the company's Board. For a company to be able to respond swiftly to changes in today's dynamic business environment, line managers led by the CEO must be given enough powers to take decisions in the most appropriate manner. However, its needs to be ensured that the powers are exercised in accordance with established procedures and they are in harmony with the broad policy guidelines and strategic objectives formulated by the Board.

The agency also analyses the governance structure, the extent of delegation of powers, the nature in which the accountability and responsibility are defined among the various constituents, and most importantly, the extent to which the policies and procedures laid down are practiced at the company being rated. In some cases, a company could have a formal two tier governing structure where the strategic supervision of the Board is sought to be supplemented with supervision by the executive management through a committee consisting of managers from key functional areas. In such a case the agency evaluates the frequency of meetings of the executive management committee, the written charter of the committee, the attendance tract record of members, the quality of agenda papers, the minutes of the meetings (especially with respect to the nature and level of detail) to form an opinion on the effectiveness of the committee in the decision making process. In cases where companies do not have any formal management committee, the spirit of the analysis, none-the-less, remains the same, namely to evaluate the nature of decision making process prevalent within the company and the delegation of powers within in.

Agencies also believe that the monitoring function of the Board is critically dependent on the quality of information that is supplied to it and on the procedures established to ensure that feedback is provided to the board on all times where queries, if any, have been raised. ICRA therefore evaluates the quality of information submitted to the Board especially in respect of major corporate decisions like mergers and acquisition; diversification, large capital expenditure, inter-corporate loans and other related party transactions.

Board Structure and Processes

An organisation's Board of Directors is expended to lend leadership and strategic guidance to it, ensure that legal and statutory requirements are complied with, and balance the rights and concerns of the shareholders and other stakeholders. The board is expected to have a major role to play in such areas as approving, monitoring and evaluating strategy, monitoring and evaluating performance, executive remuneration, succession planning, takeover matters, mergers and acquisitions, and investment decisions. However, the full Board may not be able to meet very frequently to devote its close attention to the business of the organization. Some of the Board functions are therefore performed through specially constituted board committees consisting mainly or wholly of Independent Directors. The more important among these are the audit committee, remuneration Committee, the Appointment Committee, the Investment Committee. Through these Board Committees, the organizations seek to strengthen the ability of the Non- Executive Directors to discharge their control functions more effectively.

Apart from the Listing Agreement, the Codes of Corporate governance as formulated by the Confederation of Indian Industry, the Cadbury Committee of UK, and others suggest various measures to strengthen the functioning of the Board. Taking these as guidelines, ICRA analysis the Board structure and process of the Company being rated with reference to various parameters, including:

- Size of the Board
- Selection criteria of Directors
- Proportion of Independent Directors
- Professional standing of Independent Directors
- Other Directorships held by Independent Directors
- Retirement/Compensation policy
- Frequency of Board meetings
- Time gap between any two meetings
- Action taken report during the last Board Meeting
- Number of Board Committees
- Attendance record of Directors

The emphasis, however, is on substance over form, and they essentially attempt to evaluate the effectiveness of the Board by examining issues like timeliness in the circulation of agenda papers, quality of information contained in the agenda papers, and comprehensiveness of the Minutes of Board meetings. Some key issues that are studies include deliberations related to major investments, capital expenditure, performance related to targets, related party transactions, compliance with statutory requirements, and possible product liability matters. The feedback from the Independent Directors on the subject is an important input in the rating process since Minutes of Board Meetings may not record the actual deliberations preceding a decision.

Among the Board Committees, the Audit Committee is clearly the most important in terms of the scope of activities. A proper functioning of the Audit Committee has the potential to improve the quality of financial reporting, strengthen the position of auditors, ensure that there is an effective internal audit function as well as internal control functions and increase the confidence in the integrity and objectivity of financial statements. The composition of the audit committee is an important issue since all its members need to have adequate experience in the areas of finance and accounts. They also review in detail the deliberations at Audit Committee meetings with respect to compliance with accounting standards, qualifications in published accounts, and major issues involving the financial reporting process, systems and control, and internal audit coverage. While it is not mandatory agencies, also refers to the recommendations of the Blue Ribbon Committee in assessing the effectiveness of the audit committee.

Clause 49 of the Listing Agreement does not make it mandatory for a company to set other Board level Committees like remuneration Committee and the Nomination Committee. However, it believes that issues like established and transparent criteria for selecting independent directors, determining director’s remuneration, and insuring that it is aligned with company’s performance; are important indicators of its corporate governance process. Therefore, if a company does not have formal remuneration or compensation committee consisting of independent directors, agencies evaluate the process by which these issues are decided by the company concerned.

Stakeholder Relations

An organisation’s shareholders are its owners, and their basic rights include: the right to have their shares transferred and registered smoothly; the right to access timely information; the right to participate in and vote at shareholders meetings; the right to elect members on the Board and the right to share the organizations profits through dividends. Shareholders also have a say in issues such as amendments to the organizations memorandum and articles of association, reduction or augmentation of share capital, and sale/lease/disposal of any undertaking or substantially the entire undertaking. Above all, all shareholders need to be treated equitably. Also an organization must have appropriate systems in place to enable its shareholders to participate effectively in shareholders meetings and cast their votes. Besides, an organization has the duty of keeping its shareholders informed of the rules and voting procedures that govern shareholders meetings.

1. Emphasis of analysis is on evaluating the extent to which a company goes beyond what is mandatorily required by law to serve the rights and interests of its shareholders. The issues analysed include:
2. Conduct of Annual/Extraordinary General Meetings (AGMs) and the extent of disclosure at such meetings
3. Procedure of transfer and registration of shares and payment of dividend
4. Company's responsiveness to investor complaints
5. Timeliness of release of any market sensitive information
6. History of penalties levied by regulators for violations of statutory provisions, if any.

Moreover, ICRA evaluates the functioning of a company's in-house Investor Services Centre or the Share Register and Transfer Agent, as the case may be. The key measures include the average time taken for functions like transfer of shares, transmission of shares, sub-division/consolidation/renewal of shares, issue of duplicate shares, dispatch of dividend warrants, and resolution of investor complaints. The purpose of the analysis is to assess how investor-friendly a company is, and how responsive it is to investor needs.

Agencies also evaluate the track record of the company being evaluated in-terms of servicing other financial stakeholders like banks, financial institutions and fixed deposit holders.

Transparency and Disclosures

Listed companies have several statutory requirements with regard to disclosure, financial results, and information that must be part of the published accounts. However, with the depth of capital markets increasing and institutional activity in the markets picking up, organizations are making voluntary disclosures that go beyond the minimum disclosure requirements. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail to access the quality of management, the organizations growth prospects, and the associated risk factors. At the same time, organization is not expected to disclose information that may endanger their competitive position. In ICRA's opinion, the information disclosed by the organization must be material and must shed light on their plans as well as the foreseeable risks.

The key parameters used for assessing a company's transparency and disclosure standards are as follows:

- Accounting quality including compliance with accepted accounting standards
- Changes in accounting policies
- Notes to accounts of materially significant nature
- Quality and level of detail in accounts, especially with respect to items like Loans and Advances, Inter-Corporate Advances and Contingent Liabilities.
- Disclosure of transaction with subsidiaries and associates
- Additional information to shareholders
- Quality of disclosures in Management Discussion and Analysis (MDA)

While assessing the MDA, ICRA evaluates the extent to which meaningful insights are available on the business segments in which a company operates, its growth prospects, and the associated risk factors since such insights could help an investor take an informed decision on the company's business prospects.

The trend in share price movements around major corporate announcements are also looked to evaluate whether price sensitive information is disseminated in a timely manner to all stakeholders.

Financial Discipline

The ultimate objective of corporate governance is to create and maximize shareholder value. While the actual shareholder value generated by a company may be dependent on a number of factors that are beyond the control of the management, ICRA believes that maintenance of a certain level of discipline in a conduct of business operations also has an important role to play. analysis therefore focuses on factors that are within the company's control, and which in the agency's opinion, impact the shareholder value that a company is able to generate in the long run. Such factors include:

- Business Segments in which the company operates
- Rationale for presence in multiple businesses
- Return on Capital employed in each business compared with the industry average
- History of equity dilution
- Extent of reliance on debt funding
- Dividend policy

- Number of Subsidiaries/associates and rationale for the same
- Nature of transactions with subsidiaries

The rating is designed to take a holistic view of the different aspects of a company's business policies and practices that are relevant to corporate governance. ICRA does not carry out an audit, and nor is its rating to be interpreted as an indicator of statutory compliance by the rating company. ICRA does not expect any direct correlation between credit rating of a company and its CGR, even though highly rated entities are, by and large, expected to have satisfactory corporate governance practices.

CGR PARAMETERS

OWNERSHIP STRUCTURE

- Analysis of shareholding
- Concentration of shareholding
- Cross holding

MANAGEMENT STRUCTURE INCLUDING BOARD LEVEL ISSUES

- Size of board
- Composition of Board including proportion of independent directors
- Selection/Election of the directors including qualification of directors
- Disclosure of Biographical information of Directors
- Age limit for Directors
- Tenure of Directors
- Role of nominee directors
- Independence of Directors
- Multiple Board seats(other Directorship)
- Responsibility of the Board
- Liability of Directors
- Accountability to stakeholders/shareholders
- Access to Information
- Relationship between Board and Management
- Constitution and functioning of Board Committee (Audit Committee, Nomination Committee, Remuneration Committee, Investor Grievance Committee)
- Conduct of board meetings in terms of regularity, participation and content
- Board meeting minutes

QUALITY OF FINANCIAL REPORTING AND OTHER DISCLOSURES

- Fairness and level of details in financial disclosure
- Disclosure and transparency related to management and transactions
- Disclosure and transparency with related party transactions,group/affiliate-companies,directors
- Accounting Standard
- Internal controls
- Independence and reputation of the auditors appointed
- Timeliness and accessibility of the information disclosed
- Disclosure related to compliance on corporate governance

FULFILLMENT OF INTERESTS OF THE FINANCIAL STAKEHOLDERS

- Shareholders rights and shareholder voting
- Conduct of shareholder meeting, extent of disclosure and minutes of the meeting
- Governance disclosure
- Shareholders resolution

PROBLEMS

Rating of corporate governance might not develop into a mass product as it calls for companies parting with lot of information including certain internal records. So it is unlikely that a great many companies will rush into rating their corporate governance.

ISSUES TO BE CONSIDERED

The role and importance of corporate governance are being re-emphasised even as the actual systems and practices of corporate governance are crumbling in places where that was least expected. It is only logical for stakeholders to call for a replacement of general perceptions of corporate governance with independent analytical evaluation. A recent, well-publicised survey by McKinsey & Co. in this regard is illuminating. In the survey, around one-fifth of the institutional investors in the sample expressed preference towards corporate governance over financials while deciding their emerging market portfolios. Further, around two-thirds (as high as that) felt corporate governance is almost as important as the balance sheet. In fact, the respondents to the survey were ready to pay a premium of 28 per cent for well-governed companies in emerging markets. The survey, which covered a sample of 188 companies in six emerging markets to test the link between market valuation and corporate governance, established that companies with better corporate governance command a higher price-to-book ratio.

The Cadbury Committee's recommendations, the OECD principles, the Confederation of Indian Industry (CII) Code, the Securities and Exchange Board of India directive through Clause 49 of the Listing Agreement, and the recent changes in the Companies Act provide the guiding principles of corporate governance. These could be excellent starting points for developing an analytical framework within which a corporate entity's quality of Corporate Governance may be assessed. When talking about stakeholders, the question that arises is: "Which stakeholder?" Stakeholders range from internal ones like equity investors, lenders, creditors, and employees to external ones such as sovereign authorities and social environments. Accordingly, the stakes could be financial and non-financial. Moreover, there could even be some conflict between the interests of the different categories of stakeholders. Defining the scope of corporate governance rating is thus essential. ICRA's corporate governance rating, for instance, limits its scope primarily to the interests of financial stakeholders.

Issues related to creation and distribution of corporate wealth are captured in the process, albeit indirectly. Conformance by a corporate entity to the requirements of rules, procedures and codes as prescribed by the appropriate statutory and/or regulatory authorities is the minimum in the benchmarking process that is part of ICRA's corporate governance rating exercise. Thus, the coverage of the analytical framework extends beyond mere compliance-compliance being only the starting point. The focus is predominantly on substance over form. It is more the spirit than the letter of the relevant rules, procedures and codes that is important. The sets of variables that have been identified are drawn from different guidelines, codes of governance and committee recommendations on the subject. These variables reflect the distribution of rights and responsibilities among the constituents of the corporate management including the shareholders, the board of directors, the executive management, and, of course, the committees constituted for specific purposes. There is a possibility that the corporate governance rating and the conventional credit rating for the same corporate entity would not converge. But they may not necessarily do so in all cases. The parameters, methodologies, target audiences and objectives of the two rating exercises are not identical, although they share certain common features. It is possible that a corporate entity following excellent corporate governance practices is unable to generate the kind of cash flows that would merit a high level of credit rating. Thus, credit rating and corporate governance rating are not necessarily co-directional. Having said that, one must still argue that in the medium to long term, the two ratings should converge. A corporate entity does not carry on its business perpetually to demonstrate excellence in corporate governance. Good corporate governance is the means and not an end by itself. Ultimately, the business has to create wealth and distribute it fairly and equitably among its diverse groups of stakeholders. ICRA's corporate governance rating exercise does not take a rigid view of the various evaluation parameters. A certain amount of flexibility is maintained, given the nature of some of the issues involved. Examples of such issues include: actual number of "Independent" directors vis-à-vis the actual level of independence of such directors; extent to which block shareholding is acceptable; disclosure (There could be instances in which beyond a level, disclosures would benefit competitors and thus eventually harm stakeholder interest.) and transparency beyond minimum statutory requirements; and acceptability of the accounting policies used, given the availability of permitted alternatives. A balanced view through the process of collective discussion at the Rating Committee meeting is taken to resolve such issues. To conclude, corporate governance rating is still a new concept worldwide, and the process is evolving. In the Indian market, a beginning has just been made with the recent announcement of the country's first corporate governance rating.

ANNEXURE 1

RATING ROUNDTABLE SUMMARY REPORT

Introduction

Opinions on the creditworthiness of issuers of securities and other financial obligations play a critical role in the investment decisions of both investors and the availability of capital to companies. Recent scandals have placed greater scrutiny on how and why company ratings are being conducted. Assessments by rating agencies define a globally uniform benchmark, and therefore are attractive as a reference for international regulatory standards to cope with the risk in increasingly interconnected financial markets. The questions arising from this observation with relation to sustainability issues are how are rating agencies evaluating the non-financial side of risk, and given the rapidly changing nature of material business risk, how should non-financial risk be assessed in the future by rating agencies?

Issues Discussed in the Conference

1. Materiality of Non-Financial Risks: The focal point of the discussion was centred on whether non-financial risks constitute a present and material threat to financial performance. An important condition for this, according to mainstream agencies, was the nature, timing and the impact of these risks. Raters laid out the importance of time horizons and the sector specific relevance of these risks. If risks are long term, they generally do not tend to be factored into mainstream ratings that assess default risk over a limited period and short-term performance. Additionally, these risks may not have the same impact across different sectors. Reputation risks may affect certain industries with greater exposure to these risks more than others. Therefore, the immediacy of risk and sector specification is a factor in considering non-qualitative risks on an assessment.

   Mainstream parties claimed that only those non-financial risks with immediate financial implications were material to gauging default risk and equity performance, and that these particular risks are currently being assessed where they overlap with financial risks. For instance, mainstream agencies will look at a company's exposure to legal liability and reputational damage. These specific non-financial risks are one reason that the tobacco industry has lower ratings than may be financially reflected. Other risks, such as corporate governance, were argued not to be an inherent element of accurately assessing company risk. Good corporate governance may be a subset of good financial performance, however companies with poor financial performance may also have good corporate governance. The difficulty of governance assessment is compounded by the need to quantify the metrics used.

Non-traditional raters countered that non-financial risk is a misnomer; rather that risks of a primarily non-financial nature have, or will have, a material business impact. They argued that non-financial risks are increasingly becoming relevant to the bottom line and should be assessed in anticipation of their materiality.

2. Corporate Governance: Another phase of discussion addressed the role of corporate governance and corporate social responsibility in the rating process and how the rating agencies can contribute to this multi-stakeholder dialogue. It was stated that corporate governance issues are easier to quantify than corporate social responsibility issues, and therefore make them an ideal first line of inquiry. Reference was made to various studies that demonstrated a lack of understanding by the board on operational issues, as well as highlighting the potential for exposure. Statistics cited included 30% of companies having been sued, 40% having no access to D&O insurance, and 70% of CEO's not understanding the role of the Chief Risk Officer, demonstrating the widespread nature of corporate governance issues with implications for financial risk assessment. This lack of understanding has the potential to cause organisation problems and financially impact the business. Rating agencies can therefore emphasize these issues and play a role in moving this to the Chief Financial Officer’s desk. In order to strengthen corporate governance in the markets, it was proposed that the level of board independence, financial transparency, and structural governance, together with providing a new framework for regulators, needed to be examined. A contrary view was offered that corporate governance may not be relevant to the primary goals of the rating agencies. Corporate governance metrics may identify management issues, but good corporate governance does not necessarily equate financial performance and may not impact the short-term nature of the ratings.
3. Regulation and Industry Governance: The impact and materiality of the growing move towards regulation and re-regulation, evidenced by recent developments such as Sarbanes-Oxley in the US, the Association of British Insurers guidelines, and new listing requirements was also discussed. Current UK listing requirements that refer to a disclosure of all “material business risk” were a particular area of interest for attendees. As “material business risk” is currently undefined, a definition that includes disclosure material sustainability risks could create a market demand for non-financial

risk based assessment. However, defining the disclosure may result in diluting the legislation by narrowing the scope on over which it can be applied; instead raters should focus on how government revenue shifts from ‘good’ to ‘bad’ companies are making non-financial risks ‘real’ costs. The internal governance of the ratings industry was also brought into question. Due to a market demand for ratings methodology, the information is made available and raters differentiate themselves through interpretations and weighting of the criteria. To avoid illicit relationships between companies and analysts, mainstream analysts must present to broader committees before in order to determine a rating, depending on the importance of the rating/company. To manage and assess corporate governance risks in new companies with new financial engineering structures while avoiding potential issues, raters have already had to strengthen their due diligence through engaging specialist teams to assess the financial engineering by employing CPA’s, off balance sheet experts, and forensic accountants.

Summary

For risks to become relevant in mainstream ratings, the case must be built that non-financial risks are in fact material to business. One of the difficulties in presenting the case for materiality of non-financial risk is the difficulty in quantifying and distinguishing the distinct impacts on credit and stock performance. Additional obstacles include the immediacy of the risk and the magnitude of sectorial exposure to such risk. However, if a market demand is generated, or the link between non-financial risk and financial impact receives buy-in from the market, either through regulation or by companies looking to capitalize on their responses to a reduction of risk, raters will be driven to incorporate this issue.