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Understanding Credit Ratings

Interest rates are fixed based on ratings – with highly rated borrowers getting lower interest rates.

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"Credit Risk" is considered a key risk in a financial activity. It could be in respect of a lender who has given a loan, or an investor who has subscribed to a bond or a supplier who has sold material on credit. Every creditor is keen to understand the risk he is taking, the probability of default scenario, and what loss he is likely to suffer.

Credit Rating is considered an appropriate tool to measure such a risk. As the popular saying goes, 'anything that cannot be measured cannot be controlled'. So, credit risk is evaluated in all its rigour, given a number or symbol which reflects the degree of risk, and also monitored over a period of time to assess whether the risk is stable, increasing or decreasing. Credit Rating Agencies (CRAs) are specialised institutions which provide independent and objective ratings.

Who pays for the rating?

While the lenders or investors are the users of the rating, the most common practice is for the borrower or issuer (of bonds or debentures) to pay for the services of CRAs. While this model does have the problem of conflict of interest (ex: Can the issuer agree to pay a higher fee for getting a better rating?), in practice, this is considered the most practical one, and the conflict is managed by rigorous supervision. The CRA's responsibility is to the lender/investor, and irrespective of the commercial issues; he needs to ensure 'transparency and objectivity' in the rating exercise.

Rating Process

Generally, the rating process starts with the borrower approaching a CRA, and giving a rating mandate with the requisite fee. The Commercial or Business wing of the CRA deals with the borrower at this stage, and closes the deal. Thereafter, the mandate is handed over to the Rating Team, which is not even aware of the commercial terms. The team gets all the required data, information and documents from the borrower, carries its own due diligence and analysis, and arrives at the rating based on applicable rating model. This is communicated to the borrower, and only after he accepts it, the rating is made public. Unaccepted ratings are considered infructuous. However, once the rating is published and available to lenders/investors, the CRA has a responsibility to do periodical surveillance, and publish results; at that time, acceptance of the revised rating is not required.

Evaluation of Risks

While the 'Industry Risk'' is the risk associated with the sector (ex: Steel Sector today has high risk, compared to Pharmaceutical Sector which has low risk, or Textiles which has moderate risk), Business Risk relates to the specific unit that is being rated. It could include items like location of the unit, technology or machinery being used, availability of inputs for manufacturing, market for the products, supplier or customer concentration issues, market share, etc. Financial Risk evaluates operating performance like business growth, profitability, promoter's stake in the business, gearing, liquidity, working capital management, etc. More weightage is given to this risk in most rating models, as, ultimately, ability to service debt in a timely manner is well reflected in the key financial ratios that are used. Management Risk considers strength of the ownership and professional management, succession planning, etc. In most cases, existing businesses of promoters, group activities, past track record of debt servicing, etc., are also adequately factored.

Ratings

The ratings, generally, are expressed in a scale from AAA to D, with AAA representing 'Highest Safety'', C representing the Highest Risk, and D representing Default.

What this means is that at the highest level, a very small percentage of borrowers default and reverse is true at the lower levels. BBB- and above are considered "Investment Grade" and the others ''Non-investment Grade". Anyway, the ratings are not cast in stone, and can vary if there are positive or negative developments over a period of time. For example, if a BBB rated borrower is downgraded to BB, it means, the credit quality has deteriorated, and greater caution is required.

Conclusion

While rating is mandatory in some cases (eg., issue of NCDs or Fixed Deposits in the market), it is voluntary in other cases. Interest rates are fixed based on ratings – with highly rated borrowers getting lower interest rates. Banks use the ratings for 'risk weighting' their loans for capital adequacy requirements under Basel guidelines. Credit Risk Rating, thus, has become an integral part of credit risk management, across the globe.