3.1 INTRODUCTION

The economic growth of any country depends, to a greater extent, on a vibrant capital market as it facilitates the transformation of savings into investment. It may be noted that the development of capital market depends, among other factors, on the dissemination of complete information and the existence of knowledgeable investors. The growth story of the Indian capital market started in the mid-1980s.

The Indian economy has been growing fast since the adoption of the Liberalization Policy in 1991. At present, the Indian economy is integrating with the global economy. In tandem with the economy, the capital market is also growing fast. Over the years, various tailor-made financial instruments have been introduced in the capital market to cater to the needs of diverse investors. The growth of the capital market and increase in the varieties of instruments created not only opportunities for the investors, but also complexities in the market as, even the reputation of the issuer-company is no longer a guarantee to the quality of the financial instrument which it issues. Hence, a general caution to the customers, caveat emptor (buyer beware), is also applicable to investors. Credit ratings make information about default likelihoods and recovery rates of a security widely available, limiting duplication of effort in financial markets. They allow uninformed investors to quickly assess the broad risk properties of tens of thousands of
individual securities using a single and well-known scale. In addition, ratings are relied on extensively in regulation and private contracting, and as a tool for measuring and limiting risk. Commercial banks, insurance companies and pension funds are among the institutions facing regulatory rules based on credit ratings. Many investors can only hold securities with investment grade ratings such as pension funds, money market funds are required to use different amount of capital based on the ratings of securities they hold. For these reasons, ratings constitute a key channel of information dissemination in financial markets and are considered important by legislators, regulators, issuers and investors alike. The quality of ratings is therefore quite relevant for the proper functioning of the financial system. Credit ratings have recently attracted considerable attention from financial market investors looking for objective assessments of credit worthiness and investment risk, and the default probabilities of individuals, corporations, and even countries. A credit rating is a common index for evaluating the financial health of organizations and individuals.

3.2 CREDIT RATING AGENCIES

A credit rating agency is a company that assesses the debt instruments (bonds and other securities) issued by firms or governments and assigns “credit ratings” to these instruments based on the likelihood that the debt will be repaid. Originating in the United States during the 1850s to provide information on the railroad industry's financial status, over the next century, CRAs developed in a haphazard way to rate a wide variety of debt. In the late 1960s, the CRAs began charging debt issuers to rate their securities, and these fees came to produce the vast bulk of the CRAs' income. As financial
markets became larger, more open, and more complex, the desire of both sellers and buyers to have securities rated also grew enormously. The CRAs are odd beasts: They are private firms with public purposes - hence the term credit rating agencies, not credit rating firms. They are fully private in terms of ownership, employees and, in general, revenues. Still, some analysts argue that the CRAs are "more properly viewed as quasi-government entities" because they serve the public function of determining (under existing regulations) which securities can (or cannot) be held by other regulated businesses. Credit-ratings agencies follow certain procedures and use domain knowledge to determine ratings scales using public and private financial data. Additionally, these agencies periodically update credit ratings based on changes in operating conditions and economic environments. Thus, credit ratings offer the following benefits:

(1) Credit ratings can improve a firm’s brand image;
(2) Credit ratings help investors evaluate and assess the credit risk of specific firms;
(3) Credit ratings increase financing flexibility for specific firms; and
(4) Credit ratings highlight key investment targets for investor decision-making and reduce the costs for interested parties associated with collecting information.

3.3 ORIGIN AND GROWTH OF CREDIT RATING AGENCIES

The pioneer professional thinker Louis Tappan established a mercantile rating agency in 1841 in New York, to predict the ability of merchants to pay financial obligation following the financial crisis of 1837
in USA, a financial analyst, established another rating agency and published the analytical work done by it. The application of credit rating to corporate instruments for the first time is traceable with the publication by Henry Vemum Poor's financial data of rail road companies entitled The History of Rail Roads and Canals of the United States, in the 1860's in USA. The other famous agencies in the US include Dun & Bradstreet (Moody's Subsidiary), Duff & Phelps (D&P) of Chicago, McCarthy, Cnsanti & Maffei (MCM) of New York, Xerox Corp, Unit, and Fitch's Investors service (Fitch) at New York. The credit rating has become a part of the activity of the financial market and a must for the corporate growth in the UK, Japan, Canada, Australia, Austria, France, South Korea, Philippines, Indonesia, Thailand and Malaysia. The importance of credit rating has increased more and more with the growth and development of financial intermediaries and institutional investors.

Such informal channels sufficed for a time, but by the 1830s the expanding scale and scope of American business gave rise to a new institution, the specialized credit reporting agency. The history of one of these agencies is well documented, and it ties in directly with the related business of credit ratings. In 1841, Lewis Tappan, a New York dry goods and silk merchant, who in the course of his business had compiled extensive records on the creditworthiness of his customers, decided to specialize on the provision of commercial information. Tappan founded the Mercantile Agency, which gathered through a network of agents and sold to

76 Henry Vemum Poor's name is associated with Standard & Poor's, the world famous and familiar credit rating agency.
subscribers’ information on the business standing and creditworthiness of businesses all over the United States. The Mercantile Agency became R.G. Dun and Company in 1859. The company’s subscribers, which included wholesalers, importers, manufacturers, banks, and insurance companies, grew from 7,000 in the 1870s to 40,000 in the 1880s, and by 1900 its reports covered more than a million businesses.78

John Bradstreet of Cincinnati founded a similar firm in 1849, and by 1857 was publishing what apparently was the world’s first commercial rating book. The Dun and the Bradstreet companies merged in 1933 to form Dun & Bradstreet. In 1962, Dun & Bradstreet acquired Moody’s Investors Service, the bond rating agency that John Moody had begun in 1909.79 Thus the closely related businesses of credit reporting and bond rating came together under one corporate roof, although they apparently still operate as independent organization80. A number of credit rating agencies commenced operations all over the world. These included the Canadian Bond Rating service (1972), Thomas Bank watch (1974), Japanese Bond Rating Institute (1975), McCarthy Crisani & Maffei (1975) Dominican Bond Rating Service (1997), IBCA Limited (1978), and Duff & Phelps Credit Rating Company (1980). There are credit rating agencies in many other countries such as

Malaysia, Philippines, Mexico, Indonesia, Pakistan, Cyprus, Korea, Thailand and Australia.

3.4 FUNCTIONS OF A CREDIT RATING AGENCY

A credit rating agency serves the following functions.

3.4.1. Provides unbiased opinion: An independent credit rating agency is likely to provide an unbiased opinion as to the relative capability of the company to service debt obligations because of the following reasons:

i. It has no vested interest in an issue unlike brokers, financial intermediaries.

ii. Its own reputation is at stake.

3.4.2. Provides quality and dependable information: A credit rating agency is in a position to provide quality information on credit risk which is more authentic and reliable because:

i. It has highly trained and professional staffs that have better ability to assess risk.

ii. It has access to a lot of information which may not be publicly available.

3.4.3. Provides information at low cost: Most of the investors rely on the ratings assigned by the rating agencies while taking investment decisions. These ratings are published in the form of reports and are available easily on the payment of a negligible price. It is not possible for the investors to assess the creditworthiness of the companies on their own.
3.4.4. **Provide easy to understand information**: Rating agencies first of all gather information, then analyse the same. At last, these interpret and summarise complex information in a simple and readily understood formal manner. Thus in other words, information supplied by rating agencies can be easily understood by the investors. They need not go into the details of the financial statements.

3.4.5. **Provide basis for investment**: An investment rated by a credit rating enjoys higher confidence from investors. Investors can make an estimate of the risk and return associated with a particular rated issue while investing money in them.

3.4.6. **Healthy discipline on corporate borrowers**: Higher credit rating to any credit investment enhances corporate image and builds up goodwill and hence it induces a healthy/discipline on the corporate.

3.4.7. **Formation of public policy**: Once the debt securities are rated professionally, it would be easier to formulate public policy guidelines as to the eligibility of securities to be included in different kinds of institutional portfolio.

3.5 **CREDIT RATING AGENCIES: IN INDIAN PERSPECTIVE**

The Indian economy, particularly the financial market, entered a new era in the 1980’s. Economic liberalization gave rise to several opportunities for investment. To cash in on the opportunities, entrepreneurs have taken up several projects involving a huge amount of funds. In other words,
companies have undertaken fund-raising programmes on a large scale. At the same time, business risks have increased with the liberalization of the economy. The success of industrial projects has become a gamble. As the industrial environment has become highly competitive and demanding, the companies have become jittery about their profitability. The earlier assurance of a protected environment has ceased to exit. It may be noted that one of the economic problems faced by a developing country such as India is the difficulty in mobilizing funds to meet the increasing needs of the industry. The levels of income of people are not high enough to generate adequate savings. The financial markets are not developed enough to mobilize even the meager savings generated and channelize them into capital formation. The industrial policy of the government, however, has encouraged rapid industrialization, which has resulted in a phenomenal increase in the number of investors and the amount of funds mobilized. The number of companies tapping the capital market directly has also increased. But the investors have realized that the company’s name and size has no longer a sufficient guarantee of timely payment of interest and the principal amount. It is in the context that policymakers thought of introducing the credit rating system in India."}

Accordingly, the Industrial Credit and Investment Corporation of India Ltd., (ICICI) and the Unit Trust of India (UTI) promoted the first rating agency, called the Credit Information Service of India Ltd (CRISIL), in 1988. Although many developed nations such as the United States, United Kingdom, France, Japan, Canada and Australia already had credit rating

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agencies by them, India was the first country in the developing world to set up a credit rating agency. With the integration of financial markets all over the world, credit ratings have become more important. As the financial market has become highly competitive, the credit rating symbol has replaced the country’s size and name. It is also said that the advent of the credit rating system reflects the capital market attaining a certain level of sophistication.

The following are the Indian credit rating agencies registered with SEBI.

1. Credit Rating Information Service of India Limited (CRISIL)
2. Investment Information and Credit Rating Agency of India Limited (ICRA)
3. Credit Analysis and Research Limited
4. Fitch India Limited
5. Onicra Credit Rating Agency of India Limited
7. SME Rating Agency of India Limited.

3.5.1 Credit Rating Information Services of India Limited (CRISIL)

CRISIL headquartered at Mumbai is India’s largest and first credit rating agency; and a global leader in research, ratings and risk and policy advisory services. It is one of the top credit rating agencies in India which has won many prestigious awards in the credit rating category and had assessed more than 61000 entities.

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CRISIL is India’s leading rating, research, risk and policy advisory company, and is the fourth largest in the world. It was incorporated in 1987 and was promoted by Industrial Credit and Investment Corporation of India Ltd. (ICICI) and Unit Trust of India (UTI). It commenced its operations of rating in 1987-88. CRISIL has its association with internationally recognized rating agency Standard and Poor’s (S&P) since 1996. CRISIL’s majority shareholder is Standard and Poor’s which is a subsidiary of The McGraw-Hill Companies. The latter is the world’s foremost provider of independent credit ratings, indices, risk evaluation, investment research and data. CRISIL has been recognized by SEBI under the Securities & Exchange Board of India (Credit Rating Agencies). Rating and Risk Assessment, Infrastructure Advisory, and Business Research.83

CRISIL’s services include credit ratings and risk assessment; research on India’s economy, industries and companies; financial research and outsourcing; fund services; risk management and infrastructure advisory services. Through its IPO Grading, CRISIL has also established a presence in the equity research domain. It provides all these services through its different subsidiaries. CRISIL provides rating and risk assessment services to manufacturing companies, banks, non banking financial companies, and financial institutions, housing finance companies, municipal bodies and companies in the infrastructure sector. It rates long term instruments such as debentures, bonds, preference shares, structured obligations, fixed deposits, commercial paper and short term deposits. It makes credit assessments of various entities including state governments and subsidiaries and joint

ventures of multinationals. It also assigns ratings of financial strength to insurance companies. CRISIL has developed several structured ratings for multinational corporations based on guarantees and letter of comfort from the parent companies as well as standby letter of credit arrangements from bankers.

CRISIL has also introduced CRISIL Governance and Value creation (GVC) ratings. Under this, CRISIL makes an assessment of management quality, an indicator of value creation potential, and also the value creation for various stakeholders. It is a genuine 360-degree evaluation rather than analysis of one aspect alone.

CRISIL has spearheaded the formation of the world’s first regional credit rating agency, known as the Carribean Information and Credit Rating Services Limited (CariCRIS). CariCRIS, spanning 19 countries has a diversified shareholding comprising some of the central banks in the region, U.S. and European commercial banks, development banks and financial institutions. CariCRIS has become a model for many countries in Europe, the Mediterranean and West Asia. CRISIL Investment and Risk Management Services, set up in 2003, has a developed a software tool, Corporate Risk Evaluator (CORE), to enable corporate organisations to comply with clause 49 of the listing guidelines and three distinct features.

CRISIL undertakes in-depth analysis and research on a sectoral basis. Within a span of 20 years, CRISIL has become the fourth- largest rating

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agency in the world. In spite of a competitive environment, it commands more than 60 percent of the rating market.

3.5.2 ICRA Limited

ICRA limited a joint venture between Moody’s Investors and various financial services companies, is a part of ICRA group which was founded in 1991. It is a Credit rating agency listed on the National Stock Exchange and Bombay Stock Exchange. ICRA has four subsidiaries ICRA Management Consulting Services Ltd, ICRA Techno Analytics Ltd, ICRA Online Ltd, PT, ICRA Indonesia and ICRA Lanka Ltd.

ICRA promoted by IFCI during the year 1996-97 ICRA Ltd., was (formerly called as Investment information and credit rating agency of India Ltd) incorporated on Jan 16, 1991 and launched its services on August31, 1991. ICRA holds 26 per cent share capital of IFCI Ltd, the other share holders are the Unit Trust of India(UTI) banks, LIC, GIC, EXIM Bank, HDFC Ltd., and ILFS Ltd., In order to bring international experience and practices to the Indian capital markets, the ICRA has entered into an MOU with Moody’s Investors services to provide, through its company Financial Programmes Inc (FPI), credit education, risk management software, credit research and consulting services to banks, Financial / Investment institutions, financial services companies and mutual funds in India.85

In order to enable investors to take informed decisions on investing in mutual funds, ICRA has launched rating services for debt funds and Indian

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85 www.icra.com
mutual funds. Similarly it has launched grading services for entities involved in the construction projects including contractors, consultants, project owners and the project themselves\textsuperscript{86}.

In 2001, ICRA launched corporate governance rating with a focus on corporate organization’s business practices and quality of disclosure standards with respect to the requirements of regulators and interests of financial stakeholders. The grading system developed by ICRA for real estate developers helps buyers of property to assess the risks associated with the developer’s ability to deliver in accordance with the terms and conditions.

ICRA has also launched a grading scheme for healthcare institutions as well as maritime training institutes in India. The NSIC-ICRA performance and credit rating scheme provides a boost to the development of small scale enterprises in India. The grading of initial public offerings aims at facilitating the assessment of equity issues offered to the public.

3.5.3 Credit Analysis & Research Ltd. (CARE)

CARE was incorporated in April 1993 as a credit rating information and advisory services company. It is a credit rating and information services company promoted by the Industrial Development Bank of India (IDBI) jointly with financial institutions, public / private sector banks and private finance companies. It offers a wide range of products and services in the field of credit information and equity research. In January 1994, CARE

commenced publication of CAREVIEW, quarterly Journal of CARE ratings. In addition to the rationale of all accepted ratings, CAREVIEW often carries special features of interest to issues of debt instruments, investors and other market players. CARE has 14 shareholders.

CARE currently offers the services such as rating services, advisory services, information services and equity research services. CARE ratings are recognized by Government of India, Reserve Bank of India and Stock Exchange Board of India. The rating coverage extends to industrial companies, public utilities, financial institutions, infrastructure projects, special purpose vehicles, state government and municipal bodies. CARE rates all types of instruments like commercial papers, fixed deposits, bonds, debentures and structures obligations. CARE’s information and advisory service group prepares credit reports on specific requests from banks or business partners.

Apart from rating services, CARE provides advisory services such as project advisory services and financial restructuring services. CARE also prepares confidential reports for companies, which may be useful in taking decisions with regard to financial options, joint ventures, acquisitions and collaborations. CARE conducts sector studies, which may be useful to industry participants, financial intermediaries and financial analysts. CARE helps banks and non-banking finance companies to set up or modify their credit appraisal system.

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3.5.4 Fitch India Limited

Duff and Phelps Credit Rating India Private Ltd was the first joint venture rating company promoted by JM Financials, Alliance Group and the international rating agency Duff and Phelps. Established in 1995, Duff and Phelps offered a wide range of services including rating services and advisory services. With the acquisition of Duff and Phelps Credit company in April 2000 by Fitch Ratings, Duff and Phelps Rating India Private Limited became Fitch India Limited.

Fitch introduced a ratings scale to meet the growing demand for independent analysis of financial securities. Fitch was one of the three rating agencies that were first declared as nationally recognized statistical rating organizations by the Securities and Exchange Commission in 1975. Fitch has 49 offices worldwide with the coverage of more than 3,000 financial institutions, more than 1,200 corporate issuers and 89 sovereigns. The company has over 8,600 structured finance transactions and also maintains surveillance of more than 1,200 European structured finance transactions and 200 Asian structured finance transactions.

Fitch India analysis have access to Fitch internationals large global information network. The credit rating of Fitch apply to a variety of entities and issues, including but not limited to Sovereigns, government structured financing, and corporations, debts, preferred stock, bank loans and counter parties, as well as the financial strength of insurance companies and financial guarantors.89

3.5.5 ONICRA

ONICRA Credit Rating Agency is a Credit and Performance Rating company based in Gurgaon and founded in 1993. ONICRA is among the top 10 credit rating agencies in India offering smart and innovative solutions like risk assessment, analytical solutions and ratings to MSMEs, corporate and individuals.

Onida Credit rating agency of India Ltd., has pioneered individual credit rating services in India. It was incorporated in October 1993 for providing the services of individual credit rating and information services for the first time in India. It has developed over the years the methodology to assess the financial risks in respect of various types of transactions related to individuals and small and medium enterprises. ONICRA is presently operating at commercial scale. It provides pre and post disbursement and activation solutions so as to bridge the gap between the principals and their customer. It also serves clients in auto finance, consumer finance, credit card issues and cellular phones service providers.90

3.5.6 Brickwork Ratings India Pvt Limited

Brickworks Rating India Pvt Ltd was founded in 2007 by group of professionals to provide rating of public issues and others to help investors take information decisions. The services provided by Brickwork are issuer rating (rating of issuers such as state governments, companies, financial institutions and banks), short term rating (rating of short term securities

such as CDs and CPs), long term rating (rating of long term securities such as bonds, debentures and structured products), IPO rating, fixed deposit rating, mutual fund rating, SME rating, bank loan rating, facility rating, insurance company rating, corporate governance rating, real estate project rating. In addition, Brickworks provides training and research services.

Brickworks assign two types of credit ratings - one to the issuers and the other to specific debt issues or other financial obligations. The rating of issuer, which is called “Brickworks counterparty credit rating”, reflects the current opinion about an issuer’s overall capacity to fulfill its financial obligations. The other type of rating is the rating of issues, mainly the debt issues. Four types of analysis were made on debt issues namely business analysis, industry analysis, financial analysis and management analysis.

3.5.7 SME Rating Agency of India Limited (SMERA)

The SME Rating Agency of India Limited, popularly known as SMERA, is a joint venture started by Small Industrial Development Bank of India (SIDBI), Dun & Brandstreet Information Services India Private Limited (D&B) and several leading banks in India. SMERA is the country’s first rating agency that focuses primarily on small and medium enterprises (SME) in India. The main objective of rating SMEs is to facilitate greater and easier flow of credit to SMEs from the banking sector.

SMERA makes two types of analysis- business risk analysis and financial analysis. It takes into consideration the overall financial as well as non financial performance of SME in its rating process. Financial performance is assessed by ratio analysis and important ratios considered as
profitability ratios, growth ratios, gearing ratios and liquidity ratios among others. Management experience, qualifications, customer and supplier base are also considered to assess non-financial performance.  

SMERA commenced its operations in 2005 as an exclusive credit rating agency for Micro, Small and Medium Enterprises (MSME) sector in the country. Within a span of 8 years, SMERA has assigned ratings to over 27154 MSMEs in India. SMERA is registered with the Securities and Exchange Board of India (SEBI) as a Credit Rating Agency (6th in India). More recently, the Company has received accreditation from the Reserve Bank of India (RBI) as an External Credit Assessment Institution (ECAI) under BASEL - II norms for undertaking bank loan ratings. SMERA is also empanelled as an approved rating agency by the National Small Industries Corporation Ltd. (NSIC) under the “Performance & Credit Rating Scheme for Small Industries”, approved by the Ministry of Small Scale Industries, Government of India. 

SMERA has achieved the reputation of providing comprehensive, transparent and reliable ratings, thus providing comfort and confidence to lenders and investors alike in decision making. SMERA ratings have gained wide acceptability and are now an integral part of the risk assessment process within the lending and investing community. It has its registered and Head Office in Mumbai, currently operating from 13 locations spread across the country.

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3.6 CREDIT BUREAUS

With Credit Information Companies Act getting passed by the Government of India in 2005, Credit Bureau formally got introduced to the country. CIBIL (Credit Information Bureau of India Limited) was established as the first credit bureau. The other credit bureaus approved by RBI are Esperian, Equifax and Highmark.

3.6.1 Credit Information Bureau India Limited - (CIBIL)

CIBIL headquartered at Mumbai is a Credit Information Company which maintains records of an individual’s payments related to credit cards and loans. The information about users’ credit cards and loans is later used by CIBIL to generate Credit information reports which are used to approve loan applications.93

CIBIL collects and maintains records of an individual’s payments pertaining to loans and credit cards. These records are submitted to CIBIL by banks and other lenders, on a monthly basis. This information is then used to create Credit Information Reports (CIR) and credit scores which are provided to lenders in order to help evaluate and approve loan applications.

CIBIL’s products, especially the CIBIL Trans Union Score and the CIR are very important in the loan approval process. The credit score helps loan providers quickly determine, who they would like to evaluate further to provide credit. The CIBIL Trans Union Score ranges from 300 to 900. The data indicates that loan providers prefer a credit scores which are greater

93 www.cibil.com
than 700. The loan provider has to decide which set of loan applicants to evaluate, it analyzes the CIR in order to determine the applicants eligibility. Eligibility basically means the applicants ability to take additional debt and repay additional outflows given their current commitments. Post completion of these first two steps the loan provider will request for the applicants income proof and other relevant documents in order to finally sanction the loan.

3.6.2 Equifax

Equifax Inc started operations in 1899 and has managed to be among the top credit rating agencies in India and at the global level. Equifax Inc provide information management services that process thousands of records of its members which can be used by them for various purposes and to supply risk management solutions, credit risk management and analysis, fraud detection triggers, decision technologies, marketing tools etc.94

3.6.3 High Mark Credit Information Services

High Mark Credit Information Services is a recognized credit rating company in India. It provides bureau services, analytic solutions and risk management to banks and financial institutions operating in micro-finance, Retail consumer finance, MSME, rural and cooperative sectors.

High Mark is India's newest and the fastest growing credit bureau. High Mark's sole motto is to create a comprehensive and robust credit bureau environment in India, to promote responsible lending and

financial inclusion in its truest form. Address India’s unique data challenges through innovation and the use of the best available technologies. Build India is the most comprehensive and accurate credit and identity database, which facilitate financial inclusion of India’s priority sectors by building meaningful credit assessments for these sectors, the absence of which has been a key obstacle to credit / economic growth. High Mark shares RBI's vision of total financial inclusion in India.

High Mark, brings together advanced identity management technology from its own research team and draws global best practices in top tier bureau technology, with an aim to create India’s most innovative credit bureau. High Mark offers smart and innovative solutions to Enterprises across the Industry spectrum. High Mark offerings best suits banks and financial institutions operating in retail consumer finance, MSME, microfinance, rural and cooperative lending sectors; and organizations in telecommunication and insurance sectors. It also offers “Identity Resolution” or “Entity Resolution” enterprise solutions to its clientele.

3.6.4 Experian

Experian is a global credit bureau established in 1980 with its headquarters in Dublin and operations in 36 different countries. It is a global leader in providing information solutions to organisations and consumers. They combine the power of our comprehensive credit history database, scoring expertise and sophisticated software to deliver holistic solutions to the South African credit granting industry.
3.7 CREDIT RATING

Credit rating is an alphabetical or alphanumerical representation of the credit worthiness of the individual, business or instrument of a business. However, ratings merely express an opinion on the credibility of the entity and cannot be considered to be a recommendation. A credit rating is an opinion on the creditworthiness of a debt issue or issuer. The rating does not provide guidance on other aspects essential for investment decisions, such as market liquidity or price volatility. As a result, bonds with the same rating may have very different market prices. Despite this fact, and even though each rating agency has its own rating methodologies and scales, market participants have often treated similarly rated securities as generally fungible. According to rating agencies, ratings are opinions and not recommendations to purchase, sell, or hold any security. Rating agencies have generally stated in contracts with ratings users that their opinions are not financial advice. This has traditionally shielded them from investor litigation and until recently prevented direct regulation of their operations. Credit ratings are aimed at reducing information asymmetries by providing information on the rated security. They can also help solve some principal-agent problems, such as capping the amount of risk that the agent can take on behalf of the principal. In addition, ratings can solve collective action problems of dispersed debt investors by helping them to monitor performance, with downgrades serving as a signal to take action. Indeed, a rating from a recognized rating agency, while not intended to do so, effectively reduces the burden on investors to research the credit-worthiness of a security or issuer. Credit ratings are typically among the main tools used by portfolio managers in their investment decisions and by lenders in their
credit decisions. The reliance on ratings also reflects regulatory requirements in most countries.

Credit ratings make information about default likelihoods and recovery rates of a security widely available, limiting duplication of effort in financial markets. They allow uninformed investors to quickly assess the broad risk properties of tens of thousands of individual securities using a single and well-known scale. In addition, ratings are relied on extensively in regulation and private contracting, and as a tool for measuring and limiting risk. For example, commercial banks, insurance companies and pension funds are among the institutions facing regulatory rules based on credit ratings. Many investors can only hold securities with investment grade ratings such pension funds, money market funds are required to use different amount of capital based on the ratings of securities they hold. For these reasons, ratings constitute a key channel of information dissemination in financial markets and are considered important by legislators, regulators, issuers and investors alike. The quality of ratings is therefore quite relevant for the proper functioning of the financial system. While the importance of a viable ratings industry seems clear, the provision of accurate ratings is made more complicated by the peculiar market structure of the industry.

Ratings once produced are made publicly available and investors who rely on them use them for free. Users of ratings, such as investors who consider buying a security, desire accurate ratings. However, firms whose securities are rated prefer favorable ratings as it directly lowers their cost of

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capital, and do not necessarily prefer accurate ones. Since rating agencies’
revenues come from issuers, a basic tension exists between the desire of
raters to please individual paying customers and the raters’ need to maintain
the overall precision and in formativeness of credit ratings.

3.8. CRAs Vs CREDIT RATINGS

CRAs are companies that evaluate the credit risk of banks, insurers
and other businesses. The debt securities and capital instruments of these
businesses may also be the subject of a credit rating. The evaluation, or
review, is translated into a credit rating, which is used by investors, among
others, to evaluate the risk of a loan or its likely return. The higher the credit
worthiness of a business, the higher the rating that is issued.96

3.9 RATING METHODOLOGY

Rating is defined as, “An evaluation of a corporate or municipal
bond's relative safety from an investment standpoint. Basically, it scrutinizes
the issuer's ability to repay the principal and make interest payments”. It is
an analyst's recommendation on whether to buy, sell or hold a specific
stock.

3.9.1 Factors considering for rating of instruments

i. The growth of information technology.

ii. Globalization of financial markets.

iii. Increasing role of capital and money markets.

Journal of Disclosure and Governance, 8(4), 40.
iv. Lack of government safety measures.
v. The trend towards privatisation.
vi. Securitization of debt.

3.9.1.1 Indications of the Assigned Ratings

Rating symbols assigned to a security issue is an indicator of the following:

i. The nature and terms of the particular security being issued;
ii. The ability and the willingness of the issuer of a security to make payments in time;
iii. The probability that the issuer will make a default in payments;
iv. The degree of protection available to the investors if the security issuer company is liquidated, re-organised or declared bankrupt.

3.9.1.2 Factors Affecting Assigned Ratings

The following factors generally influence the ratings to be assigned by a credit rating agency:

1. The security issuer’s ability to service its debt. In order, they calculate the past and likely future cash flows and compare with fixed interest obligations of the issuer.
2. The volume and composition of outstanding debt.
3. The stability of the future cash flows and earning capacity of company.
4. The interest coverage ratio i.e. how many times the issuer is able to meet its fixed interest obligations.
5. Ratio of current assets to current liabilities (i.e. current ratio (CR)) is calculated to assess the liquidity position of the issuing firm.

6. The value of assets pledged as collateral security and the security’s priority of claim against the issuing firm’s assets.

7. Market position of the company products is judged by the demand for the products, competitors market share, distribution channels etc.

8. Operational efficiency is judged by capacity utilisation, prospects of expansion, modernisation and diversification, availability of raw material etc.

9. Track record of promoters, directors and expertise of staff also affect the rating of a company.

3.9.2 Instruments for Rating

Rating may be carried out by the rating agencies in respect of the following:

i. Equity shares issued by a company.

ii. Preference shares issued by a company.

iii. Bonds/debentures issued by corporate, government etc.

iv. Commercial papers issued by manufacturing companies, finance companies, banks and financial institutions for raising short-term loans.

v. Fixed deposits raised for medium-term ranking as unsecured borrowings.

vi. Borrowers who have borrowed money.

vii. Individuals.

viii. Asset backed securities are assessed to determine the risk associated with them.
3.9.3 Rating other than Debt Instruments

Credit Rating has been extended to all those activities where uncertainty and risk is involved. Now-a-days credit rating is not just limited to debts instruments but also covers the following:

3.9.3.1 Country Rating

A country may be rated whenever a loan is to be extended or some major investment is to be made in it by international investors to determine the safety and security of their investments. A number of factors such as growth rate, industrial and agricultural production, government policies, inflation, fiscal deficit etc. are taken into consideration to arrive at such rating. Any upgrade movement in such - ratings has a positive impact on the stock markets. Morgan Stanley, Moody’s etc. give country ratings.

3.9.3.2 Rating of Real Estate Builders and Developers

The rating is for a particular project and not for the company as a whole. Projects with approved plans and necessary planning permits are taken up for rating.

3.9.3.3 Chit Funds

Chit funds registered as a company are sometimes rated on their ability to make timely payment of prize money to subscribers. The rating helps the chit funds in better marketing of their fund and in widening of the subscribers base.
3.9.3.4 Rating of States

States of India have also approached rating agencies for rating. Rating helps the State to attract investors both from India and abroad to make investments. Investors find safety of their funds while investing in a state with good rating. Foreign companies also come forward and set up projects in such states with positive rating. Rating agencies take into account various economic parameters such as industrial and agricultural growth of the State, availability of raw material, labor etc. and political parties’ agenda with respect to industry, labor etc., relation between Centre and State and freedom enjoyed by the states in taking decisions while assigning final rating to the states.

3.9.3.5 Rating of Banks

The debt servicing ability of a bank is rated. CRISIL and ICRA both are engaged in rating of banks based on the following six parameters also called CAMELS.

C - C stands for capital adequacy of banks. A bank needs to maintain at least 10% capital against risky assets of the bank.

A - A stands for asset quality. The loan is examined to determine non-performing assets. An asset/loan is considered non-performing asset where either interest or principal is unpaid for two quarters or more. Ratios like NPA to Net Advances, Adequacy of Provision & Debt Service Coverage Ratio are also calculated to know exact picture of quality of asset of a bank.
M - M stands for management evaluation. Here, the efficiency and effectiveness of management in framing plans and policies is examined. Ratios like ROI, Return on Capital Employed (ROCE) and Return on Assets (ROA) are calculated to comment upon the bank’s efficiency to utilise the assets.

L - L indicates liquidity position. Liquid and current ratios are determined to find out the bank’s ability to meet its short-term claims.

S - S stands for Systems and Control. Existing systems are studied in detail to determine their adequacy and efficacy.

Thus, the above six parameters are analysed in detail by the rating agency and then the final rating is given to a particular bank. Ratings vary from A to D. Where A denotes financial, managerial and operational soundness of a bank, and D denotes that bank is in financial crisis and lacks managerial expertise and is facing operational problems.

3.9.3.6 Equity Rating

The rating of equities of the companies is called equity grading. Equity rating is very common in international capital market. Now a day’s analysts specialised in equity ratings make a forecast of the stock prices of a company. They study thoroughly the trend of sales, operating profits and other variables and make a forecast of the earning capacity and profitability position of a company. They use financial statement analysis tools like ratio analysis, trend analysis, fund flow analysis and cash flow analysis to comment upon a company’s liquidity, solvency, profitability and overall
efficiency position. Analysts suggest a target price of the stock giving signal to the investor to swing into action whenever the stock hits that particular price.

3.10 FUNDAMENTAL PRINCIPLES OF RATING AND GRADING

A basic requirement in risk grading is that it should reflect a clear and fine distinction between credit grades covering default risks and safe risks in the short run. While there is no ideal number or grades that would facilitate achieving the objective, it is expected that ‘more granularity’ may serve the following purposes.

Objective analysis of portfolio risk

- Appropriate pricing of various risk grade borrowers, with a focus on low risk borrowers in terms of lower pricing.
- Allocation of risk capital for high-risk graded exposures.
- Achieving accuracy and consistency.

RBI insists that, there should be an ideal balance (in numbers) between ‘acceptable credit risk and unacceptable credit risk’ in a grading system. The scales/grades denoted by numbers (1, 2, 3…) or alphabets (AAA, AA, BBB, BB etc.). In deciding upon the number of scales / grades, the basic issue according to Michael Crouchy et al is: “Is the number of gradations appropriate to distinguish among the range of risks?”

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The main aim of the credit rating system is the measurement or quantification of credit risk so as to specifically identify the probability of default (PD), exposure of default (EAD) and loss given default (LGD). Hence it needs a tool to implement the credit rating method (generally the Point-in-time method). The agency also needs to design appropriate measures for various grades of credit at an individual level or at a portfolio level. These grades may generally be any of the following forms:

Alphabet: AAA, AA, BBB, BB etc., [Annexure II]
Number: I, II, III etc.,

3.11 DETERMINANTS OF RATINGS

The default risk assessment and quality rating assigned to an issue are primarily determined by three factors. They are:

i) The issues’ ability to pay
ii) The strength of the security owners’ claim on the issue, and
iii) The economic significance of the industry and market place of the issuer.

Ratio analysis is used to analyse the present and future earning power of the issuing corporation and to get insight into the strengths and weakness of the firms. Bond rating agencies have suggested guidelines about what value each ratio should have within a particular quality rating. Different ratios are favoured by rating agencies. Moreover, the values of each firms’ ratios vary in a cyclical fashion through the ups and downs of the business cycle. To assess the strength of security owners’ claim, the protective
provisions in the indenture (legal instrument specifying bond owners rights), are designed to ensure the safety of investors. The factors considered with regard to the economic significance and size of the issuer includes: nature of the industry in which issues is operating (specifically issues like position in the economy, life cycle of the industry, labour situation, supply factors, vitality, major vulnerabilities etc.,) and the competition faced by the issuer (Market share, technological leadership, production efficiency, financial structure etc.)

3.11.1 Non- Rating Related Activities

CRAs often undertake a variety of non rating related activities. CRAs have set up a vast research base for tracking the performance of industries/companies/state governments/financial markets. It makes available customized research and diagnostic reports for the government, investors, banks, financial organizations, project developers, corporate, e-commerce websites and market places and regulations on pre-decided terms of reference. Clients typically use the information reports for formulating investing decisions, joint venture/alliance formation, strategic planning and finalizing commercial agreements. The services include the following:

3.11.1.1 Economy and Company Research: Some Indian CRAs have set up research arms to complement their rating activities. These arms carry out research on the economy, industries and specific companies, and make the same available to external subscribers for a fee. In addition, they disseminate opinions on the performance of the economy or specific industries, available

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through releases to the media. The research would also be used internally by the rating agencies for arriving at their rating opinions. SEBI permits CRAs to carry out this activity subject to relevant firewalls.

3.11.1.2 **Risk consulting:** With the application of Basel II regulations for banks, there is a considerable demand for tools and products that will allow banks to compute their capital adequacy ratios under the revised guidelines. The risk consulting groups of credit rating agencies would leverage the agencies’ understanding of credit risk to develop and provide the tools and data that banks would require. The products in this area include tools for internal ratings, operational risk evaluation, and overall capital calculation.

3.11.1.3 **Funds research:** Some CRAs have diversified from mutual fund ratings into mutual fund research. The services that are available under this head include fund rankings, performance attribution tools (to help users understand the reasons for funds’ performance), desktop tools, and fixed income research.

3.11.1.4 **Advisory services:** CRAs offer various kinds of advisory services, usually through dedicated advisory arms. Most of this is in the nature of developing policy frameworks, bid process management, public private partnership consulting, and creating an enabling environment for business in India and globally. Advisory services are offered in the areas of securitization transactions, structuring financial instruments, financing of infrastructure projects and municipal finances.

3.11.1.5 **Knowledge Process Outsourcing:** Some Indian CRAs (CRISIL and ICRA) have KPO arms that leverage their analytical skills and other
process and manpower capabilities. These arms provide services to the CRAs’ affiliates in developed markets, and also to other clients outside.

3.11.1.6 Information Services: The broad objective of the information services is to make available information on any company, industry or sector required by a business enterprise. The value addition, through inclusive analysis enables the users of the service, like individuals, mutual funds, investment companies, residents or non residents, to make informed decision regarding investment.

3.12 RATING PROCESS

Rating is a multilayered decision making process. The process of rating starts with a rating request from the issuer, and the signing of a rating agreement. The rating agreement has important factors like confidentiality, agreement by the issuer to share information with the CRA for the purpose of assigning the rating and thereafter on an ongoing basis when the rating is under surveillance. The rating agency undertakes discussion with the management of the issuing entity. Discussions during a management meeting are wide-ranging, covering competitive position, strategy, financial policy, historical performance, and near- and long-term financial and business outlook. Discussions with company managements help rating analysts evaluate management capability and risk appetite, which is an important aspect of the evaluation. After discussion with the issuer's management, a report is prepared detailing the analyst team’s assessment of the business risk, financial risk, and management risk associated with the issuer. The report is then presented to the rating committee. This is the only aspect of the process in which the issuer does not directly participate.
Drawing on the knowledge and expertise of the participants, the rating committee determines the rating. The process is an attempt to ensure objectivity of the rating, since the decision results from the collective thinking of a group of experts analyzing the risks pertaining to the issuer and its competitors in the industry and markets in which they operate.

On finalization of a rating at the rating committee meeting, the rating decision is communicated to the issuer. As the decision to get an initial rating is at the issuer's discretion (except, in India, for public issues of debt), the global best practice is to allow the issuer to decide whether to accept the rating. If the issuer disagrees with the rating, it can also appeal for a fresh look at the rating assigned.

The rating committee then discusses the information submitted; it may or may not decide to modify the rating, depending on the facts of the case. If the rating is not changed and the issuer continues to disagree with the rating, it can choose not to accept the rating, which then does not get published.

3.12.1 Steps in Process of Rating

1. Credit Rating Agency enters into an agreement with the client whose securities are to be rated.
   a. Rights and liabilities of the parties are defined.
   b. Fees charged are specified.
   c. Tenure for periodic review of the rating is specified.
   d. The client shall disclose the credit rating received for its listed securities and disclose the same in its offer document whether or not it is accepted by him.
e. Ensure confidentiality of all the information disseminated by the client.

f. The rating agency shall exercise due diligence to ensure that the rating assigned is fair and appropriate.

2. Rating agencies on the basis of several premises assign the credit rating and communicate to the client/issuer.

3. The issuer can make one request for review of the rating based on fresh facts and clarifications.

4. Then the final rating is assigned and the same is published along with the definition of the concerned rating along with the symbol.

5. A copy of the rating is filed with the board along with any modifications and additions made thereafter.

6. The rating agency will also publish the rationale behind the rating assigned and the justification to the premises considered, favorable assessment and factors constituting risk.

7. Once accepted, it is disclosed and put in the surveillance process.

8. Surveillance: Continuous review of the ratings assigned to the rating agency. Frequency of the reviews may vary from quarterly to annually as per the agreement.

9. Credit Watch: In case of any event taking place, that may result in major deviations from the expected trends and which are likely to impact the credibility, rating of the entity, such instruments are put on credit watch, until the impact of the event is not evident or clear.

10. Investments in investment grade: Investors are advised to invest in securities up to investment grade level.
3.12.2 Obligations of Credit Rating Agencies: Code of Conduct

- They shall observe high standards of integrity and fairness in all their dealings.
- Fulfill all its obligations in a prompt, ethical and professional manner.
- Protect the interest of the investors.
- Render at all times.

- High standards of service.
- Exercise due diligence.
- Exercise independent professional judgment.
- Provide unbiased services.
  - Any conflict of interest in the rating analysis shall be avoided and disclosed, if any
  - Shall NOT indulge in unfair competition.
  - Shall maintain confidentiality of the information disclosed by the client during the process of rating or pass any price sensitive information.
  - Shall not make false statements about its capability to render services or its qualifications and achievements.
  - Shall NOT make an untrue statement or suppress material facts while rating a security.\(^99\)}
3.13 REGULATORY FRAMEWORK OF CREDIT RATING AGENCIES

The regulatory relationship can be benign or it can be adversarial. It affects virtually all corporate to an extent, and is obviously critical in the case of setting rates to credit instruments – where it is a factor in all assessment of business risk. The Securities and Exchange Commission (SEC) has designated certain firms as “Nationally Recognized Statistical Rating Organizations” (NRSROs). The ratings of these firms can be used for various regulatory purposes, and many investors will only consider ratings by an NRSRO when making investment decisions. This may also make entry in the industry more difficult. SEC Commissioner Paul S. Atkins, argues that “the unintended consequence of the SEC's approach to credit rating agencies was to limit competition and information flowing to investors. The legislative history reflects a genuine concern that the SEC facilitated the perpetuated and an oligopoly in the credit rating business.

3.13.1 Regulatory Framework of CRAs in India

Credit rating agencies are regulated by the SEBI. The main elements of Credit Rating Agencies Regulations are: (i) their registration (ii) their general obligations (iii) restrictions on the rating of securities (iv) procedure for inspection and investigation and (v) action in case of default.

3.13.1.1 SEBI Regulations

The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 empower SEBI to regulate CRAs operating in India. In fact, SEBI was one of the first few regulators, globally, to put in place an
effective and comprehensive regulation for CRAs. In contrast, the US market saw CRA regulations only recently (in 2007), and the European Union is still in the process of framing its regulations. SEBI’s CRA regulations have been used as a model by other regulators in the emerging economies. In terms of the SEBI Regulations, a CRA has been defined as a body corporate which is engaged in or proposes to be engaged in, the business of rating of securities offered by way of public or rights issue. The term - securities has been defined under the Securities Contract (Regulation) Act, 1956. SEBI has also prescribed a Code of Conduct to be followed by the rating agencies in the CRA Regulations. However, SEBI administers the activities of CRAs with respect to their role in securities market only. SEBI regulation for CRAs has been designed to ensure the following:

3.13.1.2 Registration of Credit Rating Agencies

Registration with SEBI is mandatory for carrying on the rating business. The application for the grant of certificate of registration should be made to the SEBI in Form A (Appendix 16-A) and accompanied by a non-refundable fee of Rs.25000.

3.13.1.3 Promoter of Credit Rating Agency

A credit rating agency can be promoted by a (i) Public financial institutions as defined in section 4-A of the companies Act.(ii) Scheduled Bank. (iii) Foreign Bank Operating in India with RBI approval (iv) Foreign credit rating agency having at least five years experience in rating securities and (v) any company incorporated under the companies Act/ body corporate, having continuous net worth of a minimum of Rs.100 crores as per its
audited annual accounts for the previous five years prior to filling of the application with the SEBI for registration.

3.13.1.4 Grant of Certificate of Registration

The SEBI will grant to eligible applicants a certificate of registration on the payment of a fee of Rs.5,00,000, subject to the conditions specified below:

(A) The CRA would comply with the provisions of the SEBI Act/regulations and guidelines/directions/circulars and instructions issued by the SEBI, from time to time, on the subject of credit rating.

(B) (i) where any information/particulars furnished to the SEBI by a CRA is found to be false/misleading in any material particular or has undergone changes subsequent to its furnishing at the time of application, it would immediately inform SEBI in writing and

(ii) The certificate of registration is valid for a period of three years, renewable for subsequent three years terms on payment of a renewal fee of Rs. 3,00,000 each time.

3.13.1.5 General Obligations

The following are some of the general obligations specified in the CRA regulations. CRAs are amongst the very few market intermediaries for which such detailed operating guidelines have been prescribed under the regulations.
These regulations cover issues with respect to confidentiality of information and disclosure with respect to the rationale of the rating being assigned. Several other provisions exist, like the regulator’s right to inspect a CRA. An important feature of the regulation is that CRAs are prohibited from rating their promoters and associates.

3.13.1.6 SEBI Code of Conduct

SEBI’s code of conduct for CRAs addresses some of the basic issues relating to conflicts of interest. The Code of Conduct is designed to ensure transparent and independent functioning of CRAs.

Some of the salient provisions of the Code of Conduct are:

✓ A CRA shall make all efforts to protect the interests of investors.
✓ A CRA shall at all times exercise due diligence, ensure proper care and exercise independent professional judgment in order to achieve and maintain objectivity and independence in the rating process.

✓ A CRA shall have in place a rating process that reflects consistent and international rating standards.

✓ A CRA shall keep track of all important changes relating to the client companies and shall develop efficient and responsive systems to yield timely and accurate ratings. Further, a CRA shall also monitor closely all relevant factors that might affect the creditworthiness of the issuers.

✓ A CRA shall disclose its rating methodology to clients, users and the public.

✓ A CRA shall not make any exaggerated statement, whether oral or written, to the client either about its qualification or its capability to render certain services or its achievements with regard to the services rendered to other clients. 100

3.13.1.7 Restrictions on Rating of Securities

Restrictions on rating by CRAs relate to securities issued by (i) promoters and (ii) certain other entities.

3.13.1.8 Securities issued by promoters

A CRA is prohibited from rating securities issued by its promoter(s), who holds 10 per cent, or more, of its shares. If the promoter is a lending institution, its chairman/director/employee(s) cannot hold a similar position

100 Report of Ministry of Finance, Capital Markets Division, 38.
in the CRA or its rating committee. However, a CRA may rate a security issued by its associate having a common independent director with it or rating company if

(i) The independent director does not participate in the discussions in the rating decision and

(ii) The CRA makes a disclosure in the rating announcement of such associate on its board or of its rating committee and that the independent director did not participate in the rating process or in the meeting of the Board of Directors or in the meeting of the rating committee when the securities rating of the associate was discussed.

3.13.1.9 Securities Issued by Certain Entities

The security of any entity cannot be rated by a CRA if it is (a) a borrower of its promoter (b) subsidiary of its promoter, (c) an associate (i.e., a person holding at least 10 per cent of the share capital) of its promoter when there are common (i) Chairman/director (ii) employees common to CRAs and these entities and (iii) there are common chairman/ director/ employees of rating committee. It should also not rate a security issued by its associate/ subsidiary if the chairman/ director/ employee of the ACR/ its rating committee also holds a similar position in such an entity.

3.13.1.10 Procedure for Inspection/ Investigation

The SEBI is empowered to appoint inspecting officer(s) to undertake inspection/ investigation of the books of accounts/ records/ documents of the CRAs: (i) to ascertain whether they are being maintained properly, (ii) to
ascertain whether the provisions of the SEBI Act/these regulations are being complied with, (iii) to investigate into complaints from investors/clients, whose securities are rated by any other person, regarding any matter having a bearing on the activities of the CRA and (iv) in the interest of the securities market/investors.

Before ordering an inspection/investigation, the SEBI would give at least 10 days’ written notice to the CRA, except where satisfied that, in the interest of the investors, no notice is required. The inspection would ordinarily not go on examining the appropriateness of ratings assigned on merit. In case of complaints of a serious nature, however, the appropriateness of the ratings may also be covered by the inspection, which would be carried out either by the officer(s) of the SEBI or independent experts with relevant experience, or a combination of both.

3.13.1.11 Rating and its Default Risk:

Most investors prefer to use credit ratings to assess default risk. The bond issuers pay the rating agency to evaluate the quality of bond issue in order to increase the demand for their bonds. The rating agency determines the appropriate bond rating by assessing various factors. Not all bonds are rated by the agencies. Small issues and those placed privately are generally not rated. Large number of firms with low ratings usually defaults. It suggests that knowledge about credit rating does not help in assessing the financial risk that can lead to default.
3.13.1.12 Action in Case of Default

The CRAs that (a) fail to comply with any condition, subject to which certificates of registration had been granted, or (b) contravene any of the provisions of the SEBI Act/these regulations/any other regulation under the SEBI Act, would be dealt with in the manner provided under the SEBI procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty Regulations 2002.\textsuperscript{101}

3.13.1.13 Municipality of Regulators

A significant portion of CRAs’ revenues are from products that come under the purview of SEBI. However, there are rating agency products that are regulated by RBI (such as bank loans, fixed deposits, and commercial paper). RBI carries out a detailed and rigorous evaluation of Indian CRAs before granting them External Credit Assessment Institution status for rating of bank loans under Basel II. Further, some regulators (such as IRDA and PFRDA) have incorporated ratings into the investment guidelines for the entities they regulate. The list of various products, and the relevant regulators, are as noted below

Table 3.1

Products/instruments required for mandatory rating before issuance

<table>
<thead>
<tr>
<th>S.No</th>
<th>Instruments</th>
<th>Regulators</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Public / Rights/ Listed issue of bonds</td>
<td>SEBI</td>
</tr>
<tr>
<td>2</td>
<td>IPO Grading</td>
<td>SEBI</td>
</tr>
<tr>
<td>3</td>
<td>Capital protection oriented funds</td>
<td>SEBI</td>
</tr>
<tr>
<td>4</td>
<td>Collective Investment Schemes of plantation companies</td>
<td>SEBI</td>
</tr>
<tr>
<td>5</td>
<td>Commercial papers</td>
<td>RBI</td>
</tr>
<tr>
<td>6</td>
<td>Bank loans</td>
<td>RBI</td>
</tr>
<tr>
<td>7</td>
<td>Security receipts</td>
<td>RBI</td>
</tr>
<tr>
<td>8</td>
<td>Securitized instruments</td>
<td>RBI</td>
</tr>
<tr>
<td>9</td>
<td>Fixed deposits by NBFCs &amp; HFCs</td>
<td>RBI</td>
</tr>
<tr>
<td>10</td>
<td>LPG/SKO Rating</td>
<td>Ministry of Petroleum and Natural Gas</td>
</tr>
<tr>
<td>11</td>
<td>Maritime Grading</td>
<td>Directorate General of Shipping (for some courses)</td>
</tr>
</tbody>
</table>
Table 3.2
Products not required mandatory rating

<table>
<thead>
<tr>
<th>Performance Grading (non financial instruments)</th>
<th>Rating (Financial Instruments)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate Developer/Project rating</td>
<td>Privately-placed bonds and debentures</td>
</tr>
<tr>
<td>Broker grading</td>
<td>Short term debt/Fixed deposits invested by non-banks and bank CD’s</td>
</tr>
<tr>
<td>Governance and Value Creation ratings</td>
<td>Bond Fund ratings (except Capital protection-oriented funds)</td>
</tr>
<tr>
<td>MFI Grading (encouraged by SIDBI, Nabard)</td>
<td>Financial strength ratings for insurance companies</td>
</tr>
<tr>
<td>NSIC rating for SSI/SME ratings (encouraged by NSIC)</td>
<td></td>
</tr>
<tr>
<td>Contractor grading</td>
<td></td>
</tr>
</tbody>
</table>

Regulatory Prescriptions of use of rating for investment purpose:

<table>
<thead>
<tr>
<th>S.No</th>
<th>Product</th>
<th>Regulator</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Bank investments in unrated non-SLR portfolio</td>
<td>RBI</td>
</tr>
<tr>
<td>2</td>
<td>Investments by Insurance companies</td>
<td>IRDA</td>
</tr>
<tr>
<td>3</td>
<td>Provident Fund investments</td>
<td>Government of India</td>
</tr>
</tbody>
</table>

3.14 FUTURE OF CREDIT RATING IN INDIA

At present commercial papers, bonds and debentures with maturities exceeding 18 months and fixed deposits of large non-banking companies registered with RBI, fixed deposit programme of manufacturing companies are required to be compulsorily rated. In addition, the rating agencies are
expected to be called upon to enlarge volumes of securitization of debt and structuring of customized instruments to meet the needs of issuers of different class of investors. Recently the rating agencies cover new ground namely rating of municipal bonds, state government borrowings, commercial banks, public sector undertakings, rating of educational institutions, rating of equity shares etc., so, the outlook for credit rating industry is positive.

The experiences of credit rating industry so far is about 40% to 50% of their ratings are not expected to be used. Instances are there when companies with poor ratings which are not accepted by one company have gone to another for better rating. These raise doubts about the efficacy of rating agencies in servicing the investors.

The major constraint faced by the credit rating agency is the low level of disclosure by Indian companies. Rating agencies have complained of inadequate access to information, poor quality of audit and long time lags in the availability of data. The companies often do not co-operate whenever they feel that disclosure of a particular piece of information might not be in their interest. All these act as systematic constraint on the rating service.

The Indian credit rating agencies have made strategic alliance with reputed institutional agencies. They adapt, to a large extent, the rating methodologies adopted by their western counterparts. The suitability of rating methods and models formulated in well developed markets in the west are highly doubtful in Indian conditions. The rating agencies in India have to evolve their own methodologies within the context of macroeconomic environment.