Chapter 1

1 INTRODUCTION

1.1 About Credit Rating:

Credit Rating is an opinion expressed by an independent professional organization, after making a detailed study of all relevant factors. Such an opinion will be of great assistance to investors in taking decisions regarding the investments. It also helps the issuers of debt instruments to price their issues correctly and to reach out to new investors. Regulators like Reserve Bank of India (RBI) and Securities & Exchange Board of India (SEBI) often use credit ratings to determine the eligibility criteria for some instruments like commercial papers etc. In general, credit rating is expected to improve quality consciousness in the market and establish, over a period of time, a more meaningful relationship between the quality of debt and yield from it.

Credit Rating Agencies in India have evolved as a prominent force in developing the financial markets and creating awareness amongst investors over the years. Serving as information intermediaries between the issuers and investors, the rating agencies are in the process of developing new methods for performance measurement and are transiting into new areas. During their long existence of around two decades, ratings industry has evolved greatly and has been playing a pivotal role in Indian markets. The increasing significance of credit ratings services could be discerned from their past performance. There has been a tremendous expansion of their operations thereby exerting
significant impact on industrial capitalization both in quantitative and qualitative terms.

1.2 Role & Rationale of Credit Ratings

A credit rating is technically a view on the relative degree of risk associated with timely payment of interest and principal on a debt instrument. It is an ‘informed’ indication of the likelihood of default of an issuer on a debt instrument, relative to the respective likelihoods of default of other issuers in the market. It is therefore an independent, easy-to-use measure of relative credit risk. Given the universal reliance on rating, and hence the power of the opinion, credit rating is expected to increase the efficiency of the market by reducing information asymmetry and lowering costs for both borrowers and lenders.

A simple alphanumeric symbol is normally used to convey a credit rating. *Ordinarily the company which issues the debt instrument is not rated. It is the instrument which is rated by the rating agency.* But the issuer company which has issued the debt instrument gets strength and credibility with the grade of rating awarded to the credit instrument it intends to issue to the public for raising funds. Though the purpose of rating is to rate instruments, a general perception may be gathered that the organization that issues a highly rated instrument is also sound and a highly rated entity. Thus, credit rating is a mechanism whereby an independent third party makes an assessment, based on different sources of information on the credit quality of the assessed.
1.3 Summary

I. A credit rating assesses the credit worthiness of an individual, corporation, or even a country. It tells a lender or investor the probability of the subject being able to pay back a loan.

II. Credit ratings are calculated from financial history and current assets and liabilities.

III. The ratings are expressed in code numbers which can be easily comprehended by the lay investors.

IV. A poor credit rating indicates a high risk of defaulting on a loan, and thus leads to high interest rates.

1.4 Need for Credit Rating

Over the years, Credit Rating Agencies, (CRAs) have come to occupy as information and insight gate keepers; they play an important role in the realm of modern capital markets. Their importance to various stakeholders is as follows:

1.4.1 Investors

CRAs typically opine on the credit risk of issuers of securities and their financial obligations. Given the vast amount of information available to investors today—some of it valuable, some of it not – CRAs can play a useful role in helping investors and others sift through this information, and analyze the credit risks they face when lending to a particular borrower or when purchasing an issuer’s debt and debt like securities. CRAs also provide investors with rating reports, giving detailed information and analytical judgments on the issuer's business
and financial risk profile. This assists investors in taking more informed investment decisions, calibrated to their own risk-return preferences.

1.4.2 Issuers

Issuers rely on credit ratings as an important tool to access investors and also to reach a wider investor base than they otherwise could. In most cases, successful placement of a significant bond issuance needs at least one rating from a recognised CRA; *without a rating, the issue may be undersubscribed or the price offered by investors may not be appropriate*. Further, they enable issuers to price their issues competitively. In financial markets, the price of debt is determined primarily by the rating of the debt issue.

1.4.3 Significance for Banks- Bank Loan Ratings

I. As required by Basel capital accord, risk weights are assigned to all rated and unrated bank exposures.

II. Although credit rating is not mandatory under Basel II, banks are likely to save capital if they get their loan rated. If a bank chooses to keep some of its loans unrated, it may have to provide, as per extant RBI instructions, a risk weight of 100 per cent for credit risk on such loans. As provided under Basel II, supervisors may increase the standard risk weight for unrated claims where a higher risk weight is warranted by the overall default experience in their jurisdiction. Further, as part of the supervisory review process, the supervisor may also consider whether the credit quality of corporate claims held by individual banks should warrant a standard risk weight higher than 100%.
III. In terms of RBI instructions on the 'New Capital Adequacy Framework (Basel II) issued in April 2007, banks were required to initially assign a risk weight of 100 per cent in respect of unrated claims on corporates with the caveat that such claims would be assigned higher risk weights over time.

IV. To begin with, for the financial year 2008-09, all fresh sanctions or renewals in respect of unrated claims on corporates in excess of Rs.50 crores were to attract a risk weight of 150 per cent, and with effect from April 1, 2009, all fresh sanctions or renewals in respect of unrated claims on corporates in excess of Rs. 10 crores were to attract a risk weight of 150 per cent. This higher risk weight of 150 per cent for unrated corporate claims was equivalent to the risk weight to be assigned to exposures rated BB and below.

V. However, in November 2008, as a counter cyclical measure, RBI relaxed the regulatory prescription of 150 percent risk weight for unrated claims. Accordingly, all unrated claims on corporates, irrespective of the amount currently attract a uniform risk weight of 100 percent.

VI. On the other hand, by getting loans rated, a bank can save capital on loans in the better rated categories.

VII. A large number of Indian companies, hitherto unrated by rating agencies, have now come forward to get their bank facilities rated. Basel-II norms hold significant potential for further development of the domestic debt markets, by introducing into the public domain easily accessible credit information about a large pool of mid-sized companies. This will not only
allow these companies to explore alternative sources of funds, but, through greater visibility, also facilitate healthy competition among fund providers. For banks and other investors, it creates an information base that can be used for efficient portfolio selection. The acceptance of credit ratings by the investor community has led to investors showing increasing interest in the bank loan rating portfolio. Investors have also begun to consider offering a suite of market-linked borrowing products (including non-convertible debentures, commercial paper, and MIBOR-linked short-term debt instruments) to rated mid-sized companies.

Even as per Basel II guidelines on Internal Ratings Based approach in Credit Risk Management, the significance of external ratings is same. Banks have to validate their internal rating models by benchmarking to the external ratings. Validation of internal models is a mandatory requirement under IRB approaches. Reserve Bank of India has recently permitted some Big Banks to migrate to the Advanced approaches where under, these Banks will have to demonstrate their ability to assess the credit worthiness of Borrowers based upon their data availability, after which their dependence upon External Rating Agencies will cease to exist and substantial amounts of capital can be saved.

1.4.4 Regulators

Regulators, typically banking regulators and capital market regulators, use credit ratings, or permit ratings to be used, for regulatory purposes. For example, under the Basel II capital framework of the Basel Committee on Banking Supervision, banking regulators can accredit
credit rating agencies based on specified criteria. The ratings assigned by these accredited External Credit Assessment Institutions or ECAl's are used to assign risk weights to various bank exposures in calculating capital charge for credit risk. Further, some regulators (such as IRDA and PFRDA) have incorporated ratings into the investment guidelines for the entities they regulate. Rating thus provides an additional layer of comfort to the regulators in their assessment of product risks and overall systemic risks.

1.4.5 Summary

In view of the growing number of cases of defaults in payment of interest and repayment of principal sum borrowed it is necessary to get a credit rating done.

I. It will help maintain Bankers/Investors' confidence, since defaults shatter the confidence of lenders.

II. It will also motivate savers to invest in industry and trade.

1.5 Objectives of the Study

I. To study the credit rating practices of bankers in North East India for the purpose of financing

II. To know the credit rating of the enterprises based in North East India vis-a-vis their counterparts in the rest of the country.

III. To investigate the reasons peculiar to North East India responsible for poor credit rating of the enterprises located in the region.

IV. To suggest appropriate measures for the enterprises of the region to improve their credit rating to reduce their cost of borrowing.
1.6 North East Region- Industrial Landscape

North Eastern States have largely remained industrially underdeveloped. The structural change of the economy from agriculture to industry in terms of share in national income and work force is the major component of development process. It is often misunderstood that such structural transformation of the economy in the process of development amounts to emergence of industries at the expense of shrinkage of agriculture. Actually, during this structural transformation agriculture does not decay and instead experience productivity growth. But industrial sector expands far more rapidly with faster growth of both production and productivity thereby enhancing its share in national income and the workforce. At a later stage service sector replaces industrial sector by increasing its share in national income and workforce.

The above theory explains precisely the problem which has hindered the development of North East India. The Northeast India has remained industrially underdeveloped. There is very little large-scale manufacturing activity in the region. The total number of large factories in the region is merely 1.56 per cent of the total large scale factories in India. Considering industrial employment and capital formation in the region it can be concluded that the large scale manufacturing sector in NER is virtually non-existent.

Assam is the industrial ‘hub’ of the region. It alone has 88 per cent of the factories in the region which provide 86 per cent of the employment and generate 90 per cent of the output in the region. Next to Assam is Tripura in terms of the number of industrial activities. Interestingly, Tripura does not have a single rubber plant despite being the second largest producer of natural
rubber in the country. The main locational factors determining industrial establishments in Assam and Tripura are their relatively large size and higher population density. However, there are also other equally important factors like greater availability of skilled labour and power supply and also the fact that Assam has relatively better transport connectivity. It is the junction point of major road and railway networks linking the other States of the region with the rest of India.

In responding to the need for rapid industrialization of the North Eastern Region, the Government of India (GoI) had introduced the North East Industrial Policy (NEIP), 1997 which offered a slew of fiscal incentives and subsidies to industry for a period of ten years. While NEIP, 1997 was able to attract large investments in cement (Meghalaya and Assam), ferroalloys and steel (Meghalaya) and coal and coke (Assam), it hardly had any impact in the other States. Even small ticket investments, which were mostly for facilities in the last stages of the value chain like only packaging of finished products mainly to benefit from excise duty refunds, were made in Assam and Meghalaya. The main factors attracting industry into these two States are their relatively better industrial infrastructure as compared to the other States of the region. Assam’s location at the juncture of NER States enables industries to be connected through the major road and railway networks with the rest of India. Locating industries at the junction minimizes distribution costs to other NER States. Meghalaya’s large deposits of limestone and coal and till recently the availability of power also attracted investments.
1.7 The Capital Structure of North East Region

Capital structure of the companies in the region usually gives an indication about the confidence the population holds in the development potential of the region. The capital structure of the companies in NE region shows that majority of the capital is brought in as equity and leveraging the balance sheet does not make sense due to lack of growth opportunities in the region.

The relatively low credit deposit ratio of the Banks in India in North East Region gives ample indication of the malaise. The credit deposit ratio of all scheduled commercial banks in India, is lowest for NE states which is indicative of the fact that the capital structure of the companies in the region mainly comprises of equity capital. The main reason for the same can be attributed to factors describes elsewhere in this paper , wherein the region has been shown to lack serious industrial activity, and where small and medium enterprises are predominantly present even agricultural lending is poor because the sector is largely based on subsistence farming.

1.8 General observations on Credit Rating of Enterprises based in North East

Experience has shown that the enterprises based in North East fare poorly in Credit rating vis-à-vis their peers in the other parts of the country. In addition to the reasons which lie with the unit, there are others as well. The main reason for poor rating can be attributed to lack of understanding of the business model in the North East by the external raters. All India Industry factors do come into play and the rating is sans considering the specific unique features of the North east.
To illustrate this

The North East Industrial Promotion Policy 2007 (NEIPP 2007) gives a slew of incentives for Industries to be set up. The impact of these subsidies on these units are not properly understood, also the fact that subsides take 2 – 3 years to start actually flowing is also not understood.

Moreover Partnership entities are taken skeptically by the raters. They tend to generalize the assertion, without understanding the fact that a partnership mode saves the entity outgo for MAT and dividend tax, where the combined cash outflow could be as high as 37% of the profits earned. Instead of viewing the particularly legal way of Tax planning as something that conserves cash in an entity, the raters fail to understand this and in line with their PAN India thought process, see Partnership firms as high risk, leading to lower ratings.

Many of the Industrial entities in the North East are new entities. This is because some subsides like Transport Subsidy is payable only once for 5 years in a total life span of any entity. Thus if an entity has availed this subsidy for any of its activity, it shall never be eligible for this again, even if it adds capacity or adds business lines, or expands business in the same entity. The Businesses are therefore done largely in new entities and this does not give the raters the comfort of Historical data of that entity.

There is lack of appreciation of group track record or group market reputation or group cash flow strengths.
1.9 Methodology

Altogether 17 enterprises across different sectors, both in the field of trading and manufacturing, located in the North East region have been identified for the purpose of ascertaining their credit rating as per the practices followed by the State Bank of India. The study of 17 units would be representative and would reveal the weaknesses and issues faced by the various enterprises situated in the North east. No additional or new information is likely to be revealed by adding another 5 or 10 units to the study. A credit analysis for the purpose will inevitably cover Qualitative Analysis and Quantitative Analysis. All agencies like CRISIL, CARE, NEDFI and all other banks and Financial Institutions use a methodology which is more or less similar. An attempt has been made under chapter 5 to explain the concept of Credit Rating and how it is being done.

1.10 Hypothesis

I. Enterprises based in North East India have low credit rating vis-a-vis their counterparts in other parts of the country.

II. Financial Risk of the borrowers in the North East Region is generally high.

III. High Financial Risk reduces the scope for leveraging the capital structure and hence greater reliance on equity financing.

1.11 Contribution of the Study/Usefulness

1.11.1 For Enterprises

I. Low cost of borrowing

II. Helps to improve business
III. Saves time, money, energy, and manpower
IV. Less effort in convincing company’s credit position to lenders
V. Rating as a marketing tool
VI. Encourages financial Discipline
VII. Motivation for growth
VIII. Sources of additional certification
IX. Forewarns (caution) risk
X. For Investors/Lenders
XI. Saving of capital of bankers for better rated companies
XII. Leaving more lendable resources with bankers through capital conservation
XIII. Recognition of risk
XIV. Easy comprehension (ratings) of the investment proposal
XV. Savings of resources (time and money)
XVI. Independence of investment and quick investment decision
XVII. Choice of investments
XVIII. Good bye to thumb rules
XIX. Benefits of rating surveillance
XX. Low cost information

1.11.2 For the Economy
I. Growth in the GDP of the Region as a whole
II. Increase in Per Capita Income
III. Generation of employment opportunities
IV. Creating a congenial atmosphere for entrepreneurship growth
V. Increase in labour productivity
VI. Optimum utilization of vast natural resources available in the region
VII. Greater acceptability of the enterprises of the region to outside investors

1.12 Limitations of the study

The present study, like any other studies has certain limitations that need to be mentioned to understand the present work. These are stated below:

I. The Universe of the Enterprises is very large and a very small sample of 10/20 units with limits above Rs.5.0 Crs have been picked up at random for the study.

II. The units are all banking with State bank of India and with their best branch in the North East. Hence the quality of the units is likely to be much better than other units banking elsewhere with other branches in the seven states of the NE region, covered by SBI.

III. The study merely touches the tip of the iceberg and a greater understanding of the issue can be had after a study of many more units spread across the NE region.

IV. Units banking with other Banks have not been covered due to the unwillingness of those banks like Bank of Baroda, Bank of India, IDBI Bank and others to share the credit risk information due to confidentiality.

V. Testing of the Hypothesis again has been done on a limited scale with reference to units established in the states of Gujarat, Delhi and Tamilnadu only. This will give a limited view only. A larger and broader comparison can be done if the Hypothesis can be tested with units established across the country in other states also.
VI. The Hypothesis has been tested on the basis of a limited no. of units banking with SBI though picked up at random without any bias however. A testing based on a much larger scale could possibly have a different picture.

1.13 Report Presentation

The thesis is presented in eight chapters. The present chapter “Introduction” deals with the background about credit rating, rationale, objectives, and methodology of the study. It also includes the limitations of the study. The second chapter "Genesis of Credit Rating in India "discusses the background in detail about how and when credit rating of establishments came to be introduced in the country. The benefits of credit rating to different segments of the society have also been covered therein. Third Chapter of the Thesis covers the Credit Rating of enterprises based in the North Eastern India. The issues affecting the development of businesses in the region are covered. The fourth chapter covers Review of literature broadly on credit rating and related topics on the subject in India and elsewhere. It also covers the existing Gap. The fifth chapter Methodology of credit rating deals with the methodology and Internal CRA models prevalent in SBI at the material time. The sixth chapter analyses the CRAs of seventeen units based out of NE region picked on a random basis. The seventh chapter Testing of Hypothesis analyses the data gathered about the credit rating and marks scored by units based in North East India, Gujarat, Tamilnadu and Delhi. The eighth chapter Interventions and Suggestions presents the summary/conclusions and findings of the study. Implications of the study include the suggestions so that policy makers, decision
makers, academicians and researchers may get the benefit of the study. At the end a bibliography has been provided, whereas the Acknowledgements have been made at the beginning of the study, along with a list of table of contents.