Credit Ratings

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Credit Ratings are an essential tool to gauge the creditworthiness of a borrower. With the rising defaults, the methods and efficacy of such ratings are questioned. As defaults have a wider effect in the economy, UPSC may explore your knowledge regarding the issues plaguing Credit Ratings in India.

In news: SEBI, CCI at odds over jurisdiction of rating agencies
Placing it in syllabus: Economy
Dimensions:

- What is credit rating
- Credit rating for country, company and individuals
- Agencies Involved
- Relevance for India

Content

What is Credit Rating?

- A credit rating is an **assessment of the creditworthiness of a borrower.**
- A credit rating **can be assigned to any entity** that seeks to borrow money—an **individual, a corporation, a state or provincial authority, or a sovereign government**.
- Credit rating involves **analysis of the credit risks** associated with a financial instrument or a financial entity.
- **Individuals are given 'credit scores'**, while **corporations and governments receive 'credit ratings'**.
- Credit ratings determine whether or not a borrower will be approved for a loan or debt issue and also the interest rate at which the loan will need to be repaid.

- **Credit ratings are never static**. They change all the time based on the newest data, and one negative debt will bring down even the best score.

Credit rating for a country:

- **National governments** (not countries) are **assigned credit ratings** by agencies like Standard & Poor's, Moody's and Fitch.
- These are known as **Sovereign Credit Ratings**
- Governments require ratings to borrow money (i.e. raising Sovereign Debt).
- They are also given ratings on their worth as investment destinations.
- A country requests a credit rating agency to evaluate its economic and political environment and arrive at a rating. This is done **to position itself as a destination for foreign direct investment.**
- Several criteria are used to derive a government's creditworthiness. **Sovereign risk** is calculated considering the **political risk, taxation, currency value and labor laws** etc.

Ability to Pay

- A government's ability to pay is a **function of its economic position**.
- A country with strong economic growth, a manageable debt burden, a stable currency, effective tax collection, and favorable demographics will likely have the ability to pay back its debt.
- This ability will usually be reflected in a high credit rating by the major rating agencies.
- A country with negative economic growth, a high debt burden, a weak currency, little ability to collect taxes, and unfavorable demographics may be unable to pay back its debt.

Willingness to Pay

- A government's willingness to pay back its debt is often a **function of its political system** or government leadership.
- A government may decide not to pay back its debt, even if it has the ability to do so.
- Nonpayment usually occurs following a change of government or in countries with unstable governments.
- This makes political risk analysis a critical component of investing in sovereign bonds.

Credit rating for a Company:

- The credit worthiness of a company is measured through **corporate credit rating**
- It is a quantified assessment of a company's creditworthiness.
- It **shows investors the likelihood of a company defaulting on its debt obligations** or outstanding bonds.
- A triple-A (AAA) is the highest credit quality, and C or D (depending on the agency issuing the rating) is the lowest or junk quality.
- Companies issue bonds, which are debt securities, to raise funds that can be used to invest in the long-term future of the company.
- Before investors buy a corporate bond, they need to know how financially stable the company is that's issued the bond. In other words, investors need to know whether the company will be able to meet its financial obligations.
- The risk that a company might not pay back the principal amount of a bond is called **default risk**.

Credit rating for an Individual:

- Whenever an individual approaches a bank/financial institution to avail loans or credit card, the bank will be concerned about the repayment capacity of the individual.

- The repayment capacity can be traced from the loan or credit card repayment history of the individual.
- Credit information companies (CIC) provide such credit information about individuals and assigns ranks to them based on their past repayment track record.
- Individuals are assigned **credit scores** (a 3-digit number between 300 and 900) based on his /her credit records.
- They are used by lenders to analyze an individual's creditworthiness and financial prudence.

Importance of credit rating:

- Credit rating does a qualitative and quantitative assessment of a borrower's creditworthiness.
- It **allows investors to make a sound investment decision** after taking into consideration the risk factor and past repayment behavior. In other words, it **establishes a relationship between risk and return**.
- In the case of the companies, credit ratings help them **improve their corporate image**. It is useful especially for companies that are not popular.
- The credit rating **acts as a marketing tool for companies** and also as a resource that is helpful at the time of raising money. It reduces the cost of borrowing and helps in the company's expansion.
- Lenders such as **banks and financial institutions will offer loans at a lower interest rate if the entity has a higher credit rating**.
- Credit rating **encourages better accounting standards, detailed information disclosure, and improved financial information**.

Agencies Involved:

In India, there are different agencies involved in assessing creditworthiness of borrowers.

For Individuals:

- **Credit information companies (CIC)** provide credit information about individuals
- The **Credit Information Companies (Regulation) Act, 2005 (CICRA)** and the different instructions issued by the **Reserve Bank of India** regulate these companies.
- At present there are **four Credit Information companies approved in India: CIBIL, EQUIFAX, EXPERIAN, CRIF High Mark**

For Companies:

- A **credit rating agency (CRA)** assesses the creditworthiness of a company.
- SEBI regulates the working of the CRAs using the **Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999** and its amendments.
- There are **7 credit rating agencies** currently registered to operate in India: CRISIL, ICRA, CARE, India Ratings and Research (formerly known as Fitch Ratings), Brickwork Ratings, Acuité Ratings & Research (earlier known as SMERA), and Infometrics Valuation and Rating

For Sovereign Governments:

The global credit rating industry is highly concentrated, with three agencies—**Moody's, S&P Global, and Fitch Ratings—controlling nearly the entire market**.

Relevance for India:

- With the default of big corporate houses such as DHFL, IL&FS etc, Corporate Credit Ratings have been under scanner in India.
- Reserve Bank of India (RBI) has pinpointed the **conflict of interest in the functioning of credit rating agencies** and is concerned over the role of the little known **club of 'rating advisers'**, which are unregulated entities

acting as brokers between companies and rating agencies.

- Recently the Financial Stability and Development Council (FSDC) panel has discussed ways to address challenges pertaining to the quality of credit ratings.
- Recent IL&FS defaults crisis which had AAA rating (AAA: The instrument with AAA rating is considered to have the highest degree of safety in respect of timely servicing of financial obligations) just before it started defaulting raised concerns about the credibility of Credit Rating agencies in India.
- Reliability of credit rating in India is questioned. High credit-rated companies have failed in India and there is no remedy for this. Example CRB Capital Markets, which had a turnover of Rs.1,000 crores per year and with a credit rating of ‘A’, failed, and neither SEBI nor RBI could come to the rescue of investors.
- The Securities Exchange Board of India (SEBI) and Competition Commission of India (CCI) have locked horns on jurisdiction over credit rating agencies (CRAs).

India’s Sovereign Credit Ratings:

- Government finances in India are stressed, amid a big decline in revenue growth and rising expenditure obligations during the Pandemic.
- Several analysts have warned of a negative growth for the entire fiscal, amid a nation-wide lockdown.
- Moody’s said a marked and long-lasting weakening in the health of the financial sector of India would both “raise associated fiscal costs should the government need to support some financial institutions, and increase the risk that growth remained too low to prevent a rise in the debt burden”.
- Separately, in a report S&P said it expected the banking systems of India to be among the worst hit in the Asia-Pacific region.

- As per Moody’s, India’s sovereign rating is Baa2 presently.

Mould your thought: Why are credit ratings required? Discuss the issues with Corporate Credit Ratings in India.

Approach to the answer:

- Define credit ratings
- Write about uses of credit ratings
- Write about problems in Corporate Credit Ratings
- Conclusion