

Course title: International financial regulation

Lesson 9. Regulating Credit Rating Agencies

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Topics Covered

- What is Credit Rating?
- Meaning
- Nature of Credit Rating
- Types of Credit Rating
- Financial Obligations
- Benefits of Credit Rating
 - - Investors
 - - Company
 - - Financial Intermediaries
- Factors Responsible for the growth of Credit Rating
- Credit Rating Process
- Factors Analyzed for Rating
- Rating System
- Instruments of Credit Rating
- Recent Trends in Credit Rating
- Types of Rating
- Functions of Credit Rating



What is Credit Rating?



- A Credit Rating is an opinion on the
 - ✓ Relative degree of risk associated with
 - ✓ Timely payment of interest and principle
 - ✓ on a Debt Instrument

Definition :

“Credit Rating is an assessment of an entity’s ability to pay its financial obligations.”



Meaning

- i. Assesses the **credit worthiness** of business(company)
- ii. Based on **Financial history** and **current Assets** and **Liabilities**
- iii. Determined by **Credit Rating Agencies**
- iv. Tells a lender or Investor the probability of the subject being able to **pay back a loan**



Nature of Credit Rating

- Rating is based on Information
- Many factors affect rating
 - i. Quality of Management
 - ii. Corporate Strategy
 - iii. International Environment
- Rating by more than one agency
- Publication of ratings
- Rating of Rating agencies



- *Rating can be done in symbols*
- *Rating are undertaken only at the request of the issuers in India*
- *Rating is for instrument and not for issuer company*
- *Rating is **not** applicable to equity shares*
- *Time taken in rating process*
- *Success of Rating Agency*



Types of Credit Rating

1. Sovereign Credit Rating

- i. Sovereign Entity
- ii. Risk level of the investing environment
- iii. Used by investor looking to invest Abroad
- iv. Political Risk into account



2. Short - Term

- i. probability factor
- ii. Contrast to long-term rating
- iii. Commonly used

**SHORT
TERM**

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Financial Obligations

- 1.EMPLOYEE:** Salaries, Bonus on time
- 2.SHAREHOLDERS:** Dividend on time
- 3.GOVERNMENT:** Taxes payable on time
- 4.FINANCIAL INSTITUTION:** Installments,
interest
- 5.CUSTOMERS:** Quality products, competitive
price



Benefits of Credit Rating

A. Benefits to investors

- i. Minimization of Risks
- ii. Risk Recognition
- iii. Credibility of Issuer
- iv. Ease in Decision Makings
- v. Independent Decision Making
- vi. Wider Choice
- vii. Saving in Time and Resources
- viii. Benefits of intensive surveillance
- ix. Exploits Market Conditions



RATING

B. Benefits to Company

- i. Easy to sell
- ii. Lower cost of borrowing
- iii. Wider Market
- iv. Image Building
- v. Lower cost of Public Issues
- vi. Facilitates Growth
- vii. Beneficial to new, unknown and Small Companies

**LOW
COST**



C. Benefits to Financial Intermediaries

- i. Brokers
- ii. Agents
- iii. Portfolio Managers

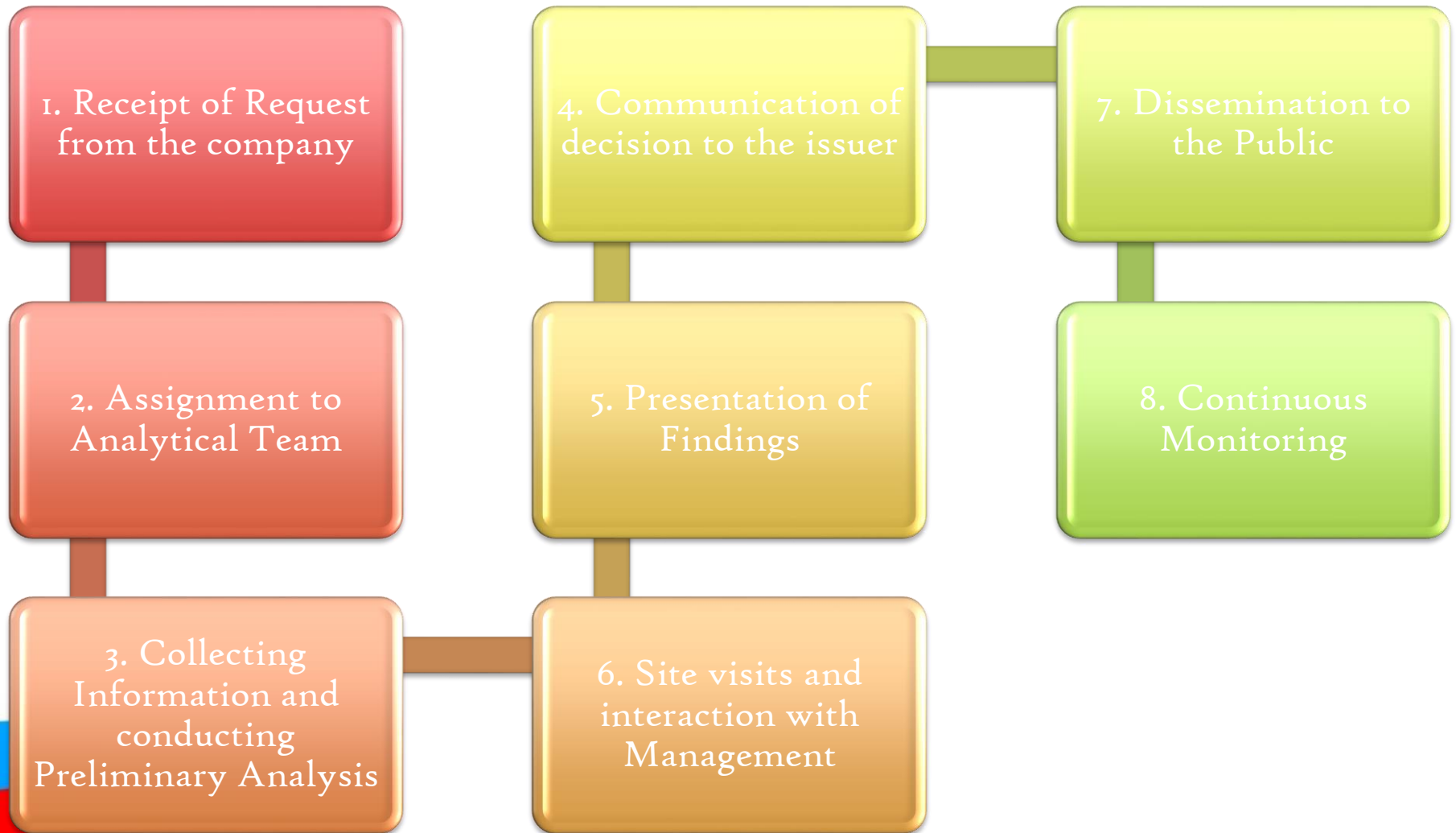


Factors Responsible for the growth of credit rating

- i. Growth of information Technology
- ii. Globalization of financial markets
- iii. Increasing role of capital and money markets
- iv. Inadequate government safety measures
- v. Trend towards Privatization
- vi. Securitization of debt



Credit Rating Process



1. Receipt of the request

- The process begins with the receipt of formal request for rating from a company
- Afterwards the rating agency and the issuer company enter into an agreement which is signed by both
- Agreement covers
 - Company will provide all material information to agency
 - Agency promises to keep the informational confidential.
 - The agreement gives to co. to accept or not the rating.



RATING

2. Assignment to Analytical team

- Credit rating agency assigns the rating task to an analytical team
- Team comprises of 3 to 5 analysts who have expertise in the relevant business area
- These analysts are responsible for carrying out the rating assignment



3. Obtaining Information

- The analytical team obtain the information from issuer company .
- The analytical team analyses the information relating to the issuer financial statement , cash flow etc
- Analytical team then proceeds to have the detail meeting with the company's management .



4. Presentation of finding to rating committee

- An opinion on the rating is formed and the finding are ultimately presented to the rating committee which then decides on the rating
- The rating committee meeting is only aspect of the process in which the issuer does not participate directly



5. Communication of decision to the issuer

- The assigned rating grade is finally communicated to the issuer along with the reasons
- In case the issuer is not satisfied with the rating assigned he can appeal against the assigned rating
- The rating which are not accepted are rejected and are not disclosed



6. Dissemination to the public

- Once the issuer accept the rating , the rating agency disseminate the information through printed reports the public



7. Monitoring

- The credit rating agency constantly monitors on rating with reference to new political , economics & financial development etc.
- All this information is reviewed regularly .
- Any changes in the rating are made public through published reports by credit rating agency .



Factors Analyzed for Rating

1. Business Risk Analysis

- i. Country and macroeconomic Risk
- ii. Industry Risk
- iii. Competitive Position
 - Market Position
 - Diversification
 - Operating Efficiency
 - Ownership/governance
 - Profitability



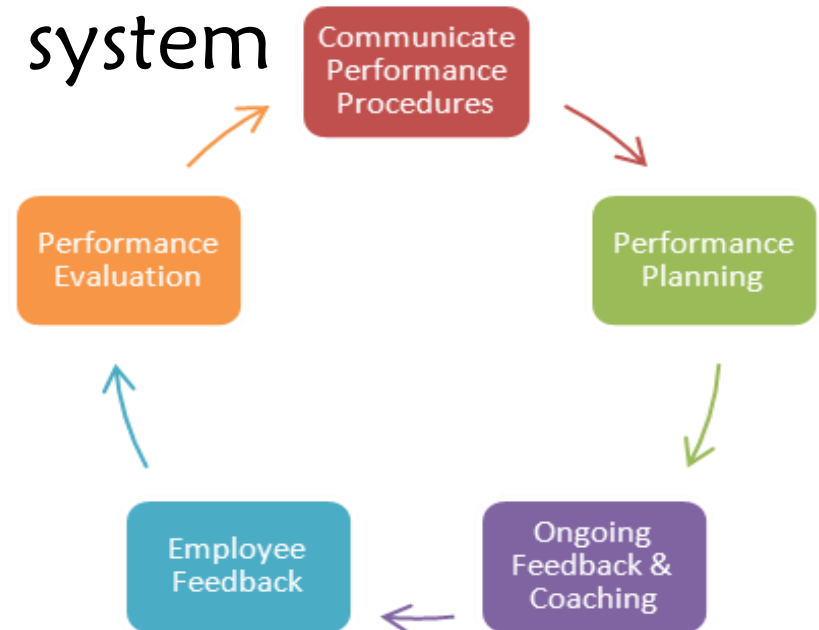
2. Financial Analysis

- i. Accounting
- ii. Cash flow adequacy
- iii. Financial Governance and policies/risk tolerance
- iv. Liquidity/Short term Factors



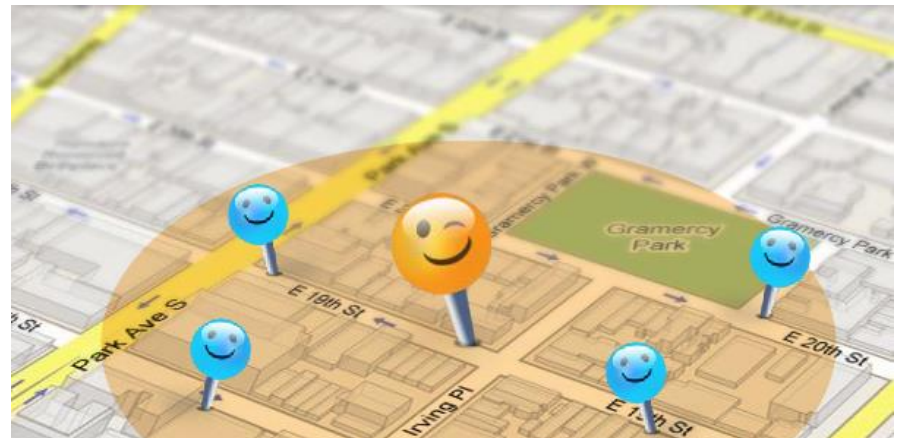
3. Management Evaluation

- i. Management Goals, plans and strategies
- ii. Capacity to overcome unfavorable conditions
- iii. Staff's own experience and skills, planning and control system



4. Geographical Analysis

- i. Diversification
- ii. Subsidies from the government
- iii. Undertaken to determine the locational advantages



6. Fundamental Analysis

Includes Analysis of-

- i. Liquidity Management
- ii. Profitability & Financial Position
- iii. Interest and tax rates sensitivity of the company



Rating System



- *Usually expressed in alphabetical or alphanumeric symbols*
- *Symbols helps to differentiate between debt instruments on basis of their underlying credit quality*



A typical Credit Rating Scale

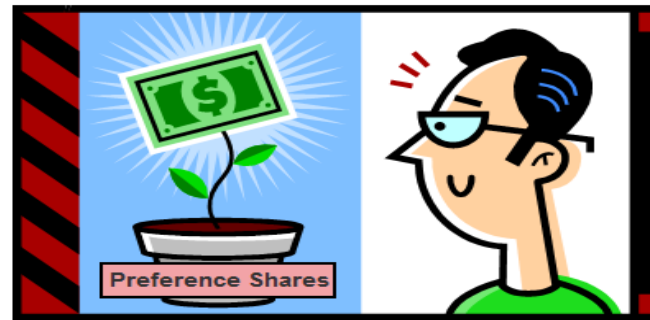
	Rating Marks for Long-Term Bonds	Definitions
High ↑ ↓ Low	AAA	Most likely that debt obligations will be honored.
	AA (+-)	High likelihood that debt obligations will be honored.
	A (+-)	Reasonable likelihood that debt obligations will be honored.
	BBB (+-)	There is a likelihood that debt obligations will be honored, but compared to the higher rating (A), there is the possibility of a diminished likelihood of debt repayment.
	BB (+-)	Repayment does not pose a problem at present but may become problematic in the future.
	B (+-)	Probability of repayment is weak, with cause for concern.
	CCC	Repayment is uncertain and there is the danger of default on debt obligations as a real possibility.
	CC	High likelihood of default on debt obligations.
	C	Extremely high probability of default on debt obligations.
	D	Defaulting on debt obligations.

Note: Credit ratings range from AAA to D, and are further subdivided into a total of 20 ratings (see chart) by the use of plus and minus signs for ratings AA to B.



Instruments for Credit Rating

- ✓ Preference shares issued by a company



- ✓ Bonds, Debentures issued by Corporate, Government etc.



- ✓ Commercial Paper issued by manufacturing companies, finance companies, banks, and financial institutions for raising short term loans

D 921-72

NO. 4326 SANTOS, BRAZIL, APRIL 20th 20* U.S. \$ 50,000.00 1-23
210

NINETY (90)----- DAYS AFTER SIGHT PAY TO THE ORDER OF
OURSELVES

FIFTY THOUSAND AND 00/100-----DOLLARS
Drawn under Morgan Guaranty Trust Company of New York L/C No. 89054, dated New York
April 2nd 20* covering shipment of 1,000 bags coffee.

TO } GUARANI MENDOZA & CO.
MORGAN GUARANTY TRUST COMPANY
OF NEW YORK
NEW YORK, NEW YORK

:0210*0023:

D 921-72

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TO } **\$ 50,000 AND 00 CTS**
MORGAN GUARANTY TRUST COMPANY
OF NEW YORK
NEW YORK, NEW YORK
GUARANI MENDOZA & CO.

NO. }
ACCEPTED
PAYABLE AT 15 BROND STREET, NEW YORK
MORGAN GUARANTY TRUST COMPANY
NEW YORK

:0210*0023:



- ✓ Fixed deposits raised for medium term ranking as unsecured borrowings

**Fixed
Deposits**



✓ Borrowers who have borrowed money



✓ Individuals



✓ Mutual Fund Debt Scheme



✓ Asset backed securities



Proforma of Commercial Paper (CP)

To be stamped as per the applicable rate in force

Commercial Paper

Issued at: _____ Date of issue: _____

Date of Maturity: _____ without days of grace (If such date happens to fall on a day which is a public holiday, the date of maturity shall be the immediate preceding working day)

For value received _____ (NAME OF THE ISSUING COMPANY/ INSTITUTION) Promises to pay _____ (NAME OF THE INVESTOR) maturity date as specified above the sum of Rs. _____ (in words) upon presentation and surrender of this Commercial Paper to _____ (NAME OF THE ISSUING AND PAYING AGENT)

Issued on behalf of _____ (NAME OF THE ISSUING COMPANY/ INSTITUTION) (AUTHORIZED SIGNATORY/SIGNATORIES)

In India

Issue, Investment and Buyback

ALL ENDORSEMENTS ON THIS COMMERCIAL PAPER MUST BE CLEAR AND DISTINCT. EACH ENDORSEMENT MUST BE WITHIN THE SPACE ALLOTTED.

Pay to _____ (NAME OF TRANSFEREE) or order (in amount within named).

For and on behalf of _____ (NAME OF THE TRANSFEROR)

www.aubsp.com

✓ Bank Certificate of Deposit

भारतीय रिज़र्व बैंक
Reserve Bank of India
India's Central Bank

1ST FLOOR, MAIN BUILDING SHASHID BHAGAT SINGH MARG MUMBAI 400 001.

DEPOSIT CERTIFICATE DEPOSIT REF #: RBI/042/0130601

This certificate is the Original Specimen and valid documents from the treasury and security department of the RESERVE BANK OF INDIA The Agreement therein contained are true, correct and binding on the parties. Alteration made on this specimen after it has been legally issued and accepted renders this documents valueless, null and void.

This is to certify that:

BENEFICIARY NAME: [REDACTED]
OF [REDACTED]
BANK NAME: [REDACTED] AC/NO: [REDACTED]
BANK ADDRESS [REDACTED]

Deposited with this Apex Bank

AMOUNT **750,000.00.GBP**

REFERENCE CODE: RBI/AN/PLC-118/WB-NL-014-09
DEPOSIT NUMBER: BA/Sd/380660001
DEPOSIT CODE: RBI/AN/PLC/DRPO 01
DEPOSIT TYPE: LLOYDS LAMP BANK CERTIFIED DRAFT
INSURANCE: HARD COVER INSURANCE

SECURITY CODE
XXXZ000750AXXX
XXX001000127-81988XX
000127050001XXABTSF
004531/VOL-45

DEPOSITOR'S SIGNATURE [Signature]

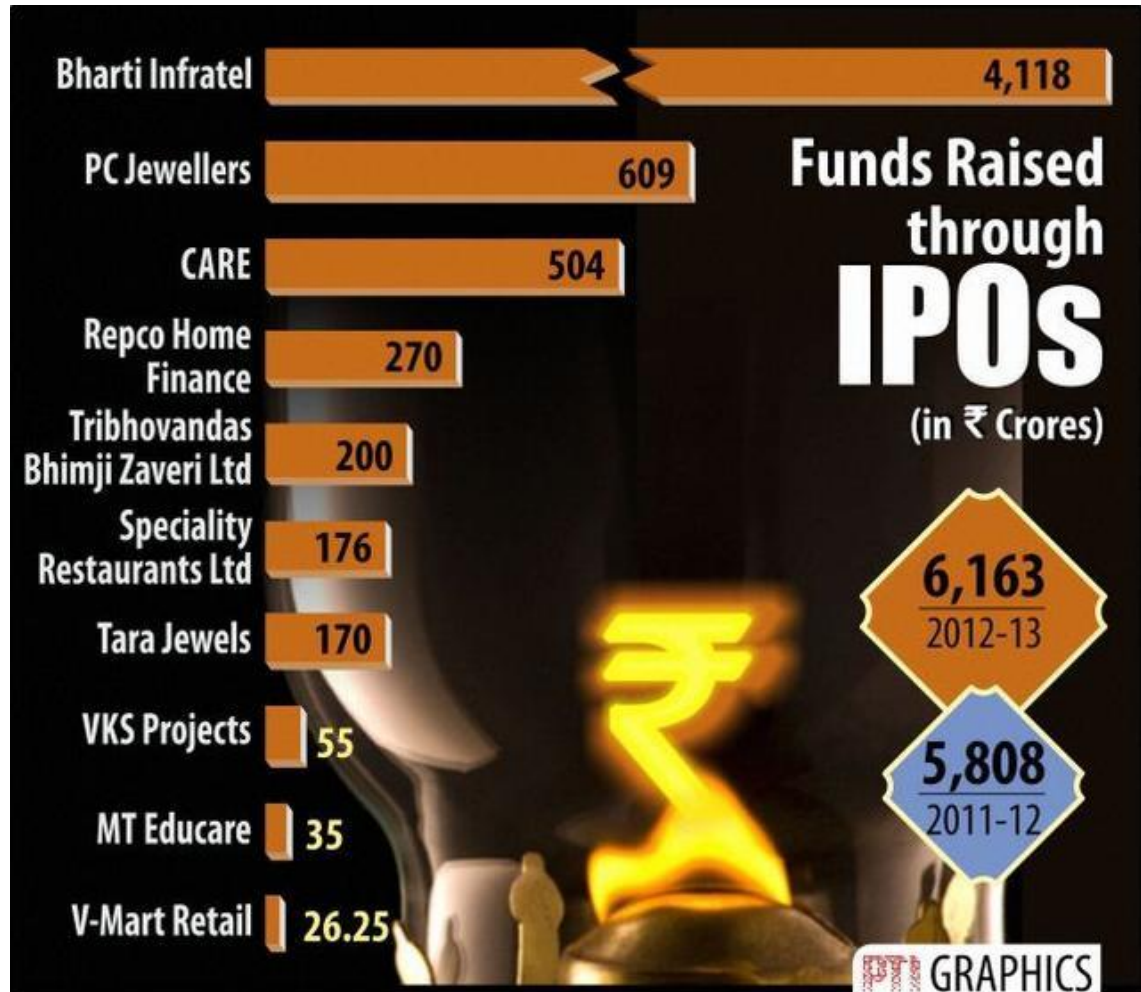
419-bit.com

RATING

In case of death of the beneficiary of this deposit or inability to appear in person, the Next of Kin or any Appointed representative with a Power of Attorney/Sworn Affidavit takes delivery of funds.

RESERVE BANK OF INDIA

✓ Initial Public Offers (IPO)



Recent Trends in Credit Rating

- ✓ Country rating
- ✓ Rating of states
- ✓ Rating of real estate builders and developers
- ✓ Chit funds
- ✓ Industry specific rating
- ✓ Short term rating
- ✓ Regulatory trends



1. Country Rating

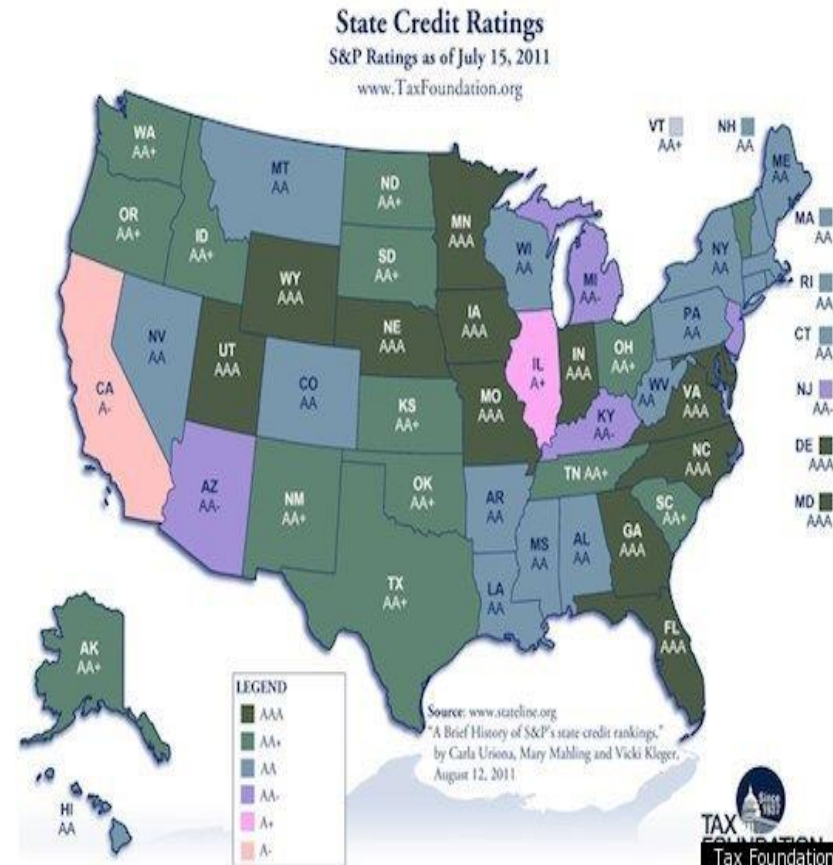
- i. When loan is extended or major investment made by international investors,
- ii. With the purpose of safety and security of their investments,
- iii. Factors such as Growth rate, government policies, fiscal deficit etc. are taken for making the rating

	Country	Rating	Outlook	Date
	Australia	AAA	Stable	Jul-11
	Austria	AAA	Stable	Jul-11
	Canada	AAA	Stable	Jul-11
	Denmark	AAA	Stable	Jul-11
	Finland	AAA	Stable	Jul-11
	France	AAA	Stable	Jul-11
	Germany	AAA	Stable	Jul-11
	Guernsey	AAA	Stable	Jul-11
	Hong Kong	AAA	Stable	Jul-11
	Isle of Man	AAA	Stable	Jul-11
	Liechtenstein	AAA	Stable	Jul-11
	Luxembourg	AAA	Stable	Jul-11
	Netherlands	AAA	Stable	Jul-11
	Norway	AAA	Stable	Jul-11
	Singapore	AAA	Stable	Jul-11
	Sweden	AAA	Stable	Jul-11
	Swiss Confederation	AAA	Stable	Jul-11
	United Kingdom	AAA	Stable	Jul-11
	Belgium	AA+	Negative	Jul-11
	New Zealand	AA+	Stable	Jul-11
	United States of America	AA+	Negative	Aug-11



2. Rating of States

- i. Helps the state to attract investors from India and abroad,
- ii. Investors also keen to know about the safety of their funds while investing,
- iii. If there is positive rating then foreign and domestic companies prefer to set project in that states



3. Rating of real estate builders and developers

- i. The credit rating agency CRISIL start assigning rating to builders and developers,
- ii. For the purpose of helping prospective buyers,
- iii. For these the past experience of builder, properties built by builder, financial strength etc. are taken into account for taking their final decision,



4. Chit Funds

- i. Chit fund company rated on the bases of their ability of making timely payment of prize money to subscribers,
- ii. It helps the chit fund company in better marketing of their fund and widening of their subscribers,



Top Chit-Fund Companies in Delhi

Sl No.	Company	Contact Number	Paid-up Capital (in Rs)	Total Chit Groups	Total Amount Invested in Groups (in Rs)
1	BLA Chit Fund	011-26531334	4,500,000	10	15,760,000
2	Abhilashi Chit Fund	011-25419710	2,500,000	12	6,280,000
3	Rani Sati Chit Fund	011-22226693	1,000,700	3	2,300,000
4	The Balussey Benefit Chit Fund	011-23231424	960,000	70 (16 in Delhi)	11,730,000
5	Gee Aar Chits	011-23964083	900,000	2	6,050,000
6	Nu Count Chit Fund	011-25713518	850,000	5	4,050,000
7	JB Chit Fund & Trading	9810069759	200,000	40	1,900,000
8	Valentino Chit Fund	011-25825964	500,000	2	4,880,000
9	Profit Chit Fund	011-27374466; 987122300	5,00,000	5	5,000,000
10	Shikh Shikh Chits	9810028898	500,000	2	1,300,000
11	Path Gamini Chit Fund	9311567747	100,000	7	800,000



5. Industry Specific Rating

- i. Industry outlook over a short as well as long term period depending on global and domestic trends now,
- ii. Rating is Not just firm specific



6. Short Term Rating

- i. States the probability factor of an individual going into default within a year,
- ii. Rating should be made within one year



7. Regulatory Trends

In India credit rating agencies(CRAs) are regulated by SEBI. It has been entrusted with the power to oversee all matters pertaining to the operations of these agencies operating in capital market so, there are some guidelines issued by SEBI time to time that are:

(A) SEBI(credit rating agencies) regulations 1999

- 1.Registration of CRAs,
- 2.General obligations of CRAs,
- 3.Restrictions on rating of securities issued by promoters or by certain other persons and
- 4.Procedure for action in case of default



(B) Internal audit for credit rating agencies (CRAs) dated January 06,2010

- i. Conducted on a half yearly basis.
- ii. Conducted by chartered accountants, company secretaries or cost and management accountants
- iii. Cover all aspects of CRA operations and procedure
- iv. Report shall state the methodology adopted, deficiencies observed, and considerations of response of the management on the deficiencies
- v. Report shall include the summary of operations and of the audit covering size of operations, number of transactions audited and number of instances where violations were observed.



RATING

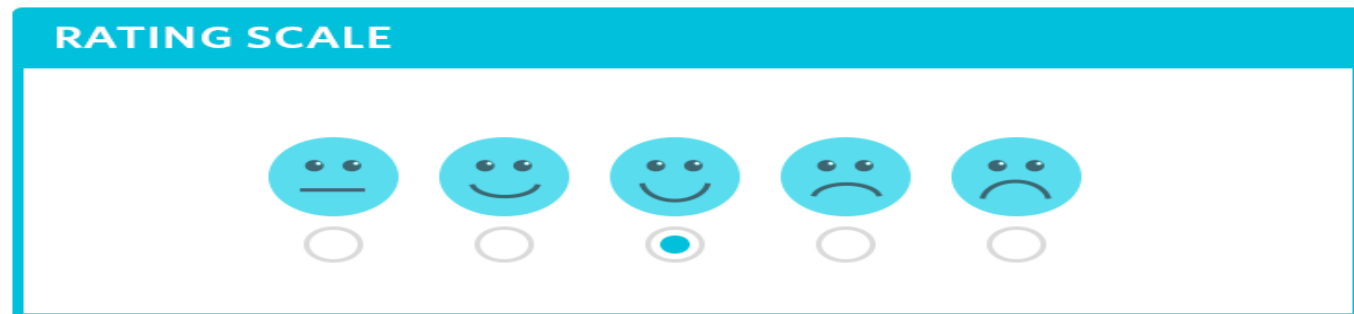
(C) guidelines for credit rating agencies dated may 03,2010

1. Rating Process
2. Default Studies
3. Dealing with conflicting Interest
4. Obligations in respect of Rating structured finance products
5. Unsolicited Credit Ratings
6. Disclosers



Types of Rating

- ✓ Education Grading
- ✓ Real Estate Developers Grading
- ✓ Broker Quality Grading
- ✓ Financial Strength Ratings
- ✓ GVC (Governance & Value Creation) Ratings
- ✓ Fund Ratings
- ✓ Recovery Risk Ratings
- ✓ MFI (Micro Finance Institution) Grading



Functions of a Credit Rating

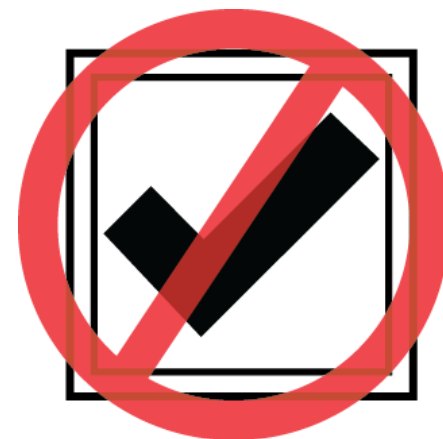
1. Provides Reliable Information
2. Provides Unbiased opinion
3. Provides information at low cost
4. Statement of risk and return
5. Investor Confidence
6. Best Price
7. Enhance corporate image
8. Formulate public policy
9. Facilitates growth
10. Facilitates stock brokers and other financial intermediaries



RATING

Limitations of Credit Rating

- i. Concealment of Material Facts
- ii. Static in Nature
- iii. No Conclusive Proof of Soundness
- iv. Human Bias
- v. Rating under Unfavorable Conditions
- vi. Lack of Objectivity
- vii. Difference in rating grades



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