

“A Systematic Study of Credit Rating Agencies, its Methodologies And Significance With Reference To CRISIL Ltd.”

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Abstract

Credit rating agencies play a vital role in influencing an investor’s overall decision on making investment in a particular sector, organization and/or instrument. Credit rating agencies basically evaluate the exposure of the corpus towards systematic and unsystematic risk. CRA’s, rating Service Company, assign rating to a debtor on his/her ability to pay back debt by making timely principal and interest payments and also shows any chance of default and these agencies rate the creditworthiness of the company. A good rating specifies a higher creditability and shows good payment history. The study was done based on theoretical aspects making use of the secondary data available from various sources. The major objectives of the study was to understand CRA’s, their functions; to know different rating scales and their meanings; to have fair knowledge about its significance and limitations and also about CRISIL and its process to rate a company as well as CRISIL’s criteria and methodologies of rating companies of different sector in brief. From the study it is found that CRA’s are regulated by SEBI and RBI. SEBI has formulated certain guidelines and also has put forth some rules and regulations for functioning of CRA’s. CRAs give ratings only to those companies who approach for rating and thus rating is not mandatory except for certain instruments. CRISIL is the major rating agency among other CRAs. The study mainly focuses on CRISIL’s criteria and methodology for rating Banks/FIs, Software Industries and Pharmaceuticals. So, it has been found that CRISIL acquires CRAMEL framework for rating Banks/FIs and for rating Software Industries and Pharmaceuticals it examines Business, Financial, Management and Project Risk.

Key Words: Credit rating agencies, creditworthiness, risk, SEBI, CRAMEL framework.

INDUSTRY PROFILE

FINANCIAL SERVICES INDUSTRY

The financial services industry provides financial services to people and corporations. This segment of the economy is made up of a variety of financial firms including banks, investment houses, lenders,

finance companies, real estate brokers, and insurance companies. As noted above, the financial services industry is probably the most important industry of the economy, leading the world in terms of earnings and equity market capitalization. Large conglomerates dominate this industry, but it also includes a diverse range of smaller companies.

Companies in the financial services industry manage money. For instance, a financial advisor manages assets and offers advice on behalf of a client. The advisor does not directly provide investments or any other product; rather, they facilitate the movement of funds between savers and the issuers of securities and other instruments. This service is a temporary task rather than a tangible asset.

The term “financial services” became more prevalent in the United States partly as a result of the Gramm-Leach-Bliley Act of the late 1990s, which enabled different types of companies operating in the U.S. financial services industry at that time to merge.

Before the 1970s, each sector of the financial services industry more or less stuck to its own specialty. Banks provided a place for customers to hold checking and savings accounts. Loan associations offered mortgages and personal loans. Brokerage companies offered consumers investment opportunities in stocks, bonds and mutual funds. And credit card companies, like Visa and MasterCard, solely provided credit cards.

By the 1990s, the lines that separated the different financial services sectors had become blurred. Not only were companies offering products outside of their original range, but companies were merging together to become bigger financial conglomerates that would enable them to earn and offer even more.

According to “India in Business,” a website of the Union Government, India’s banking sector assets were worth \$1.8 trillion in the 2014-15 financial year.

According to a report by KPMG-CII, India’s banking sector is on the way to becoming the fifth largest in the world by 2020. The country’s life insurance sector is the biggest in the world, and the market size is expected to touch about \$400 billion by 2020.

The assets of the mutual fund industry are worth \$190 billion. The pension corpus fund is projected to record \$1 trillion by 2025. Reforms to put the financial services industry and the economy on the fast track include measures to make finance available to medium, small, and micro industries.

COMPANY PROFILE

CRISIL, India’s first credit rating agency, was incorporated on 29th January, 1987 with the name Credit Rating Information Services of India Limited. The company was promoted by the erstwhile ICICI Ltd., UTI along with leading financial institutions, nationalized banks, foreign banks and private sector banks. Mr. N Vaghul and Mr. Pradip Shah are CRISIL’s first Chairman and Managing Director, respectively. It is headquartered at Powai, Mumbai, Maharashtra.

CRISIL operates through two segments: Ratings and research. Rating service include credit ratings for corporate, banks, small and medium enterprises (SME), training in the credit rating field, credit analysis

services, grading services and global analytical services. Research segment provides equity research, industry reports, customized research assignments, subscription to data services and initial public offer grading. It operates from 7 research centers worldwide. They operate businesses from India, the United States (US), the United Kingdom (UK), Argentina, Poland, China, Hong Kong, Singapore, and the United Arab Emirates (UAE).

They are majorly owned by S&P Global Inc., a leading provider of transparent and independent ratings, benchmarks, analytics, and data to the capital and commodity markets worldwide. Presently Ashu Suyash is the MD and CEO of CRISIL Ltd.

In 2018, CRISIL launched India's first index to benchmark performance of investments of foreign portfolio investors (FPI) in the fixed-income market, in both rupee and dollar versions. CRISIL has announced the launch of WE-Check, a digital verification and assessment service dedicated to women entrepreneurs, in association with NITI Aayog.

RESEARCH METHODOLOGY

Title of the study

“A SYSTEMATIC STUDY OF CREDIT RATING AGENCIES, ITS METHODOLOGIES AND SIGNIFICANCE WITH REFERENCE TO CRISIL LTD.”

Objectives of the Study

To have an understanding about Credit Rating Agency and their functions.

To know about CRISIL Ltd. in brief and its rating process.

To understand the guidelines and regulations put forth by SEBI and RBI on CRAs.

To study the criteria and methodologies adapted by CRISIL Ltd. to rate Banks and Financial Institutions, Manufacturing and Service Sector, which includes Software industries and Pharmaceuticals.

Need for the Study

Credit Rating Agency plays a very vital role in financial markets for lenders, issuers and investors. These agencies assess and rate credit worthiness of a particular individual, company's product or country. These ratings define the risk factor attached with them. Thus there is an essential need of knowing about these rating agencies and rating symbols which can be used for making of effective investment decisions.

Scope of the Study

Financial Services Industry; its History and Evolution.

CRISIL Ltd; its Origin, Developments

CRISIL's Rating Process

SEBI Regulations (CRAs), 1999

CRISIL's different Rating Criteria and Methodology for Banks/Financial Institutions, Manufacturing and Service Sector, which includes Software industries and Pharmaceuticals.

Research Methodology

The study is descriptive in nature and the secondary data is collected through the following sources:

Various circulars, operating guidelines, code of conduct published by the company CRISIL Ltd. in its website www.CRISIL.com

Annual reports of CRISIL Ltd. published by the BSE in its website.

Various reports, guidelines and code of conduct published by the regulatory authority i.e. Securities Exchange Board of India (SEBI)

Limitations of the Study

This study is limited to theoretical aspects of credit rating agencies with reference to CRISIL Ltd. The project is only restricted to methodologies followed by CRISIL only for Banks/FI, Software Industries and Pharmaceuticals due to the time constraint. There is no data collected directly but is acquired from secondary source due to the pandemic Covid-19.

LITERATURE REVIEW

G Sunita and Rinku Sanjeev: This article deals with the origin, benefits and role of credit rating agencies in the economy. The article clearly explains how the developments in credit rating agencies have impacted the GDP of Indian Economy. The study also helps us to know the financial position of the country and part played by different sectors in the progress of the nation.

Toran Lal Verma: The article mainly explains in brief the meaning, functions, advantages and different credit rating agencies providing service in India.

DNB Working Paper: DNB is a bank in The Netherlands. It publishes working papers on different topics. This particular working paper contains the information about the credit rating agency its origin, its present performance in European countries and also deals with the criticisms of credit rating agencies.

INTRODUCTION TO THE STUDY

With an increasing market orientation, investors face different types of risk namely, “business risk” which arises out of “open economy”, “market risk”, “liquidity risk”, “credit risk” and so on. In order to protect the investors from such uncertainty, which may cause a huge damage; and some small investors, who are the main target for unlisted corporate debt, credit rating has been made mandatory.

Meaning of Credit Rating Agency

A Credit Rating Agency (CRA), also called as a rating service, is a company which assigns rating to a debtor on his ability to pay back debt by making timely principal and interest payments and also shows his chance of default. Such agencies rate the creditworthiness of a company. A good rating specifies a higher creditworthiness and shows a good payment history. This credit rating influences the bank’s decision of approving the loan application at a considerate rate of interest. It is usually expressed in alphabetical symbols. It helps investors to recognize the risk involved in lending the money and gives a fair assessment of the borrower’s creditability.

When the United States began to expand to the west and other parts of the country, so did the distance of businesses to their customers. When businesses were close to those who purchased goods or services from them, it was easy for the merchants to extend credit to them. Due to their accessibility and the fact that merchants knew their customers personally and knew whether they would be able to pay them back or not. As trading distances increased, merchants no longer personally knew their customers and became cautious of extending credit to people who they did not know in fear of not getting paid back. Business owners’ hesitation to extend credit to new customers led to the birth of the credit rating industry.

In 1913, the publication by Moody’s underwent two significant changes: it expanded its focus to include industrial firms and utilities, and it began to use a letter-rating system. For the first time, public securities were rated using a system borrowed from the mercantile credit rating agencies, using letters to indicate their creditworthiness. In the next few years, antecedents of the “Big Three” credit rating agencies were established. Poor’s Publishing Company began issuing ratings in 1916, Standard Statistics Company in 1922, and the Fitch Publishing Company in 1924.

In the late 1960s and 1970s, ratings were extended to commercial paper and bank deposits. Also during that time, major agencies changed their business model by beginning to charge bond issuers as well as investors. The reasons for this change were because of the problem related to the increased availability of inexpensive photocopy machines and the increased complexity of the financial markets.

The rating agencies added levels of gradation to their rating systems. In 1973, Fitch added plus and minus symbols to its existing letter-rating system. The following year, Standard and Poor’s did the same, and Moody’s began using numbers for the same purpose in 1982.

Functions of a Credit Rating Agency

Various aspects are taken into account by a credit rating agency when a borrowing company applies for rating. Following are functions of a typical credit rating agency:

Provides unbiased opinion: An independent credit rating agency has to provide an unbiased opinion about the creditworthiness of the company because of the following reasons:

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

Its own reputation is at stake.

Provides quality and dependable information: A credit rating agency will provide quality information on credit risk which is authenticated and reliable because:

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

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

Provides information at low cost: As investors cannot assess creditworthiness of a company on their own, most of them rely on the ratings assigned by the ratings agencies while taking investment decisions. These ratings are published in the form of reports and are available easily on the payment of negligible price.

Provide easy to understand information: Rating agencies first of all gather information, and then analyze the same. At last they interpret and summarize 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 details of the financial statements.

Provide basis for investment: An investment rated by a credit rating agency 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.

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 corporate.

Credit Rating

Credit rating is a quantified analysis of the creditworthiness of the borrower associated with a financial instrument or a financial entity. A credit rating can be assigned to any entity that seeks to borrow money—an individual, corporation, state or provincial authority, or sovereign government.

Characteristics of Credit Rating

The few main characteristics of credit ratings are as follows:

Expressed in Symbols

Assessment of issuer's capacity to repay

Based on Data

Universal Acceptance

Done by Experts

Guidance about investment-not recommendation

Not for company as a whole

Does not create a fiduciary relationship

Rating not forever

Compulsions for Credit Rating

Obtaining credit rating is compulsory in the following cases

For debt securities: The RBI and SEBI have made credit rating compulsory in respect of all non-government debt securities where the maturities exceed 18 months.

Public deposits: Rating of deposits in companies has also been made compulsory.

For commercial papers (CPs): Credit rating has also been made compulsory for commercial papers. As per RBI guidelines rating of P2 by CRISIL or A2 by ICRA or PP2 by CARE is necessary for commercial papers.

For fixed deposits with non-banking financial institutions (NBFCs): Under the Companies Act, credit rating has been made compulsory for fixed deposits with NBFCs.

Credit Rating Process

In India credit rating is done mostly at the request of the borrowers or issuer companies. The borrower or issuer company requests the credit rating agency for assigning a ranking to the proposed instrument. The process followed by most of the credit rating agencies is as follows:

Agreement: An agreement is entered into between the rating agency and the issuer company. It covers details about terms and conditions for doing the rating.

Appointment of analytical team: The rating agency assigns the job to a team of experts. The team usually comprises of two analysts who have expert knowledge in the relevant business area and is responsible for carrying out rating.

Obtaining information: The analytical team obtains the required information from the client company and studies company's financial position, cash flows, nature and basis of competition, market share, operating efficiency arrangements, managements track, cost structure, selling and distribution record, power (electricity) and labor situation etc.

Meeting the officials: To obtain clarifications and understanding the client's business the analytical team visits and interacts with the senior executives of the client.

Discussion about findings: After completion of study of facts and their analysis by the analytical team the matter is placed before the internal committee (which comprises of senior analysts) an opinion about the rating is taken.

Meeting of the rating committee: The findings of internal committee are referred to the "rating committee" which generally comprises of a few directors. It is the final authority for assigning ratings.

Communication of decision: The rating decided by the rating committee is communicated to the client company.

Information to the public: The rating company publishes the rating through reports and the press.

Revision of the rating: Once the issuer company has accepted the rating, the rating agency is under an obligation to monitor the assigned rating. The rating agency monitors all ratings during the life of the instrument.

Users of Credit Ratings

Credit ratings are used by investors, intermediaries such as investment banks, issuers of debt, and businesses and corporations.

Both institutional and individual investors use credit ratings to assess the risk related to investing in a specific issuance, ideally in the context of their entire portfolio.

Intermediaries such as investment bankers utilize credit ratings to evaluate credit risk and further derive pricing of debt issues.

Debt issuers such as corporations, governments, municipalities, etc., use credit ratings as an independent evaluation of their creditworthiness and credit risk associated with their debt issuance. The ratings can provide prospective investors with an idea of the quality of the instrument and the kind of interest rate they should be expecting from it.

Businesses and corporations that are looking to evaluate the risk involved with a certain counterparty transaction also use credit ratings. They can help entities that are looking to participate in partnerships or ventures with other businesses evaluate the viability of the proposition.

Regulatory Framework for Credit Rating Agencies in India [as per SEBI (Credit Rating Agencies) Regulations, 1999]

Credit rating is entirely a new concept in the history of Indian corporate sector and is intended for investors' guidance and protection. It came into limelight only when Securities Exchange Board of India (SEBI) made credit rating compulsory for the Indian companies. The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 empower SEBI to regulate credit rating agencies operating in India. Thus, SEBI regulates the credit rating agencies under the SEBI (Credit Rating Agencies) Regulations, 1999 of the Securities and Exchange Board of India Act, 1992. In fact, SEBI was one of the first few regulators, globally, to put in place an effective and comprehensive regulation for Credit Rating Agencies.

SEBI regulates the functioning of credit rating agencies in order to protect the interest of investors and to make the system more helpful to them. Credit rating agencies are amongst the very few market intermediaries for which such detailed operating guidelines have been prescribed under the regulations. The supervisory frameworks for credit rating agencies have been established recently and these regulatory efforts mark a turning point in the credit rating industry.

Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 was passed which made even the SEBI keep a watchful eye on the Credit Rating Companies in India with the help of various regulation needed for it. The Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999 contains:-

Regulation regarding the registration of credit rating agencies regulating the application for grant of certificate eligibility criteria for promoter of credit rating agency, furnishing of information, clarification and personal representation by the promoter, grant of certificate of the SEBI, its conditions validity period, clauses of its renewal and procedure for refusal of certificate and its effect.

General obligations of credit rating agencies regulating the Code of Conduct, Agreement with the client, Monitoring and process of ratings and the Procedure for review of rating, Appointment of Compliance Officer and compiling the letter circulars of the SEBI, maintaining of proper book of Accounts and having regular audits.

Restriction on rating of securities issued by promoters or by certain other persons regulating the securities issued by promoter, certain entities, connected with a promoter or securities already rated.

Procedure for inspection and investigation regulating SEBI's right to inspect after a due notice and obligations to be fulfilled by taking actions on the inspection or investigation report.

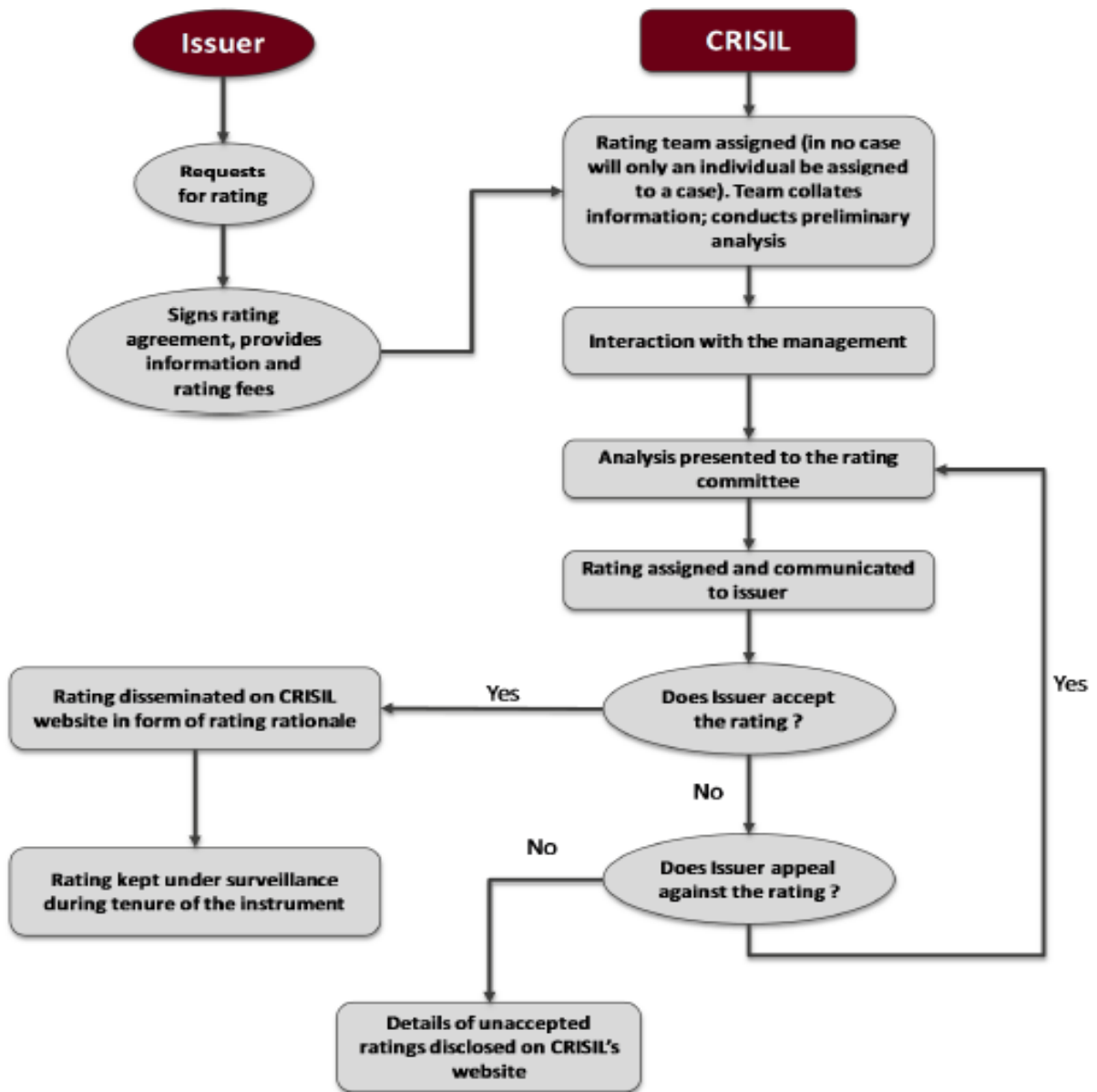
Procedure for action in case of default fixing the liability of the credit company.

The study of regulatory environment regarding credit rating reflect that the SEBI regulations for credit rating agencies has been designed to protect the interest of investors in securities through widespread investor access to ratings, through a clearly articulated rating dissemination process, and to promote the development of, and to regulate the securities market. Further, the SEBI regulations ensure that the credible players enter this business (through stringent entry norms and eligibility criteria) and credit rating agencies operate in a manner that enables them to issue objective and fair opinions.

DATA ANALYSIS AND INTERPRETATION

Rating Process of CRISIL

The following flowchart shows the rating process followed by CRISIL



The rating process is explained in detail as follows:

Preliminary analysis: The rating process starts with a rating request from the issuer. Thereafter, the rating agreement is signed and the fees are collected from the issuer. All interactions with regard to rating fees are carried out by CRISIL's business development team and there is no involvement of CRISIL's analytical team in the process. When this process is completed, an analytical team is assigned the responsibility of analyzing the issuer's credit risk profile. This rating team (comprising at least two analysts) then gathers preliminary information from the issuer to understand its business, management, and financial risk profiles.

Management interaction: CRISIL strongly believes that investor interest is best served if there is an open dialogue between the issuer and CRISIL. This enables CRISIL to incorporate non-public information into its rating decision and also helps it arrive at forward-looking ratings.

Management interactions can be carried out telephonically or at any of CRISIL's or issuer's offices. Discussions during management interactions cover many details such as competitive position, strategy, financial policy, historical performance, and near and long-term financial and business prospects. In these discussions, CRISIL's rating teams mainly focuses on the issuer's business risk profile and strategies and also study its financial data. CRISIL's ratings are not based solely on financial projections made by the issuer or the management's outlook. Instead, they serve as a valuable input in CRISIL's assessment of the issuer's profile as they are based on the management's assumptions, strategy, and contingency plans.

Rating committee and assignment of ratings: After the interaction with the issuer's management, CRISIL's analysts prepare a report detailing their assessment of business risk, financial risk, and management risks associated with the issuer. The report is prepared according to rating methodologies and criteria that are published in CRISIL's website, and consistently applied. These rating methodologies differ from one sector to another. 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. The rating committee comprises experienced professionals who have extensive experience in credit assessment. The rating committee assigns a rating after thorough discussion on the report prepared by the analysts.

The Rating Committee Meeting (RCM) process ensures objectivity of the rating, as the decision results from the collective thinking of a group of experienced professionals. The RCM process also ensures high quality and consistency of analysis because the reports and discussions are focused on key rating factors that are relevant to the issuer. If CRISIL and the issuer have any common directors, such directors do not participate in the RCM or rating process. A disclosure to this effect is also made with the announcement of the rating.

Communicating the rating to the issuer: On finalization of a rating at the RCM, the rating decision is communicated to the issuer. Thereafter, a document (rating rationale) highlighting the key reasons for assigning the ratings are shared with the issuer. This is to assist the issuer in understanding the key analytical factors that have been assessed for arriving at the rating decision.

If the issuer decides to accept the rating, it can do so by sending a letter of acceptance to CRISIL. If, on the other hand, the issuer disagrees with the rating decision, it can appeal for a fresh look at the rating assigned. In such a case, the issuer needs to submit additional facts, data or new information to the ratings team which are presented to the rating committee. Such information must be material to the

appeal, and should ideally address areas that have been highlighted as factors constraining the rating in the rating rationale. The rating committee then discusses the information submitted. It may or may not change the rating, depending on the facts of the case. If the rating is not changed and issuer continues to disagree with the rating, then the issuer has an option of not accepting the rating. Recently, SEBI has mandated CRAs to publish such unaccepted credit ratings on their website. Hence in line with these guidelines, the unaccepted ratings shall be disclosed on CRISIL's website.

Publication of accepted ratings: The accepted ratings are disseminated to CRISIL's subscriber base, and to local and international media. Rating information is also updated online on www.crisil.com, the CRISIL website, in the form of a rating rationale, which provides information about the company, rated instrument, assigned rating and outlook, rationale for assigning the rating, applicable criteria, etc.

Also, CRISIL, in compliance with International Organization of Securities Commission (IOSCO) code of conduct, publishes a more detailed credit rating report (CRR) on its dedicated website, www.crisilratings.com. The publication of the CRR ensures transparency in CRISIL's ratings methodologies and assumptions and also enables investors to understand how CRISIL arrives at a rating. In addition, CRISIL publishes credit insights derived from its rated universe through periodic publications called Ratings Roundup (published semi-annually) and Default Study (published annually).

Timeframe: From the initial management meeting to the assignment of rating, the rating process can take up to four weeks, but CRISIL sometimes arrives at rating decisions in shorter timeframes to meet urgent requirements.

Surveillance: All CRISIL ratings are under continuous surveillance. After a rating has been assigned, CRISIL continues to monitor the performance of the issuer and the economic environment in which it operates. The surveillance process ensures that the analysts are updated on current developments, review sensitive areas, and learn about changes in issuer's plans.

CRISIL's analysts maintain periodic contact with the issuer and ensure that financial and other information are shared with CRISIL regularly. Moreover, CRISIL endeavors to interact with issuer's management at least once a year. These interactions essentially focus on developments over the period since the last interaction, and the outlook for the coming year.

Withdrawal of ratings: Debt instruments rated by CRISIL are under continuous surveillance over the life of the instrument. CRISIL's policy for withdrawal of ratings stipulates that ratings on securities/facilities that have scheduled repayment dates (such as bonds, or term loans), may be withdrawn only on redemption/maturity of the rated facilities. The ratings may also be withdrawn if obligations on these instruments are pre-paid by the borrower, with the lender's consent, before maturity. In such instances, CRISIL relies on independent confirmation from the banks or auditors or any other independent sources; whether the obligations have been repaid in full.

Ratings on bank loan facilities can also be withdrawn by CRISIL after receiving request for withdrawal from the client/borrower along with No Objection Certificate (NOC) from all the lending bank(s) and on clearance of fees due (if any) to CRISIL.

CRISIL's withdrawal policy is in line with the recent SEBI circular titled 'Enhanced Standards for Credit Rating Agencies (CRAs)' that is applicable for all Credit Rating Agencies.

Non-cooperation by the issuers: CRISIL monitors its ratings on a continuous basis. However, in rare cases, the monitoring of rated entity might become difficult because of the entity's non-cooperation. In case the rated entity does not share information with CRISIL on regular basis, or does not provides access to its management or discuss quarterly/annual results or does not pay fee for conducting surveillance, that entity can be classified as non-cooperative. CRISIL rates the non-cooperative issuer on the basis of best available information till the lifetime of the instrument. However the aspects of non-cooperation are highlighted in the press release disseminated on CRISIL's website. In such cases, the rating symbol will be accompanied by 'Issuer did not cooperate; based on best available information'. This is in accordance with the recent SEBI circular.

Confidentiality: A substantial portion of the information shared by the company is highly sensitive, and is provided by the issuer only for the purpose of arriving at the rating. Such information is kept strictly confidential by the ratings group and not shared with other divisions or group companies of CRISIL. CRISIL doesn't disseminate confidential information about entities it rates. However, in accordance with recent SEBI guidelines, CRISIL has started to disclose unaccepted ratings on its website from January 2017.

All CRISIL employees are required to sign a confidentiality agreement. CRISIL does not disclose issuer-specific confidential information that it has obtained for the purpose of credit rating to anyone (other than to market regulators or law enforcement authorities, if required).

CRISIL's Rating Criteria and Methodology for Banks and Financial Institutions

Methodology : CRISIL's approach towards rating banks and FIs involves a comprehensive assessment of the following parameters:

Market position: CRISIL factors in the size of a bank/FI and its position in the industry. A large size helps withstand business and systemic shocks and helps determine the extent of systemic support that can be expected. CRISIL also factors in the diversity in product portfolio, business lines, and customer base.

CRAMEL framework

Capital adequacy

Resource-raising ability

Asset quality

Management and systems evaluation

Earnings potential

Liquidity/asset liability management

1. Capital adequacy

Capital provides a bank/FI with the cushion to withstand credit and other risks in business. While assigning a rating, CRISIL analyses the capital adequacy and its sustainability over the medium-to-long term. This assessment is significantly influenced by the perception of relative profitability, the bank/FI's risk profile, and asset quality. The analysis encompasses the following factors:

Adherence to capital adequacy requirements as per Basel III regulatory norms

Size of capital

Sustainability of capital ratios and flexibility to raise Tier I and hybrid capital

Quality of capital (Tier I capital)

Growth plans

2. Resource raising ability

CRISIL analyses the resource position of the bank/FI in terms of its ability to maintain a low-cost, stable resource base. In the domestic context, the resource composition of a bank is very different from that of an FI. Banks are significantly deposit-funded whereas FIs depend on wholesale funds. While some FIs do raise retail funds, they are at a natural disadvantage compared with the banking sector, because of restrictions on minimum tenure and interest rates, the absence of cheque-issuing facility, and relatively small branch network. In general, dependence on wholesale funding attaches a degree of risk to the funding profile of FIs. These risks (especially stability of resources) are mitigated by the access that all-India financial institutions (AIFIs) have to resources from provident funds and the insurance sector. Such resources have a retail origin.

Size of deposit base

Diversity in deposit base and the geographical spread

Deposit mix

Growth in deposits

Diversity of investor base

Funding mix and cost of funds

Retail penetration and tax benefits

3. Asset quality

A bank/FI's asset quality is a measure of its ability to manage credit risks. In recent years, asset quality of banks has been under stress mainly due to the deterioration in the credit quality of corporate. The Reserve Bank of India (RBI), along with the government, has been taking measures to address the challenge and to strengthen credit and risk practices. Some of RBI's tools to support banks to manage asset quality include restructuring of loans under corporate debt restructuring (CDR), structuring of stressed assets under schemes such as 5:25, strategic debt restructuring, and the scheme for sustainable solution of stressed assets. The operationalization of the Insolvency and Bankruptcy Code (IBC) by the Government of India for effective resolution of stressed assets is a step towards improving asset quality.

Besides studying a bank's credit appraisal mechanism, portfolio monitoring procedure, and asset resolution strategies, CRISIL analyses asset quality on the basis of the following parameters:

Geographical diversity

Client profile of corporate asset portfolio

Quality of non-industrial lending

Level of stressed assets

Movement of provisions and write-offs

Growth in advances

4. Management and systems evaluation

Quality of management is an important differentiating factor in the future performance of a bank/FI. The management is evaluated on the following parameters:

Goals and strategies

Systems and monitoring

Appetite for risk

Competence and integrity

5. Earnings potential

CRISIL analyses a bank/FI's earnings on the basis of the level, diversity, and stability of earnings.

- i. Level of earnings
- ii. Diversity of income sources
- iii. Efficiency measures

6. Liquidity/ asset liability management

CRISIL assesses the quantum and quality of liquid assets available, reliance on short-term funding, and the asset-liability maturity profile to form an opinion on the liquidity and interest rate risks. The policy on asset and liability management is also analyzed.

- i. Liquidity risk
- ii. Interest rate risk
- iii. Government support

Conclusion

CRISIL's rating analysis of banks and FIs focuses on analysis of all the factors in the CRAMEL framework. No single factor is of overriding importance, or is considered in isolation. All six factors are viewed in conjunction when assigning a rating. The analysis factors in market position and systemic importance of the entity. Based on rating criteria, and the strengths and weaknesses of each bank/FI compared with peers, a final opinion on the credit quality is given in the form of a credit rating.

CRISIL's Rating Criteria and Methodology for Manufacturing and Service Sector Companies which includes Software Industries and Pharmaceuticals

CRISIL's framework for assessing the credit quality of manufacturing and service sector companies entails the four broad areas of business, financial, management, and project risks:

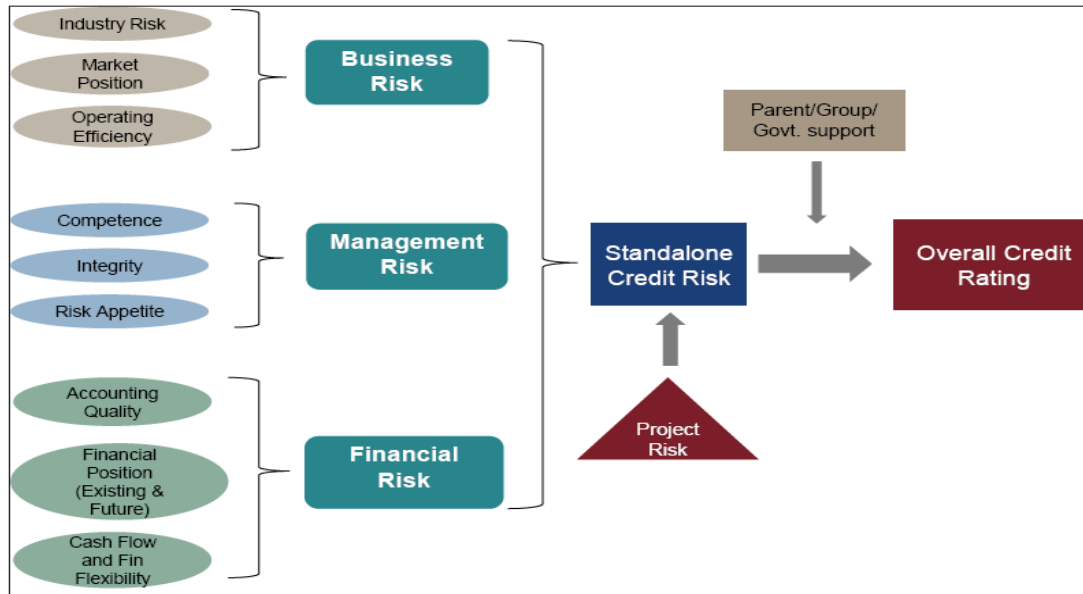
Business risk analysis is an assessment of the sustainability and stability of a company's cash flows. It includes the business fundamentals of the rated company, the characteristics of the industry in which it operates, its competitive market position in the industry, and its operational efficiencies.

Financial risk analysis assesses the sustainability and adequacy of the company's cash flows with particular emphasis on debt servicing ability. It includes an assessment of how the business strengths of the rated company are translated into its current and future financial performance and its financial flexibility, with particular emphasis on its liquidity.

An evaluation of the company's management philosophies, strategies/policies, and risk appetite is undertaken while assessing management risk.

If the company is implementing any large project, the risks associated with the project's implementation, funding, and marketing are also evaluated.

Support from the parent/group/government is also analyzed and factored into the overall rating.



➤ Business Risk Analysis

The analysis begins with a fundamental assessment of the environment in which the company operates, and essentially covers the overall aspects of the industry, the risks to which that industry is exposed, and the government policies affecting that particular industry. The evaluation extends to an assessment of the company's market position and its operational efficiencies.

➤ Industry risk

Assessing the industry risk is fundamental to evaluating a company's business risk profile. The industry risk rating largely indicates the median rating for companies in that industry. However, it should be noted that the presence or otherwise of strong credit quality factors in terms of market position, operating efficiency, and financial position will eventually determine the final rating assigned to the debt instruments of individual companies.

For industry risk analysis, CRISIL evaluates the size of the industry, its growth prospects, the competitive scenario and demand-supply dynamics, vulnerability to technological change, the importance of the industry to the economy, government policies, entry barriers, profitability, and cyclicity. Industries that have steady demand growth, ability to maintain margins without impairing future prospects, flexibility to time capital expenditure, and moderate capital intensity are regarded favorably. Favorable industry risk factors may not, however, directly translate into higher ratings for all companies within that industry, but such factors do support the credit quality of these companies.

➤ Market position

An analysis of the rated company's market position, in essence, is an assessment of its ability to profitably sell goods and services in a stable and sustainable manner. The ability to sell what is produced

and to control selling prices critically determine the market position of a company. Thus, a large market share is not always synonymous with competitive advantages or industry dominance if the company does not have the flexibility to determine the selling price of its products.

CRISIL undertakes a detailed analysis of both the factors—the degree of competition in each market segment and the competitive dynamics among different players—to evaluate a firm’s market position. Entry barriers to the industry and capacity expansions of existing players are analyzed to understand the dynamics of demand and supply on a forward-looking basis.

CRISIL also analyses regional demand-supply balances especially for those industries where the logistical cost of transporting products across regions is prohibitive.

For industries such as cement, branded consumer goods, and fast-moving consumer goods, the key factors for assessing market position are distribution network and brand equity. For service industries, strong customer relationships, and ability to brand and differentiate the service offerings are critical factors. An analysis of positioning categories on the basis of their size, features, price range, and consumer segments gives CRISIL an insight into the company’s market strategy. The market position of companies in industries such as software, drugs and pharmaceuticals, and consumer durables is analyzed in terms of their track record and their ability to innovate and launch products and achieve commercial success.

➤ **Operating efficiency**

Operating efficiency is an analysis of a company’s ability to produce goods and provide services at competitive costs, in a sustainable manner. The factors considered while evaluating operational efficiency vary from industry to industry. Some of the key factors common across industries are technology, access to resources, human resources, capacity utilization, flexibility in the manufacturing process, extent of integration, and research and development (R&D). These factors could contribute to the stability of a company’s cost structure or create sustainable cost advantage, or conversely, lead to volatile cost structures and only short-term cost advantage.

➤ **Technology**

Technology remains a significant factor in maintaining a competitive position in the business. Companies with strong technology-oriented businesses have fewer competitors as technology provides a significant entry barrier to the unorganized sector.

➤ **Access to resources**

Companies with easy access to raw materials and a bargaining power with suppliers maintain healthy operating margins in the long term. Domestic availability of raw materials and captive sources impart flexibility in protecting operating margins.

➤ **Price volatility of key raw materials/inputs**

The extent of volatility in raw material prices is another key element of CRISIL's analysis. CRISIL analyses the linkage of input prices and the pricing of goods sold. Strong linkages will normally imply low volatility of operating margins.

➤ **Human resources**

CRISIL analyses a company's ability to attract and retain qualified and experienced manpower while evaluating knowledge-based industries. CRISIL also evaluates the depth and diversity of skill sets available in the company, and policies regarding training and upgrading skills of employees. The company's attrition levels are compared with those in the industry levels, and CRISIL analyses the impact of attrition on the company.

CRISIL also evaluates the company's relations with labor unions and the workforce in general, and any history of disruptions in operations driven by labor unrest.

➤ **Capacity utilization and flexibility**

Economies of scale achieved through optimum capacity utilization are very important to reduce production costs per unit. CRISIL assesses the flexibility of the company to shift between products or redeploy human resources. Operating parameters are developed for each industry and individual industry rating criteria highlight these parameters, which are critical for the relative profitability levels of in that sector.

➤ **Level of integration**

A high level of vertical integration usually results in a better cost structure. CRISIL analyses the flexibility available to a company to alter various stages in its process in the event of adverse movements in its cost structure.

➤ **R&D**

CRISIL examines the rated company's ability to develop new products to serve changing needs or to acquire new domain knowledge. CRISIL also studies the quality of the R&D activities, annual R&D spend, and the adequacy of the company's R&D facilities.

B. Financial Risk Analysis

CRISIL's financial risk analysis essentially focuses on determining the sustainability and adequacy of the issuer's cash flows in relation to its debt servicing obligations. The key parameters for assessing financial risk are accounting quality, adequacy of cash flows, and financial flexibility. CRISIL considers various financial ratios while analyzing the financial risk profile of a firm.

➤ **Accounting quality**

The financial ratios and statements used by CRISIL to analyze a company's financial performance are derived from the audited financial statements. Consequently, CRISIL commences its financial risk analysis by assessing the company's accounting quality. Some key areas that are analyzed are:

- Any overstatement/understatement of profits
- Qualifications made by auditors
- Method of income recognition and depreciation
- Inventory valuation policies
- Off-balance-sheet items/contingent liabilities and similar factors

Wherever required, analytical adjustments are made and the company's financial statements are recast to reflect an accurate picture of its true financial position. This is essential for an accurate assessment of the company's financial performance.

➤ **Adequacy of cash flows**

As a credit rating is an assessment of a company's ability to meet its debt obligations in future, CRISIL's financial risk analysis primarily revolves around an assessment of the company's future earning capacity in relation to its debt servicing obligations. It is relevant to note that CRISIL's analysis is cash-flow based: CRISIL uses a proprietary financial model to estimate the cash flow that will be generated by the company during a particular year. Several adjustments are made to the reported financial statements, including those for working capital changes and provision for expenses, to ensure comparability and to provide analytically sound metrics for assessment of financial performance.

CRISIL's cash flow analysis includes two steps:

1. Assess the company's financial performance (that is, its income statement). An evaluation of the company's past and future profit potential is carried out to understand the available credit protection and the sustainability of the same. This encompasses an analysis of absolute levels of various ratios, trends across years, and comparison across industry peers. CRISIL evaluates the profitability of the company's operations and its sensitivity to price fluctuations and downturns in the industry. Based on this understanding, CRISIL arrives at an estimate of the company's future financial performance and cash flows, and assesses its adequacy with respect to its debt servicing needs.
2. Assess the company's financial position, that is, balance sheet analysis. The assessment includes the company's capital structure, cost of funding, and working capital management. This is studied in relation to the company's business risk profile. Companies with volatile earnings may increase their financial risk if they leverage excessively, while companies with stable operations can operate with a high leverage without adversely affecting their financial risk profiles. CRISIL also analyses capital expenditure plans, organic and inorganic growth plans, the funding plans, and maturity profile of debt.

➤ **Financial flexibility**

CRISIL evaluates a company's ability to generate funds through alternative sources in the event of any financial distress. The company's contingency plans and its ability to deal with various adverse scenarios

are analyzed. Its ability to raise funds through internal sources and external sources to cover temporary shortfalls is evaluated. The company's record in raising funds, especially from the capital markets, its relations with lending institutions, and the quantum of marketable securities that it holds are some of the indicators of its financial flexibility.

To assess the company's liquidity, CRISIL also evaluates bank limit utilization with respect to drawing power on a monthly basis. The bank limit utilization indicates the flexibility available to the company to manage its working capital from external sources.

For service sector entities, especially those in IT sector, employee salaries form major portion of operating costs and firms have limited flexibility in deferring this expense. Therefore these firms, as a policy, maintain necessary cash to pay specified months of employee costs. CRISIL's analysis of financial flexibility of such firms takes into account the cash in excess of what they are required to maintain as per policy.

Additionally, a company's flexibility to defer its capital expenditure plans in case of weakening in its financial position is also analyzed. If the rated company is a subsidiary or part of a group, the external support that it can receive from the parent company or group companies is analyzed.

C. Management risk analysis

CRISIL's evaluation of a company's management entails understanding the goals, philosophies, and strategies that drive the company's business and financial performance. Furthermore, if the company is a part of a larger business group; or if it is a multinational, the parent company's management philosophies or those of the business group are used as pointers to assess managerial responses in the enterprise being evaluated.

An evaluation of the management involves several aspects such as understanding the organizational and reporting structure, the management's experience and track record, the level of commitment and track record in debt payments, and the adequacy of its planning and control systems.

The management's past success in introducing new products and its ability to manage change in the external environment, such as regulatory or technological changes, are also analyzed. In addition, the company's overall risk appetite is assessed.

Succession is another key area of concern if the company's operations are dependent on a single promoter or manager. Corporate governance principles followed by the management in its daily operations and transparency in management actions are also evaluated.

D. Project risk analysis

If a company is implementing a new project, CRISIL evaluates the risks associated with that project and factors in these risks while assigning the overall rating. The relative size of the new project compared with the existing operations indicates the significance of the project risk in the overall rating.

Implementation risks such as time and cost overruns and technology obsolescence risk, along with the impact of these risks on the project's viability, and funding risks in terms of the project's capital structure and funding arrangements, are also evaluated.

The project's market risks in relation to the company's existing product line and track record in implementing such projects are given adequate importance in assigning the rating.

Conclusion

CRISIL's rating methodology for manufacturing and service companies involves intensive analysis of the business, financial, and management risk profiles of the company. The analysis primarily seeks to determine the quantum, stability, and adequacy of the company's future cash flows in relation to its debt servicing requirements. The above note provides the basic parameters for the analysis which are applicable to all sectors. Separate industry-specific criteria will dive deep into the specific issues considered while evaluating various sectors.

FINDINGS

The following are the observations from the above study carried out on Credit Rating Agencies with reference to CRISIL Ltd.

SEBI is regulator of Credit Rating Industries, which explains the general guidelines to be followed for rating process. Rules and Regulation regarding assigning ratings, its publication in the company's website and withdrawal of a particular rating.

Credit Rating is made compulsory for Debt Securities, Public Deposits, Commercial Papers and Fixed Deposits with NBFCs.

CRISIL Ltd. is first among top ten credit rating agencies in India.

CRISIL is acquiring 60% of market particularly in SME ratings.

CRISIL's criteria for rating Banks/FIs are done with CRAMEL Framework.

Capital adequacy

Resource-raising ability

Asset quality

Management and systems evaluation

Earnings potential

Liquidity/asset liability management

CRISIL's criteria for rating Manufacturing and Service sector: Software Industries and Pharmaceuticals is done by assessing the following risks

Business Risk

Financial Risk

Management Risk

Project Risk

CONCLUSION

The study on Credit Rating Agencies is important for an individual not only for imparting of knowledge but also to make better investment decisions which indeed helps in economic growth of a country. Credit Rating agencies are in the boundary of SEBI and RBI and hence entry to such a sector is restricted by certain rules and regulations.

CRISIL being the top rating agency has evolved from being merely a Rating Agency to Analytical and Research unit nationally and internationally. CRISIL is also in Business Intelligence and Risk Management and also in Infrastructure Advisory Services. It covers almost all the sectors of the economy. CRISIL has different rating criteria and methodology for different sectors which makes it unique.

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