

Concept of Credit Rating

Khurram Khan

According to State Bank of Pakistan

”Credit rating is an independent opinion expressed by the professional bodies i.e. credit rating agencies that states about capacity of an entity to meet its obligations and is based on various quantitative and qualitative factors”

Credit Rating concept developed from the point of view of investors who wants to Judge the default risk. Therefore for investor, default risk is judged in terms of quality ratings assigned by the principal rating agencies. These investment agencies assign and publish letter grades fro the use of investors. In their ratings the agencies rank companies with reference to probability of default. The standard rating used by the agencies are shown as follows:

Aaa	Best quality	AAA	Highest grade
Aa	High Quality	AA	High grade
A	Upper medium grade	A	High medium grade
Baa	Medium grade	BBB	Medium grade
Ba	Possess speculative elements	BB	Speculative
B	Generally lack characteristics Of desirable investment	B	Very Speculative
Caa	Poor standing may be in default	CCC-CC	Outright speculation
Ca	Highly speculative often in Default	C	Reserved fro income bonds on which no interest in being paid
C	Lowest Grade	D	In default

Securities rated below the top four categories are referred to as “speculative grade

The terms is used by regulatory agencies to identify securities that are eligible for investment by financial institutions such as commercial banks and insurance companies.”

In Pakistan, credit rating is at its early stages and there are two rating agencies i.e; Pakistan Credit Rating Agency (Pvt.) Limited (Pacra) and JCR-VIS. Securities and Exchange Commission of Pakistan (SECP) and the State Bank have made compulsory for financial institutions to obtain credit rating on regular basis. In order to augment ongoing efforts to maximize disclosure for the benefit of stakeholders and market participants, all banks / NBFIs were required to get themselves credit rated with effect from June 30, 2001.

The Banking Policy Department of SBP on August 30, 2002 give Standard Rating Scales And Definitions Being Used By (Pacra and JCR-VIS)

**STANDARD RATING SCALES AND DEFINITIONS BEING
USED BY PAKISTAN CREDIT RATING AGENCY (PACRA)**

LONG TERM RATINGS	SHORT TERM RATINGS
<p>AAA – HIGHEST CREDIT QUALITY: ‘AAA’ ratings denote the lowest expectation of credit risk. Assigned only in case of exceptionally strong capacity for timely payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.</p> <p>AA – VERY HIGH CREDIT QUALITY: ‘AA’ ratings denote a very low expectation of credit risk. The capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.</p> <p>A – HIGH CREDIT QUALITY: ‘A’ ratings denote a low expectation of credit risk. This capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.</p> <p>BBB – GOOD CREDIT QUALITY: ‘BBB’ ratings indicate that there is currently a low expectation of credit risk. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity. This is the lowest investment grade category.</p> <p>BB – SPECULATIVE: ‘BB’ ratings indicate that there is a possibility of credit risk developing, particularly as a result of adverse economic change over time; however, business or financial alternatives may be available to allow financial commitments to be met. Securities rated in this category are not investment grade.</p> <p>B – HIGH SPECULATIVE: ‘B’ ratings indicate that significant credit risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.</p> <p>CCC, CC, C – HIGH DEFAULT RISK: Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. A ‘CC’ rating indicates that default of some kind appears probable. ‘C’ ratings signal imminent default.</p>	<p>A1+ : Obligations supported by the highest capacity for timely repayment.</p> <p>A1 : Obligations supported by a strong capacity for timely repayment.</p> <p>A2 : Obligations supported by a satisfactory capacity for timely repayment, although such capacity may be susceptible to adverse changes in business, economic, or financial conditions.</p> <p>A3 : Obligations supported by an adequate capacity for timely repayment. Such capacity is more susceptible to adverse changes in business, economic, or financial condition than for obligations in higher categories.</p> <p>B : Obligations for which the capacity for timely repayment is susceptible to adverse changes in business, economic, or financial conditions.</p> <p>C : Obligations for which there is an inadequate capacity to ensure timely repayment.</p> <p>D : Obligations which have a high risk of default or which are currently in default.</p>

N.B.

A plus (+) or minus (-) may be appended to a rating to denote relative status within major rating categories. Such suffixes are not added to ‘AAA’ long-term rating category, to categories below ‘CCC’, or to short-term ratings.

**STANDARD RATING SCALES AND DEFINITIONS BEING
USED BY JCR-VIS CREDIT RATING COMPANY**

LONG TERM RATINGS	SHORT TERM RATINGS
<p>AAA : Highest Credit quality. The risk factors are negligible being only slightly more than for risk-free Government of Pakistan debt.</p> <p>AA+, AA, AA- : High credit quality. Protection factors are strong. Risk is modest but may vary slightly from time to time because of economic conditions.</p> <p>A+, A, A- : Good credit quality. Protection factors are adequate. Risk factors may vary with the possible changes in the economy.</p> <p>BBB+, BBB, BBB- : Adequate credit quality. Protection factors are reasonable and sufficient. Risk factors are considered variable if changes occur in the economy.</p> <p>BB+, BB, BB- : Obligation deemed likely to be met when due. Protection factors are capable of weakening if changes occur in the economy. Overall quality may move up or down frequently within this category.</p> <p>B+, B, B- : Obligations deemed less likely to be met when due. Protection factors are capable of fluctuating widely if changes occur in the economy. Overall quality may move up or down frequently within this category or into higher or lower rating grade.</p> <p>CCC : Considerable uncertainty exists towards obligations when due. Protection factors are scarce and risk may be substantial.</p> <p>CC : A high default risk.</p> <p>C : A very high default risk.</p> <p>D : Defaulted obligations.</p>	<p>A-1+ : Highest certainty of timely payment short-term liquidity, including internal operating factors and / or access to alternative sources of funds, is outstanding and safety is just below risk free Government of Pakistan's short-term obligations.</p> <p>A-1 : High certainty of payment. Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.</p> <p>A-2 : Good certainty of timely payment. Liquidity factors and company fundamentals are sound. Although ongoing funding needs may enlarge total financing requirements, access to capital markets is good. Risk factors are small.</p> <p>A-3 : Satisfactory liquidity and other protection factors qualify issues as to investment grade. Risk factors are larger and subject to more variation. Nevertheless, timely payment is expected.</p> <p>B : Speculative investment characteristics. Liquidity may not be sufficient to ensure timely payment of obligations.</p> <p>C : Capacity for timely payment of obligations is doubtful</p> <p>D : Defaulted obligations.</p>

N.B.

A plus (+) or minus (-) is added to the rating symbols from 'AAA' to 'B' to indicate relative standing within each of those rating categories.

These two credit rating agencies are associated with Association of Credit Rating Agencies in Asia (ACRAA) an association formed by Asian credit rating agencies organized on September 14th, 2001 and assisted by the Asian Development Bank. The purpose of creating ACRAA was to create a forum for conversation of thoughts among rating agencies, to promote best practices and norms of conduct, and thereby to aid in the development of Asia's financial market. It has following members.

1. The Credit Rating Information Services of India Ltd.
2. ICRA Limited
3. Credit Analysis and Research Limited
4. PEFINDO Credit Rating Indonesia
5. P. T. Kasnic Credit Rating Indonesia
6. Japan Credit Rating Agency, Ltd.
7. Seoul Credit Rating & Information, Inc.
8. Rating Agency Malaysia Berhad
9. Malaysia Rating Corporation (MARC)
10. JCR-VIS Credit Rating Co., Ltd.
11. The Pakistan Credit Rating Agency (Private) Ltd.
12. Philippine Rating Services Corporation (PhilRating)
13. Taiwan Ratings Corp.
14. Thai Rating & Information Services Co. Ltd. (TRIS)