Understanding and Use of Credit Rating in India: A Survey of Individual and Institutional Investors

BY

Ranadev Goswami*
S. Venkatesh

March 1999

Please address all correspondence to:

S. Venkatesh
Assistant Professor
Indian Institute of Management
Bannerghatta Road
Bangalore - 560 076
India

Fax: (080) 6644050

*Doctoral candidate in the Finance and Control Area at IIMB

ABSTRACT

Credit rating, although a relatively new concept in the Indian financial market, have gained wide acceptance among investors. At the same time, casual and anecdotal evidence suggests that there are concerns among investors and regulators about the performance of rating agencies in India. This paper examines investors' awareness, perception, understanding level and usage of credit rating through a questionnaire-based sample survey covering individual as well as institutional investors. We discover a high diffusion of rating usage among all class of investors, though there is a perceptible disenchantment with reliability of ratings, propensity of subsequent downgrading and timeliness of rating surveillance. The survey also reveals that the institutional investors possess superior knowledge and understanding about ratings than individual investors. Thus, the survey underlines the need for rating agencies to work on educating the common investors to propagate proper understanding and usage of credit rating.

1. Introduction:

Credit rating is an opinion on credit quality of a firm. i.e. the ability of a firm issuing a debt instrument to service that instrument. Assessment of credit quality calls for expertise which credit rating agencies should possess. The rating issued by a rating agency serves as a summary information about credit quality for economic decision-makers. As long as the agency assigning the rating is perceived as being credible, economic decision-makers would not evaluate the inputs that go into the rating process.

Credit rating originated in the U.S.A. in 1909 when Moody's began rating corporate and railroad bonds. Since then the practice of credit rating has been adopted in several countries around the world. In India the practice of credit rating began in 1988 with the setting up of the Credit Rating and Investor Services of India Ltd.(CRISIL). This was followed by the setting the setting up of Investment Information and Credit Rating Agency (ICRA) in the year 1991. Subsequently, Credit Analysis and Research (CARE) and Duff and Phelps have also started providing rating services. Table 1.1 below provides the number and type of ratings done by CRISIL and ICRA to date.

Table 1: Summary Statistics of Ratings done by Two Major Agencies

CRISIL	Ratings Done	ICRA	Ratings Done
Debenture	995	Long Term Instruments	418
Fixed Deposits	697	Medium Term Instruments	613
CP	674	Short Term Instruments	343
Others	150	Others	82
Total	2516	Total	1456

As on May 1998

2. The Evidence on Usefulness of Credit Ratings:

In an early study, Hickman (1958). using U.S. data found that bond rating was a useful indicator of default risk. Response of bond prices to rating change announcements is a test of the usefulness of ratings. If bond prices react to rating change announcements, it is evidence of new information conveyed to the market by such announcements. Empirical evidence based on this argument is mixed. Weinstein (1977) found that corporate bond returns were unaffected by rating change announcements, which suggests that markets view ratings as reflecting information that is already available. However other studies, such as, Grier and Katz (1976), Ingram, Brookes, and Copeland (1983), and, Wanseley and Clauretie (1985) find significant bond price reactions to rating change announcements.

Rating change announcements should also effect prices of the underlying equity shares. Assuming porosity to information flow between the stock and bond markets, it can be argued that factors that lead to rating changes should also affect the prices of the underlying equity shares. The exceptions would be those cases in which the factors influencing the rating change affect the interests of bondholders and stock-holders in opposite ways. Pinches and Singleton (1977) test for the information content of rating change announcements by examining their impact on equity returns. Their samples of 207 rating change announcements are classified into portfolios based on whether they are upgrades or downgrades. Their study finds significant changes in equity prices preceding the rating change announcements indicating that the rating agencies lag the market. However, they also find that there is an adjustment of prices subsequent to the announcement of the rating changes indicating some information content in the rating change announcements.

In a study covering both stock and bond prices Hand, Holthausen, and Leftwich (1992) find that the negative impact on bond prices and stock prices following a downgrade is significant. The effect of upgrade on bond prices is weaker and negligible on stock prices. Hand *et al* also classify rating change announcements into those which are *non-contaminated* i.e. the first news of the rating change was from the rating agencies concerned and was not reported in the press earlier, and *contaminated* i.e. rating change announcements which were preceded by news in the press and other sources which anticipated the rating change. Surprisingly, their sample of non-contaminated rating change announcements showed a statistically insignificant effect on bond prices for downgrades. The positive effect on bond prices following upgrades was significant and more pronounced for the non-contaminated sample compared to the entire sample. These results provide only a weak support of the usefulness of rating change announcements.

The inconclusive nature of the empirical evidence on the usefulness of rating change announcements is supported by conclusions of the Bi and Levy (1993) study. They examine stock price reaction to a set of announcements of rating downgrades. They also classify the firms whose bonds were downgraded into two categories: those, which subsequently filed for bankruptcy and those, which did not file for bankruptcy till the time of the study. They find that "... downgrading of bonds, on average, conveys new information to the market resulting in a negative excess return. In this respect, the agencies provide important information to the market. However, when we take a matching sample with identical bond downgradings which are not followed by Chapter 11 filing (i.e. bankruptcy), we find that for the matching sample the excess negative return is almost zero. Thus, the stock market differentiates between two identical downgrading. This implies that the agency rating services do not provide

sufficiently refined ratings, or are unable to distinguish between the two evolutionary patterns of financial distress."

Crabbe and Post (1994) are more unequivocal in their conclusion that rating change announcements provide new information to the market and are, therefore, useful. They examine the impact of a set of downgrade announcements of commercial paper on the volume of such paper outstanding. The volume of commercial paper outstanding experienced abnormal declines following the downgrades. Since such declines in volume were not observed prior to the downgrade, Crabbe and Post conclude that the announcement of downgrades has information content.

Nayar and Rozeff (1994) find excess positive returns accompany a "superior" initial commercial paper rating while the stock prices remains unaffected by a lower initial rating. Rating downgrades, particularly those that imply an exit from the commercial paper market, produce significantly negative abnormal returns - although upgrades have no such effect.

It would be difficult to summarise these findings and conclude about the usefulness of ratings. Our review did not include studies using data from countries other than the U.S.A. No such studies were reported in the journals covered in our review. We are not aware of any systematic studies in the Indian context which have examined the usefulness of ratings.

Casual and anecdotal evidence suggests that there are concerns among investors and regulators about the performance of rating agencies in India. Notable financial failures such as those of CRB capital markets have led to writings in the press which have raised questions about the role of rating agencies in providing sufficiently early warnings to investors. The impact of the institutional features of the business of ratings on the independence and performance of rating agencies in India

has also been the subject of considerable debate. CRISIL, ICRA, and CARE are all promoted by large financial institutions. Firms, which borrow from such financial institutions, it can be validly argued, would also be under some compulsion to hire the rating agency promoted by the lending institution. Secondly, rating in India is compulsory for any firm that chooses to raise money through a public issue of debt. This results in an assured market for the rating agencies. The choice is not between rating and not-rating but one of which agency to hire. This could well lead to a situation of having to choose the best among the worst. Thirdly, rating agencies engage in a variety of other businesses such as corporate advisory services. Such services are often on offer to the same firms which also hire the agencies for rating services. This situation can justifiably raise questions about potential for a conflict of interest. Fourthly, firms which are not satisfied with the rating assigned by an agency are under no obligation to publish such a rating. They can instead go to a competing rating agency and try to obtain a better rating. This can and perhaps led to a "shopping for rating" and some expeditious business strategy being adopted by rating agencies.

Venkatesh and Gupta (1997), examine the universe of ratings assigned to fixed deposits issued by investment firms and find that there is a significant concentration of ratings on the border between the speculative and investment grades. A possible explanation for this concentration could be obliging agencies which assign "on-the-border" investment grades to firms which would otherwise find it difficult to raise money in the markets. Such expeditious strategy can result in a significant number of such ratings being downgraded subsequent to the issue of debt. Gupta and Venkatesh (1997), on an analysis of 124 rating changes assigned to debt instruments issued by manufacturing companies find that the number of ratings downgraded are significantly larger than those upgraded. Finally, in the absence of a bond market in

India, the debt issuing firms do not experience the negative effects on their wealth of downgrades and the investors are often left with no recourse but to hold these downgraded (and sometimes upgraded) instruments at the coupon rates at which they were issued.

3. The Study:

In this study we seek to answer the question: " Are the ratings assigned by the rating agencies in India understood and found useful by the individual and institutional investors India?" Studies which investigate the usefulness of ratings using stock and bond prices are founded information theory. If an event has information that is useful to market participants, such usefulness will be reflected by a change in the security price behavior. Such an approach to testing usefulness has the advantage over questionnaire based approach to testing usefulness which suffer problems of "reconstruction of events" and "non-serious responses". But the data requirements of conducting bond or stock market based tests of usefulness are substantial and in our view not met in the Indian context for testing the usefulness of ratings. The questionnaire based approach that we adopt in this study, besides being more amenable to such conditions, can also provide richer details about the investors' understanding and use of ratings - aspects that may often be missed out in a market based study.

Our preliminary investigations revealed a variety of rating symbols with different scales being adopted for different types of instruments by the same agency and different scales being adopted by different agencies for the same instrument. Reference to publications of the rating agencies provides explanations for each of these symbols. However, when firms use these symbols in their advertisements soliciting subscriptions to their offerings of bonds etc, most often the explanations of

6

these symbols are not provided in the advertisements. A symbol such as AAA is unambiguous as a symbol such as D. But there is whole range of symbols in between, which have the potential to create confusion in the minds of the user. A user may be able to say that a AA is better than AA-, but could be ignorant of what AA by itself conveys. One of the objects of our investigation is to find out whether investors were aware of the various nuances in the rating scales in use and whether they had an understanding of what the symbols were intended to convey.

The other objective of our investigation is to find out how information on ratings are obtained and used by our respondents. Ratings assigned to a public issue of debt by a firm are required to be published in the advertisement soliciting subscriptions to the offering. In addition, the periodicals published by the rating agencies such the "CRISIL Rating Scan" also publish the new ratings and rating changes assigned the agency in the period covered by the periodical. Some newspapers and financial dailies also carry sections on ratings which report both new ratings and rating changes. It is conceivable that even an investor, who is aware of ratings and rating symbols, may ignore them out of a belief that rating agencies are not credible. Given casual evidence of investment behavior, it is also conceivable that investors rely on advice of brokers and other intermediaries in making investment decisions and do not consider ratings at all. Some may even go by the long-standing reputation of the issuing firm and see no use for referring to ratings. The issue of use of ratings is important because under the current regulations in India, ratings are mandatory. It would be important to understand, even if not in precise numbers, whether the costs imposed by such regulations are matched by benefits.

4. The Methodology:

In this section we describe our methodology. In the next section we present our findings. The concluding section discusses the findings and suggests some possible extensions of this study.

The final questionnaire used in the study is presented in the Appendix.

The questionnaire was designed to cover the following:

- Profile of the respondents including their investment habits.

- The respondents' understanding of the ratings symbols and the rating process.

- The respondents access to and use of rating information in making investment decisions.

We use a mix of open ended and close ended questions. The choice of open or close-ended questions was based on our assessment of our understanding of the question being investigated and accordingly our ability to formulate a close-ended question. For e.g. in trying assess the respondents' source of information about ratings, we had to adopt an open ended approach since we were not sure of being able to list all possible sources that the respondents may have access to. On the other hand we use a close-ended approach in trying to assess the importance and reliability of ratings. We also used some "mix and match" type of questions to assess the awareness of the respondents about ratings in use and the meaning of rating symbols. Our analysis of responses is tailored to the type of question whose responses were being analysed.

The questionnaire was pre tested with 12 respondents comprising of faculty, postgraduate students, and executive participants at the Indian Institute of

Management Bangalore. Based on the pre test the following changes were made to the original questionnaire:

- The number of open questions was reduced to 16 from 20.

- The sequencing of the open-ended questions was changed.

- Questions relating to the profile of the respondents were shifted to the end.

- Two separate sets of questionnaires - one for individual and the other for institutional investors - were created.

A total of 125 questionnaires were administered to individual investors. Response rate was 100%. 25 questionnaires were rejected because of incomplete responses. Additionally, responses were obtained from 15 institutional investors.

All the individual respondents were from Bangalore, India. The precondition to being a respondent was that they had to be investors in debt instruments. The respondents were participants in Executive Development Programmes (EDPs) in Indian Institute of Management Bangalore, executives of three large software companies based in Bangalore, some students of the post graduate programme at the Indian Institute of Management Bangalore who had work experience, and a few young professionals in Bangalore city. Respondents from among institutional investors were from Bangalore, Mumbai, Delhi, and Calcutta. Respondents were from commercial banks, investment banks, non-banking financial institutions, brokerage firms, mutual funds and financial institutions. Some of the responses from institutional investors were obtained on the electronic mail.

The profile of the respondents is summarised in Tables A & B below.

Table A: Profile of Respondents

	Individual Investors	Institutional Investors	Total no. of Investors
Panel A : Academic Profile of Respondents			
CA/CFA/MBA	23	12	35
Engineer	64	-	64
Graduate	11	2	13
Other	2	1	3
Total	100	15	115
Panel B : Organisational Profile of Respondents			
Financial	12	15	27
Manufacturing	50	-	50
Service	29	-	29
Other	9	-	9
Total	100	15	115

Note :
CA: Chartered Accountant
CFA· Chartered Financial Analyst
MBA · Master of Business Administration

Table B: Investment Habits of Respondents

Preferred Instrument	No. of Response	Preferred Time Span	No. of Response	Annual Investment Amount	No. of Response
Panel A : Investment Habits of Individual Investors					
Bank term deposits	90	Less than 1 year	24	Less than Rs.25000	40
Bonds	42	1 - 3 years	54	Rs.25000 – Rs.50000	40
Company Fixed Deposits	61	3 - 5 years	24	Rs.50000 – Rs.100000	13
Debentures	39	More than 5 years	8	More than Rs.100000	7
Post Office Deposits	37				
Others	31				
Total	300*		100		100
Panel B : Investment Habits of Institutional Investors					
Bank Term Deposits	2	Less than 1 year	2	Less than 10 crore	2
Bonds	13	1 - 3 years	8	10 – 50 crores	3
Commercial Papers	2	3 - 5 years	5	50 – 100 crores	5
Company Fixed Deposits	2	More than 5 years	-	More than 100 crores	5
Debentures	10				
Government Securities	13				
Inter Corporate Deposits	2				
Others	1				
Total	45**		15		15

* *Since 100 respondents mentioned three debt instruments they would prefer most, total number of response was 300*
** *As above (the number of respondents in this category was 15)*

5. Findings:

5.1: What are the sources of information about ratings and rating changes for investors? Table F.1 summarises our findings on this question. The survey shows that newspapers and financial periodicals constitute the important source of information about ratings and rating changes. The prospectus accompanying the public issue is an important source of rating information. In addition investors also rely on "market sources" such as brokers, agents and friends.

Table F.1. : Sources of Rating Information

	No. of Responses					
	Individual		Institutional		Total	
No. of respondents	100		15		115	
Panel A: Source of information about ratings						
	No.	%	No.	%	No.	%
Newspaper etc.	76	76	12	80	88	76.52
Prospectus	43	43	15	100	58	50.43
Market source	16	16	5	33.33	21	18.26
Agency rating guides	7	7	9	60	16	13.91
Total	142	-	41	-	183	-
Panel B: Source of information about rating changes						
Newspaper etc.	86	86	11	73.33	97	84.35
Market source	31	31	9	60.00	40	34.78
Agency rating guides	10	10	7	46.67	17	14.78
Total	127	-	27	-	154	-

Note: Percentage (%) of responses is calculated on the basis of number of respondents in each category and not on the basis of total number of responses obtained.

5.2: What do investors believe to be the purpose of credit ratings? Anecdotal evidence prior to our survey suggested that users of ratings believed that ratings were a statement about the company per se and not just about the instrument being issued by the company. Thus, it was customary hear of a AAA company or a AA company. We found that a majority of our respondents made a distinction between the instrument and the company. However, even among those who believed that ratings were an expression about an instrument and not about the company, opinion was divided on whether the opinion was an assurance about the safety of the instrument or about the riskiness of the instrument.

11

Table F.2. : Purpose of Ratings

Purpose	No. of Respondents					
	Individual		Institutional		Total	
	No.	%	No.	%	No.	%
Assurance about safety	42	42	5	33.33	47	40.87
Information about risk	43	43	10	66.67	53	46.09
Company fundamentals	15	15	-	-	15	13.04
Total	100	100	15	100	115	100

5.3: The rating scales used by the different rating agencies make very fine distinctions between successive points on the rating scale. We sought to ascertain whether investors were able to understand these fine distinctions without referring to the descriptions put out by the agencies in their publications and documents. While it is obvious that a AAA is better than a AA and so on, were investors aware of what AAA meant?

Table F.3. below summarises our findings on this point.

Table F.3. : Understanding of Rating Scale

	No. of Respondents					
	Individual		Institutional		Total	
Panel A: "AAA" symbol signifies						
	No.	%	No.	%	No.	%
Highest safety	57	57	11	73.33	68	59.13
Moderate safety	19	19	4	26.67	23	20
High safety but low return	5	5	-	-	5	4.348
Financial strength of Co.	19	19	-	-	19	16.52
Total	100	100	15	100	115	100
Panel B: "speculative grade" signifies						
Likely to default	18	18	11	73.33	29	25.22
Risky	54	54	3	20	57	49.57
Low safety but high return	13	13	1	6.67	14	12.17
Financial weakness of Co.	15	15	-	-	15	13.04
Total	100	100	15	100	115	100

We provide below the explanation of some of the ratings as provided by the rating agencies.

AAA (for debenture): Debentures rated AAA are judged to offer highest safety of timely payment of interest and principal. Though the circumstances providing the degree of safety are likely to change, such changes as can be envisaged are most unlikely to affect adversely the fundamentally strong position of such issues.

AAA (for FD): The rating indicate that the degree of safety regarding timely payment of interest and principal is very strong.

Speculative Grade: The rating indicates an inadequate degree of certainty regarding timely payment of financial obligations of the instrument.

5.4: Better rated instruments should be able to pay lower coupon rates and still attract the same investments which would require higher coupon rates from lower rated instruments. In other words, better the rating lower the interest rates. Does this relationship hold in practice? That is an empirical question we do not investigate in this paper. We, however, ask of our respondents whether they believe that this relationship holds. Our findings are presented in Table F.4 below. As can be seen, a majority of our respondents believe that the inverse relationship between ratings and returns holds.

Table F.4. : Belief about Rating-Return Relationship

Are returns commensurate with ratings assigned?	No. of respondents					
	Individual		Institutional		Total	
	No.	%	No.	%	No.	%
Yes	51	51	10	66.67	61	53.04
No	39	39	4	26.67	43	37.39
Can't say	10	10	1	6.66	11	9.57
Total	100	100	15	100	115	100

5.5: Following on 5.3 above, we further explored the respondents' awareness of ratings Scale, ratings Symbols, and ratings Statements.

We provided a set of statements used by rating agencies to describe the ratings symbols. The statements are almost identical for different points on the same scale used by different agencies. We asked our respondents to assign a rating symbol corresponding to each rating statement. Our findings are presented in Table F.5. below. The percentage of correct responses is higher at the extremes than in the middle. Even if we consider the ratings one point on either side of the correct rating to be within an acceptable range of responses, the respondents were better able to assign

ratings at the extremes than in the middle. This finding may lend some credence to the belief that the market understands the AAAs and the poor quality instruments. It finds it difficult to distinguish among the instruments rated in between. Comparing the mean and the actual ranks in the table we find that the ratings assigned on the average are higher than the actual in the middle of the scale.

Table F.5. : Understanding of Rating Statements

Panel A: Summary statistics of rating understanding												
Actual Ratings	Rank	Individual Investors				Institutional Investors				Total			
		Correct Response		Mean Rank	Std. Devn.	Correct Response		Mean Rank	Std. Devn.	Correct Response		Mean Rank	Std. Devn.
		No.	%			No.	%			No.	%		
AA	2	53	53	2.00	1.14	11	73.33	1.87	0.52	64	55.65	1.98	1.08
A	3	45	45	2.87	1.06	10	66.67	3.00	0.53	55	47.83	2.89	1.01
BBB	4	33	33	4.24	1.13	7	46.67	4.33	0.82	40	34.78	4.25	1.09
B	6	36	36	6.47	1.10	9	60.00	6.53	0.74	45	39.13	6.48	1.05
C	7	45	45	6.64	1.18	11	73.33	6.93	0.70	56	48.70	6.68	1.13

Panel B: Distribution of responses					
Rating Assigned			Actual Rating		
	AA	A	BBB	B	C
AAA	35	8	1	-	-
AA	64	30	6	-	1
A	9	55	19	1	1
BBB	1	11	40	2	4
BB	3	11	35	14	9
B	2	-	14	45	21
C	1	-	-	30	56
D	-	-	-	23	23
TOTAL	115	115	115	115	115

5.6: Although in 5.2 above we find evidence that respondents associate ratings with instruments rather than companies, we investigate the possibility that given a company's name, respondents assign a rating to its instruments. This test will show up the errors in associating company name to ratings since many well-known companies' instruments do not enjoy a correspondingly higher rating. Accordingly, we presented the respondents with a set of companies-instruments and asked them to guess the ratings that these company-instruments are likely to have. The findings are reported in Table F.6. Broadly, the respondents' ability to guess a AAA rating was much better

than their ability to guess other ratings. None of the individual investors and only one of the institutional investors could guess the D rated debenture correctly. We do not report on any statistical tests of the differences in mean scores of the Individual and Institutional responses. But on a first glance it would appear that the institutional investors have not done remarkably well in guessing the rating of the company-instruments. We do not suggest by this finding that our respondents' awareness should extend to knowing the ratings of the numerous ratings of company-instruments currently in use. But the respondents' ability to guess the AAA ratings better than the others supports our earlier observation that ratings at the extremes are more easily distinguishable though the inability to guess the D rated debenture is an anomaly.

Table F.6. : Rating Assessment based only on Company-instrument

Panel A : Summary Statistics for Response to Debenture Ratings

Actual Ratings	Rank	Individual Investors				Institutional Investors				Total			
		Correct Response		Mean Rank	Std. Devn.	Correct Response		Mean Rank	Std. Devn.	Correct Response		Mean Rank	Std. Devn.
		No.	%			No.	%			No.	%		
AA-	4	23	23	5.19	2.95	4	26.67	4.80	1.82	27	23.48	5.14	2.82
A-	7	3	3	8.81	3.78	2	13.33	9.67	1.84	5	4.35	8.92	3.59
AAA	1	50	50	2.33	1.55	10	66.67	1.40	0.63	60	52.17	2.05	1.49
AA	3	9	9	1.98	1.50	2	13.33	2.20	0.94	11	9.57	2.01	1.44
D	16	-	-	9.44	3.50	1	6.67	11.87	2.45	1	0.87	9.76	3.47
AA-	4	16	16	5.34	2.91	5	33.33	4.93	2.69	21	18.26	5.29	2.87
AAA	1	31	31	3.61	3.06	7	46.67	1.73	0.80	38	33.04	3.37	2.94
AA+	2	22	22	4.39	2.86	2	13.33	3.47	2.47	24	20.87	4.27	2.82
AAA	1	45	45	2.57	2.23	7	46.67	1.87	1.19	52	45.22	2.48	2.13
AA	3	5	5	8.00	3.28	3	20.00	5.87	3.07	8	6.96	7.72	3.32

Panel B : Summary Statistics for Response to Fixed Deposit Ratings

Actual Ratings	Rank	Individual Investors				Institutional Investors				Total			
		Correct Response		Mean Rank	Std. Devn.	Correct Response		Mean Rank	Std. Devn.	Correct Response		Mean Rank	Std. Devn.
		No.	%			No.	%			No.	%		
A	6	5	5	8.94	3.79	3	20.00	9.69	1.87	8	6.96	9.04	3.60
AAA	1	48	48	2.32	1.58	11	73.33	1.46	0.65	59	51.30	2.21	1.49
A	6	31	31	6.73	3.67	4	26.67	4.17	2.56	35	30.43	6.42	3.63
AA-	4	37	37	4.55	3.07	3	20.00	5.71	3.45	40	34.78	4.71	3.11
AAA	1	89	89	1.26	0.90	15	100.0	1.00	0.00	104	90.43	1.22	0.84
AAA	1	26	26	5.30	3.20	6	40.00	2.86	0.90	32	27.83	4.96	3.10
AA-	4	36	36	5.30	3.23	5	33.33	5.33	0.52	41	35.65	5.31	3.03
AAA	1	28	28	3.74	3.10	9	60.00	1.77	0.82	37	32.17	3.48	2.94
AA	3	26	26	4.33	2.79	4	26.67	3.43	2.49	30	26.09	4.21	2.82
AAA	1	48	48	2.61	2.27	8	53.33	1.91	1.23	56	48.70	2.52	2.14

5.7: Did our respondents use ratings in making investment decisions? We pose this as a question. As is evident from Table F.7. below, a large majority of the respondents claim to use ratings in making investment decisions. From the responses it was also noted, as can be expected, that ratings were a subset of a wider set of information used by the respondents in making investment decisions. These included information about company's fundamentals (28.82% of the responses), information about the company's future prospects (17.01%), Quality of the management (11.45%) and advice from experts (11.8%).

Table F.7. : Use of Ratings

Usage	No. of Respondents					
	Individual		Institutional		Total	
	No.	%	No.	%	No.	%
Use ratings	78	78	15	100	93	80.87
Does not use ratings	22	22	-	-	22	19.13
Total	100	100	15	100	115	100

5.8: Information used in decision making should be reliable. Reports in the press would lead us to believe that ratings issued by Indian rating agencies are not very reliable. Our survey found that the percentage of respondents who believe either that the ratings are not reliable at all or that they are very reliable is very small. Most respondents consider ratings as either somewhat reliable or reliable. Our findings are presented in Table F.8. below. This cautious opinion of reliability of ratings is understandable in light of the much publicized failures of firms particularly in the financial services sector which had enjoyed better than speculative ratings on the eve of their failures.

Table F.8. : Reliability of Ratings

Statement	No. of Respondents					
	Individual		Institutional		Total	
	No.	%	No.	%	No.	%
Not at all Reliable	9	9	-	-	9	7.83
Not very reliable	7	7	1	6.67	8	6.96
Somewhat reliable	38	38	7	46.67	45	39.13
Reliable	32	32	4	26.67	36	31.30
Very reliable	14	14	3	20.00	17	14.78
Total	100	100	15	100	115	100

5.7. and 5.8. taken together suggest that while a majority of the respondents use ratings, not all of them consider the ratings very reliable. This is characteristic of information that is costless to the user. The ratings are paid for by the existing shareholders of the company. The principal beneficiaries are the investors and potential investors in the market for debt instruments. Had these beneficiaries been asked to pay for the rating information, we would have a direct test of the usefulness such information in the demand for such information. As such 5.7. and 5.8. together would leave the question of rating usefulness inconclusive.

5.9: 21 out of our 115 respondents believe that all rating agencies are equally reliable. 13 of the remaining do not have an opinion on the question. But a majority of 81 out of 115 respondents believe that rating agencies are not all equally reliable. Given an option to choose a rating agency, 76 out of the 81 chose CRISIL. 5 chose ICRA. None chose CARE or any of the other agencies in the market. Table F.9. below presents the findings.

CRISIL is the oldest rating agency in the country and has the largest market share. But the respondents' belief in its reliability must be because of factors other than age and market share, though we have not explored the same. Credibility is a more important source of capital for business such as a rating agency, than it is for other businesses. In the absence of any regulation requiring mandatory rating, agencies would have to fall back on their credibility to garner business. Our respondents overwhelming endorsement of one agency should serve to activate other agencies to take actions that will enhance their credibility.

Table F.9. Reliability of Rating Agencies

	No. of Respondents					
	Individual		Institutional		Total	
Panel A: Agencies are equally reliable						
	No.	%	No.	%	No.	%
Yes	17	17	4	26.67	21	18.26
No	71	71	10	66.67	81	70.43
Cannot say	12	12	1	6.66	13	11.30
Total	100	100	15	100	115	100
Panel B: Most reliable agency						
CRISIL	61	61	15	100	76	66.09
ICRA	5	5	-	-	5	4.35
CARE	-	-	-	-	-	-
Cannot say	34	34	-	-	34	29.56
Total	100	100	15	100	81	100

5.10: Rating changes seem, from the responses of the respondents, to be synonymous with downgrades. Rating agencies have both downgraded and upgraded their initial ratings though the incidence of downgrades is more than the upgrades. (see for e.g. Gupta and Venkatesh, 1997). A majority of the respondents believe that the rating change announcements are not timely (see Panel A of Table F.10.). Most of the respondents believe that the rating changes can be anticipated only sometimes. Panel B of the same Table presents our findings.

In Panel C, we present our findings on what our respondents believe to be the incidence of downgrades. Respondents' assessment of possible causes that triggered such downgradings is reported in Panel D. Though most of them wish to sell their holdings following a downgrade of an instrument, few of them have actually been able to do so (see Panel E).

These findings should present a source of concern for rating agencies. The belief that downgrades occur frequently combined with the absence of any institutional mechanisms for investors to adjust their holdings following the downgrades has the potential to grow into disenchantment with ratings. Perhaps, rating agencies can publish in their periodicals the details of the downgrades and

18

upgrades, on an aggregate basis, in much the same way that they now publish their ratings to date.

Table F.10. Beliefs about Rating Changes

Statements	No. of Respondents					
	Individual		Institutional		Total	
	No.	%	No.	%	No.	%
Panel A: Timeliness of rating change						
Yes	16	16	6	40	22	19.13
No	68	68	9	60	77	66.96
Sometimes	16	16	-	-	16	13.91
Total	100	100	15	100	115	100
Panel B: Rating change can be anticipated						
Yes	31	31	6	40	37	32.17
No	27	27	-	-	27	23.48
Sometimes	42	42	9	60	51	44.35
Total	100	100	15	100	115	100
Panel C: Estimated percentage of rating downgrade						
10% or less	11	11	-	-	11	9.57
Between 10% - 20%	17	17	2	13.33	19	16.52
Between 20% - 30%	23	23	6	40.00	29	25.22
Between 30% - 40%	20	20	4	26.67	24	20.87
Between 40% - 50%	6	6	1	6.67	7	6.09
50% and above	7	7	2	13.33	9	7.83
Can not say	16	16	-	-	16	13.91
Total	100	100	15	100	115	100
Panel D: Possible reason for rating downgrade						
Economic sluggishness	26	26	4	26.67	30	26.09
Poor industry scenario	29	29	7	46.67	36	31.30
Corporate mismanagement	33	33	2	13.33	35	30.43
Rating agency inefficiency	12	12	2	13.33	14	12.17
Total	100	100	15	100	115	100
Panel E: Intention to sell after rating downgrade						
Yes	76	76	9	60	85	73.91
No	9	9	6	40	15	13.04
Depends	15	15	-	-	15	13.04
Total	100	100	15	100	115	100

6.Summary and Conclusions:

78% of the individual respondents and 100% of the Institutional respondents claim to use ratings in making investment decisions though only a small percentage of the respondents (14% of individual and 20% of institutions) consider ratings as very reliable information. A majority considers ratings as somewhat reliable. This finding indicates acceptance of the idea of ratings among investors. The ratings not perceived as being very reliable indicates the shortcomings in the rating process adopted by the rating agencies.

A majority of our respondents believe that not all the rating agencies in India are equally reliable. An overwhelming majority considers CRISIL to be the most reliable rating agency in India.

As further evidence of ratings not being perceived as being reliable, a majority of our respondents believe that rating change announcements by rating agencies are not timely. While there appears to be no objective way of establishing whether the rating at any point reflects all the information available to the rating agency, it is possible in some research in the future to ascertain whether the stock and bond markets are able to anticipate rating change announcements. Only a small percentage of our respondents believe that rating changes cannot be anticipated at all.

It would be evident from a reading of the financial press in India that downgrades are more prominent in the public eye than upgrades. Most of our respondents believe that between 20% and 40% of all instruments rated are subsequently downgraded. This is significantly higher than what the data suggests (Gupta and Venkatesh, 1997). There appears to be a need for rating agencies to work on changing these perceptions by systematic dissemination of information on their performance. Answers to questions such as how many of the initial ratings were changed, what was the direction and extent of each change, what were the reasons for such change, being provided systematically to wide cross section of investors can help change perceptions. Periodicals such as the Rating scan have limited circulation to be of use in helping such dissemination.

Our respondents indicate an understanding of ratings being related to instruments issued by a company rather than to the company itself. Only a small proportion of individual respondents (15%) and none of the institutional respondents believe that ratings are a statement about company fundamentals. A similar

percentage of respondents believe that AAA indicates financial strength of a company and speculative grade indicates financial weakness of a company.

Safety and Risk are two sides of the same coin. Descriptions of rating symbols provided by the rating agencies use "safety" in the upper end of the scale and the term "certainty" (or lack thereof) in the lower end of the scale. When a rating agency describes a speculative grade instrument as one with "an inadequate degree of certainty regarding timely payment of financial obligation", the description offers no precise estimate of the risk involved except on a relative scale. A majority of our institutional respondents believe that a speculative grade is one, for which there is a likelihood of default, while a majority of our individual investors believe that a speculative grade instrument is risky. This may indicate that these individual respondents do not believe that there is any risk attached to a higher-grade instrument. Understanding and interpreting the rating scale is not easy. The larger rating agencies in India must have gathered sufficient data by now to able to publish probability estimates of default of instruments under various rating categories.

Expectedly, our institutional respondents were found to be able to better assign rating symbols to a given set of rating statements compared to our individual respondents. The percentage of correct responses from individual respondents in matching rating statements to rating symbols ranges from 33% (for BBB) to 53% (for AA). This may suggest that most of our individual respondents can only interpret the ratings on a relative scale i.e. be able to say that AAA is better than AA and so on. They do not seem to understand what, for e.g., AAA, by and of, itself means.

We attempted to assess the awareness of our respondents to ratings in use. Institutional respondents were better able to identify what rating an instrument of a company was likely to have than individual respondents. Respondents' success in

identifying AAA rated instruments was significantly better than in identifying lower rated instruments. While this does not in any way reflect on our respondents' understanding of ratings, it shows the gap between what the respondents intuitively believe to be the rating and the actual rating assigned by the rating agencies.

Our respondent set covers a sufficiently wide cross section of the investor population in India to provide generality to our findings about the understanding and use of credit ratings in India. However, the issue merits periodic investigation. More detailed questionnaires could have provided finer insights but probably at a cost in terms of response rates.

References:

Bi, Keqian, and Haim Levy, 1993, Market reaction to bond downgradings followed by chapter 11 filings, Financial Management 22, pp.156-162.

Crabbe, Leland, and Mitchell A. Post, 1994, The effect of a rating downgrade on outstanding commercial paper, Journal of Finance 49, pp. 39-55.

Grier, Paul, and Steven Katz, 1976, The differential effects of bond rating changes among industrial and public utility bonds by maturity, Journal of Business 49, pp. 226-239.

Gupta, Subhashish, and S. Venkatesh, 1997, Rating the performance of rating agencies, The Economic Times.

Hand, John R. M., Robert W. Holthausen, and Richard W. Leftwich, 1992, The effect of bond rating agency announcements on bond and stock prices, Journal of Finance 47, pp. 733-752.

Hickman, W.Bradcock, 1958, Corporate bonds, quality and investment performance, Princeton, N.J.: Princeton University Press.

Ingram, R., L. Brookes, and R. Copeland, 1983, The information content of municipal bond rating changes: a note, Journal of Finance 38, pp. 997-1003.

Nayar, Nandkumar, and Michael S. Rozeff, 1994, Ratings, commercial paper and equity returns, Journal of Finance 49, pp. 1431-1449.

Pinches, George E., and J. Clay Singleton, 1977, The adjustment of stock prices to bond rating changes, Journal of Finance 33, pp.29-43.

Venkatesh, S., and Subhashish Gupta, 1997, Investment rating: on the border, The Economic Times October 6.

Wanseley, James W., and Terrence M. Clauretie, 1985, The impact of CREDITWATCH placement on equity returns and bond prices, Journal of Financial Research 8, pp. 31-42.

Weinstein, M., 1977, The effect of a rating change announcement on bond price, Journal of Financial Economics 5, pp. 329-350.

Annexure: Survey Questionnaire

We are doing a survey on the **credit ratings of corporate debt instruments**. There are no right or wrong answers - so, please feel free in answering the questions. The secrecy of your response will be strictly maintained and the findings will be used for purely academic purposes at IIM Bangalore. We appreciate your effort and time spent in filling up the questionnaire.

---

1. Do you provide investment advice to people in a **professional** capacity -

Ω Yes   Ω No

2. Are you **involved** with your organisation's investment decisions -

Ω Yes   Ω No

3. Please tick (✓) the THREE **debt instruments** in which you mostly invest -

Ω   Bank deposits
Ω   Bonds
Ω   Company fixed deposits
Ω   Debentures (NCD / PCD)
Ω   Post office deposits
Ω   Government securities
Ω   Any other (please specify) ....

4. What is your **preferred time span** for investing –

Ω   Upto 1 year
Ω   1 – 3 years
Ω   3 – 5 years
Ω   More than 5 years

5. On an average how much do you **invest annually** –

Ω   Less than Rs.25,000
Ω   Rs. 25,000 - Rs. 50,000
Ω   Rs. 50,000 - 1 lakhs
Ω   More than Rs. 1 lakhs

6. Below given are some questions on **credit ratings**. Please answer them in one or two sentences.

i) What in your view is the purpose of credit rating of corporate debt instruments?

☞...
....
....
....

ii) Do your organisation's policies and procedures make it obligatory to consider credit rating in making investment decisions ? If yes, what form does the prescription take?

☞...
....
....
....

iii) Do you use credit ratings in making investment decisions?

☞...
....
....
....

iv) Apart from ratings, what other information do you use for making investment decisions?

☞...
....
....
....

v) How important is credit rating in the set of information you use in making investment decisions?

☞...
....
....
....

vi) What information should go into assigning a rating ? Do you think rating agencies take all these into account?

☞...
....
....
....

vii) In your view, are ratings reliable as a source of information for making investment decisions?

☞.. ....
....
....
....

viii) Are the ratings provided by all the agencies equally reliable? If you had to choose an agency to rate your instrument which agency would you prefer?

☞..
....
....
....

ix) If an instrument is rated "AAA", what does it convey to you?

☞..
....
....
....

x) If an instrument is rated under "speculative grade", what does it convey to you?

☞..
....
....
....

xi) In your view, does the difference in ratings of two instruments reflect in the returns they offer?

☞..
....
....
....

xii) What is your source of information about instrument's ratings?

☞..
....
....
....

xiii) How do you get to know the changes in ratings of your investments?

☞..
....
....
....

xiv) If an instrument were downgraded, would you prefer to sell it or claim refund ? If yes, have you been able to do so?

☞..
....
....
....

xv) In your view, what percentage of the instruments rated is subsequently downgraded? What are the reasons for such downgrades?

☞..
....
....
....

xvi) Are rating change announcements timely? Can you anticipate, on the basis of other information, an impending rating change?

....
....
....
....

7. Please choose a **RATING SYMBOL** against each of the following statements that in your opinion best describes the rating statements (Please select a symbol from the rating scale given below) -

STATEMENTS :	RATING SCALE :
	AAA AA A BBB BB B C D
1. The rating indicates an adequate degree of certainty regarding timely payment of financial obligations on the instrument. However, change in circumstances can adversely affect such instruments more than those in the higher rated categories. **RATING SYMBOL : _____**	
2. The rating indicates moderate degree of certainty regarding timely payment of financial obligations on the instrument. However, changing circumstances are more likely to lead to a weakened capacity to meet financial obligations than for instruments in higher rated categories. **RATING SYMBOL : _____**	
3. The rating indicates high risk and greater suceptibility to default. Any adverse business or economic conditions would lead to lack of capability or willingness to meet financial obligations on time. **RATING SYMBOL : _____**	
4. The rating indicates that the degree of certainty regarding timely payment of financial obligations is doubtful unless circumstances are favourable. **RATING SYMBOL : _____**	
5. Instrument carrying this rating are judged to be of high quality by all standards. They are also classified as investment grade with slightly lower margins of protection compared to the higher category. Changes in assumptions may have a greater impact on the long term. **RATING SYMBOL : _____**	

8. What ratings are likely to have been assigned to the **debentures** and **fixed deposits** issued by these companies ? (Please select the <u>appropriate rating(s) in your opinion</u> from the scales given below)

COMPANY NAMES	Rating Scale	Debentures	Rating Scale	Fixed Deposits
1. Apollo Tyres	AAA	1.	AAA	1.
2. Apple Finance	AA+	2.	AA+	2.
3. Bajaj Auto	AA	3.	AA	3.
4. Bata (India)	AA-	4.	AA-	4.
5. BPL	A+	5.	A+	5.
6. Hindusthan Lever	A	6.	A	6.
7. Indian Aluminium	A-	7.	A-	7.
8. Infosys Technologies	BBB+	8.	B+	8.
9. Lloyds Steel	BBB	9.	B	9.
10. Philips (India)	BBB-	10.	C	10.
11. SAIL	BB+	11.	D	11.
12. Sundaram Finance	BB	12.		12.
13. Tata Finance	BB-	13.		13.
14. TISCO	B	14.		14.
15. Zee Telefilms	C	15.		15.
	D			

9 . Please tell us about yourself in the following questions -

a) Your **last** academic qualification is -

Ω CA / CFA / MBA
Ω Engineer / Doctor
Ω Graduate
Ω Any Other (please specify) ....

b) The organisation you work with can be described as a -

Ω Financial firm
Ω Manufacturing company
Ω Non-financial service firm
Ω Any Other (please specify) ....

c) If you work with a "financial firm" please tell us its nature -

Ω Commercial bank
Ω Investment bank
Ω NBFC / Brokerage firm
Ω Financial institution / Govt. financial corporation
Ω Mutual fund
Ω Insurance company
Ω Any Other (please specify) ....