UNIT-3

WHAT IS A CREDIT RATING?

The term credit rating refers to a quantified assessment of a borrower's creditworthiness in general terms or with respect to a particular debt or financial obligation. A credit rating can be assigned to any entity that seeks to borrow money—an individual, a corporation, a state or provincial authority, or a sovereign government.

Credit for individual consumers is rated on a numeric scale based on the FICO calculation by credit bureaus. Credit assessment and evaluation for companies and governments is generally performed by a credit rating agency such as S&P Global, Moody's, or Fitch Ratings. These rating agencies are paid by the entity seeking a credit rating for itself or one of its debt issues.

A loan is a debt—essentially a promise, often contractual. A credit rating determines the likelihood that the borrower will be willing and able to pay back a loan within the confines of the agreement without defaulting.

Credit scores are derived from the credit history maintained by credit-reporting agencies such as Equifax, Experian, and TransUnion. An individual's credit score is reported as a number, generally ranging from 300 to 850.

A short-term credit rating reflects the likelihood that a borrower will default within the year. This type of credit rating has become the norm in recent years, whereas in the past, long-term credit ratings were more heavily considered. Long-term credit ratings predict the borrower's likelihood of defaulting at any given time in the extended future.

A Brief History of Credit Ratings

Moody's issued publicly available credit ratings for bonds in 1909, and other agencies followed suit in the decades after. These ratings didn't have a profound effect on the market until 1936 when a new rule was passed that prohibited banks from investing in speculative bonds—that is, bonds with low credit ratings. The aim was to avoid the risk of default, which could lead to financial losses. This practice was quickly adopted by other companies and financial institutions. Soon enough, relying on credit ratings became the norm.

These five factors are included and weighted to calculate a person's FICO credit score-

1. Payment history (35%)

2. Amounts owed (30%)
3. Length of credit history (15%)
4. New credit (10%)
5. Types of credit (10%)

Credit ratings apply to businesses and governments. For example, sovereign credit ratings apply to national governments while corporate credit ratings apply solely to corporations. Credit rating agencies typically assign letter grades to indicate ratings. S&P Global, for instance, has a credit rating scale ranging from AAA (excellent) to C and D. Credit scores, on the other hand, apply only to individuals and are reported as a number, generally ranging from 300 to 850.

What Is a Good Credit Score?

FICO rates its scores as exceptional, very good, good, fair, and poor. The table shows which scores are associated with which rating.

FICO Score Ratings

Exceptional	800 to 850
Very Good	740 to 799
Good	670 to 739
Fair	580 to 669
Very Poor	300 to 579

Types of Credit Ratings

Each credit rating agency uses a different set of terms to highlight the risk associated with a corporate entity as it is a part of the credit rating scale that they have developed for such purposes. But, they can be broadly put under the following two categories:

- **Investment Grade:** Investment grade credit ratings indicate that the corporate entity has made sound investment decisions and can repay their debts on time. Companies with ratings that fall under this category can easily avail a loan and that too at low interest rates.

- **Speculative Grade:** Ratings that fall under this category indicate that a corporate borrower has made very risky business investments and thus may not be able to repay the loan given to them. Entities which get ratings that fall in this category get loans at higher interest rates.

Who are the Users of Credit Ratings

The following types of entities/organisations look at credit ratings of companies:

- **Lenders:** Lenders look at credit ratings of companies to determine their loan repayment capability. A good credit rating of a company would be an indication of a healthy repayment behaviour and their ability to repay the loan on time. On the other hand, average or poor credit ratings will tell the lender that the borrowing company may not be able to make timely payments.
- **Investment Banks:** Credit ratings come in handy for investment banks at the time of taking the debt instruments/equity shares of the company to the market. More specifically, it helps investment banks decide on the price of such securities before they are listed on financial markets.
- **Debt Issuers:** This refers to the borrowing companies/entities themselves. These entities take a look at their own credit rating from time to time to assess their creditworthiness.
- **Retail/Institutional investors:** These are individuals/organisations that invest in the securities of companies. Most retail and institutional investors look at credit ratings of companies to determine the returns they can make from investing in their shares/bonds. Good credit ratings indicate healthy returns over a long period of time and vice-versa.
- **Other businesses/corporations:** Other businesses also look at the credit ratings of organisations before entering into a business transaction/partnership with them.