



# ICRA RATINGS A TRANSITION STUDY

**ICRA** recently completed 10 years of operations. Since inception, the agency has made rapid strides, with its progress characterised by a consistent improvement in market share in all markets and services. While this is of significance, the most noteworthy aspect of ICRA's growth has been the credibility it has established as an independent and reliable rating agency.

The last few years have been truly significant for the Indian rating industry, in terms of increase in investor awareness about ratings and their general acceptability. From the times when ratings were used primarily for regulatory compliance, till now when ratings are recognised as a measure of credit risk and thus an important pricing determinant, the transition has been significant. Currently, most of the credit ratings in India are for debt instruments for which rating is not mandatory.

For most Indian businesses, too, the last few years mark a phase of adjusting to the new realities of a changing economic landscape. With deregulation and lowering of government protection, the Indian business environment is witness to intense competition, both from a larger number of domestic competitors (following removal of artificial entry barriers), and from imports (with the lowering of tariff and non-tariff barriers). Currently, the economy is in the slowdown phase, even as the globalisation-induced uncertainty because of exposure to dynamic demand-supply equations is chipping away at the growth and profitability figures. At the corporate level, most Indian companies are seeing their performance take a dip, resulting in a number of rating changes.

While the correlation between macro-economic shifts and rating changes is theoretically obvious, the question is, whether, in reality, ratings adequately and reliably reflect the impact of the shifts on the credit quality of issuers.

To answer this question, ICRA has been analysing the performance of its ratings since inception. This paper shares the results of this analysis. As the evidence presented here shows, ICRA ratings have clearly reflected the impact of macro-economic factors on the credit quality of issuers at two levels. One, more ratings are downgraded than upgraded during an economic downturn. Two, more lower-category ratings are assigned during downturns. Besides, the evidence also clearly brings out the negative correlation between (higher) ICRA ratings and probability of default: higher the ICRA rating, lower has been the default likelihood, and vice versa.

## Rating Migrations: Methodology for Study

- The salient features of the methodology<sup>1</sup> that ICRA has adopted to study rating migrations are discussed in the following bullet points.
- The study tracks the year-wise movement of all accepted ratings assigned by ICRA since inception. It tracks the rating of the corporate and not of individual instruments. For each year, beginning January 1992, separate “cohorts” have been formed and the individual company ratings in each such cohort have been tracked till beginning January 2002.
- The cohort for a year consists of all ratings outstanding at the beginning of that (calendar) year. The 1998 cohort consists of all those companies which had an outstanding ICRA rating as on January 01, 1998. The 1999 cohort is formed by considering the ratings outstanding at the beginning of 1999 (after taking into account the retentions/revisions/withdrawals in the ratings of the cohort of 1998 and adding to them the ratings assigned and accepted during 1998). Since ICRA started its operations in 1991, there are 11 cohorts till beginning January 2002 (cohort of 1992 till 2002). The behaviour of the ICRA ratings in each cohort is followed over the various number of years to form one-year, two-year, three-year (and so on) transition matrices for each rating category. The cohort formed in January 1992 has one-year, two-year till 10-year transition matrices, whereas the cohort formed in January 2001 has only a one-year transition matrix; the cohort of January 2002 does not yet have even a one-year transition matrix.
- The study has not considered a withdrawn rating in the cohort of the year following the year in which it was withdrawn. Ratings are withdrawn either when the instrument is redeemed or if the debt was never issued.
- Rating transitions for investment grade ratings have been analysed from 1992 till beginning 2002. No distinction has been made between rating revisions to the non-default non-investment grade category and to the default category. ICRA has adopted this conservative approach as it believes that the non-default non-investment grade rating ( *below LBBB-, excluding LD*) have a significant propensity to default. Moreover, the ability of investors to exit a paper which no longer has an investment category rating, is restricted.

## ICRA Long-Term Ratings: Average One-Year Transition

The numbers in Table 1 represent the movement of ratings within a one-year period for cohorts of 1992 till 2001, that is, for ICRA ratings since inception.

**Table 1: One-Year Average Transition Matrix—Since Inception**

	<i>Data Points</i>	<i>LAAA</i>	<i>LAA</i>	<i>LA</i>	<i>LBBB</i>	<i>NI</i>
<b>LAAA</b>	142	92.3%	7.0%	0.7%	0.0%	0.0%
<b>LAA</b>	287	1.7%	86.4%	10.1%	0.3%	1.4%
<b>LA</b>	279	0.0%	1.4%	83.5%	7.5%	7.5%
<b>LBBB</b>	133	0.0%	0.0%	0.8%	85.7%	13.5%

*NI: Non-investment grade; ratings below BBB- (i.e. LBB+ till L D)*

*The categories of LAA, LA and LBBB include ratings with the suffix “+” or “-” within the respective categories. Thus, for instance, the category LAA includes three ratings: LAA+, LAA, and LAA-.*

As the table shows, ever since ICRA’s inception, no “LAAA” rating has moved into the NI category within a one-year period, while only four ratings (i.e. 1.4%) from the “LAA” category have been revised to the NI category over a one-year period. The percentage of “LBBB” ratings moving into NI category is the highest amongst all investment category ratings (there could be exceptions in certain individual year cohorts as discussed in the following section).

The analysis clearly establishes the lower propensity of default (or near default) of the higher category ICRA ratings.

<sup>1</sup> *The methodology is similar to the ones followed by leading rating agencies internationally.*

## Behaviour of ICRA Ratings in Recent Years

As Table 2 shows, the recent rating revisions reflect greater stress due to the deteriorating general economic conditions.

**Table 2: One-Year Transition Matrix—2001**

	LAAA	LAA	LA	LBBB	NI
LAAA	87.1	12.9%	0.0%	0.0%	0.0%
LAA	0.0%	80.0%	14.3%	2.9%	2.9%
LA	0.0%	0.0%	69.4%	16.7%	13.9%
LBBB	0.0%	0.0%	0.0%	90.9%	9.1%

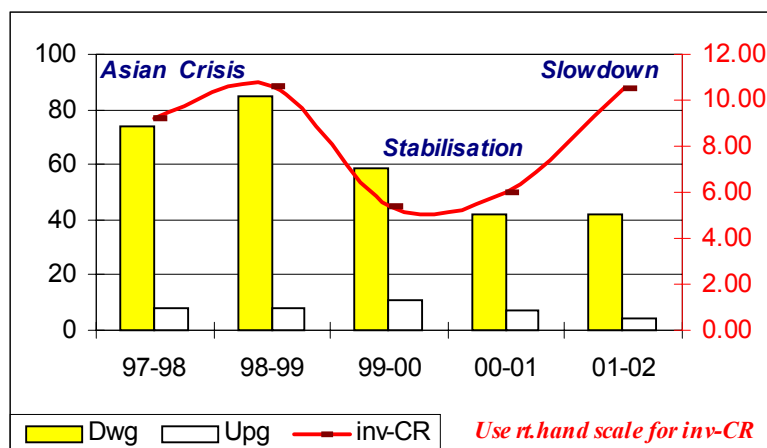
A comparison of the one-year transition for the cohort of 2001 (Table 2) with the average one-year rating transition matrix since 1992 (Table 1) shows a relatively greater volatility for the ratings in the 2001 cohort. The relatively higher percentage of “LA” ratings moving into the NI category, as compared with “LBBB” ratings moving into the NI category, in the 2001 cohort can, however, be termed exceptional. In the 2000 cohort, 8.3% of the “LBBB” ratings moved into the NI category, while there was no movement into NI from any other category.

Thus, the pattern of rating migration not only reflects the general depressed economic environment but also reiterates the greater resilience/stability of higher ICRA ratings.

## Increase in Downgrade to Upgrade Ratio during FY 2001-02

The graph below presents the number of companies whose long- and medium-term debt instruments were upgraded or downgraded between April 1997 and April 2002. The line represents the inverse credit ratio (inv-CR), which is the ratio between the number of downgrades to upgrades.

**Figure 1: Rating Revisions (Long & Medium Term) Since 1997-98**

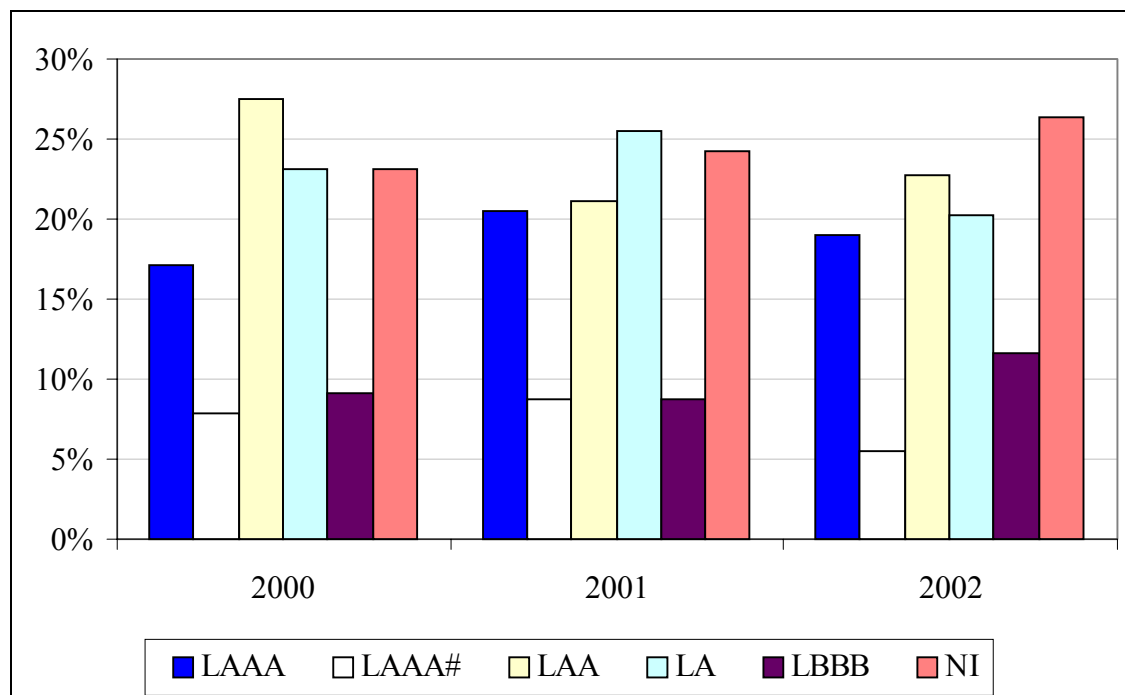


The lower inv-CR after 1998-99 till 2000-01, reflects a period of relative stability after the Asian crisis. The lower inv-CR during this phase was mainly on account of the decrease in the number of downgrades, and not due to any dramatic increase in upgrades, which, in fact, points at ICRA’s cautious approach to rating. With the subsequent deterioration in the economic environment in India, 2001-02 witnessed a significant rise in the inv-CR. Again, this rise in inv-CR can be attributed to lower number of upgrades, and not to any increase in downgrades as the number of downgrades during 2001-02 remained at the 2000-01 level. Thus, although the number of downgrades decreased during a period of relative stability, they did not increase when the situation deteriorated in 2001-02.

## Shift in Outstanding Ratings towards Lower Categories

The category-wise outstanding long-term ICRA ratings as at the beginning of April each year since 2000 form the pattern as shown in Figure 2.

**Figure 2: Distribution of Outstanding Long-Term Ratings**



“LAAA#” column indicate the percentage of outstanding LAAA ratings of entities other than Banks and PSUs.

- The ratings outstanding as in April 2002 mark a distinct shift towards the lower categories as compared with the ratings outstanding as in April 2000. “LBBB” and “NI” category ratings accounted for 38.1% as in April 2002 as against 32.3% of the ratings outstanding as in April 2000. The proportion of the higher category ratings of “LAA” and “LA” as a percentage of outstanding ratings declined from 50.6% as in April 2000 fell to 42.9% as in April 2002.
- The “LAAA” rated entities predominantly consist of Banks and strong PSUs. As in April 2002, these entities comprised almost 70% of the total outstanding “LAAA” ratings. “LAAA” rated companies, other than banks and PSUs accounted for only 5.5% of the total long term ratings outstanding as in April 2002 in comparison with almost 8% as in April 2000.



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