AN EMPIRICAL STUDY ON IMPACT OF CREDIT RATING ON CREDIT RISK OF BANKS: A LITERATURE REVIEW

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ABSTRACT

In the financial markets, for investors, lenders, and issuers, credit rating agencies (CRAs) have a critical part in reducing the asymmetry of information between various parties. Credit ratings allow us to recognize the credit impending of a region's individuals. The paper clearly describes the role played in the establishment of a nation by credit rating agencies; there is a rise in new start-ups as all investors are rated favorably. Banks are helping to recognize the investment position of India. The main aim of the study is to analyze the research gap on the impact of credit rating on credit risk with a review of the literature. The study briefly explains the research gap which helps to analyze the factors which are responsible for credit risk. The study analyzes the definitions of basic terms, the origin of credit rating agencies' objectives, and the scope of the present study and the literature review by assessing the credit rating users and examined the consequence of credit rating agencies on the Indian financial markets. Based on the nationwide and worldwide literature it is found that if the credit history of the investors is good then their credit score would be better and positive. It would also be incredibly convenient to collect loans. Finally, it is concluded that there is a positive impact of Credit Rating on Credit Risk of banking sectors in India.

Keywords: Credit Rating, Credit Rating Agencies, Banks, Services, Credit Risk.

JEL Classification Codes: A31, G21, G33, N2, D53.

INTRODUCTION

The service sector is an essential industry that contributes significantly to the growth of the country, Credit ratings fall below those of financial services because their scores have financial security. Significant participants are the credit rating companies in the financial sector. To compose a knowledgeable conclusion on the capital markets, they have an objective assessment of the credit capability of debt issuers. The CRA's, the 'gatekeepers' of the financial and capital market, have over time become a position of immense power and influence.

According to United States Congress, the appraisal affects the ability of an organization to borrow money. This decides whether a mutual fund or a money market fund is capable of investing in a company's bonds and has an effect on the price of the stock. For decades, the three main credit rating

agencies - Moody's, Standard & Poor's (S&P), and Fitch Ratings - have dominated the credit rating industry all over the world in the nonappearance of a countrywide and worldwide regulatory system. Credit scores are arguably one of the most severe financial issues as a consequence of the recent economic downturn. In the last few years, the position and significance of credit rating agencies have been increasing. Concerning credit risk, credit ratings are judgments. Standard & Poor's ratings reflect the view of the institution of the ability and ability of an issuer to fulfil its financial obligations in full and on time, like a state or regional company or government. It is also possible to relate credit ratings to the credit value of an entity debt issue, like a business or public bond, as well as to the relative probability of a default issue. Credit rating agencies' responsibility specialized in the evaluation of credit risk to issue credit ratings. To measure creditworthiness, each and every agency applies its methodology and utilizes a particular ranking scale to issue opinions on ratings. To express the organization's judgment on the relative extent of credit risk, ratings are usually conveyed as correspondence results ranging from 'AAA' to 'D'.

Definition Credit Rating

Credit rating refers to recognizing the ability of consumers to judge credit, which means respecting the customer's credit repayment history. Both customers who want to browse for credit facilities use credit scores.

Credit Rating Agencies

Besides, there are regional, specialized credit rating agencies that are focusing on a geographic area or industry, in addition to overall credit rating agencies like Standard & Poor's Ratings Services. To measure creditworthiness, each and every agency uses its methodology and makes a particular ranking scale to publish its opinions on ratings. To express the organization's opinion on the relative degree of credit risk, ratings are expressed in the form of letter grades which range from 'AAA' to 'D'.

The Genesis of Credit Rating Agencies

The Credit Rating Agency's journey started with Lewis Tappan in New York City in 1841. Then, Robert Dun, who published his first guide to scores in 1859, received it. John Bradstreet, an additional agency, began in 1849 and has published a guide on ratings in 1857. Credit rating agencies were born in the early 1900s when ratings, especially those relating to the railway bond market, started to be realistic for securities. The creation of wide-ranging railway networks in the United States contributed to the growth of business bond-related problems to fund them and, consequently, to a bond market that was several times larger than that of other nations. The demand for autonomous market expertise, especially for independent bond lending analysis, began to increase following the 1907 financial crisis. In 1909, a journal focused exclusively on railroad bonds was written by the financial analyst John Moody. His evaluations were the first to be widely distributed in an easy-to-get format, and his business was also the first to charge subscription charges to investors.

NEED AND IMPORTANCE OF CREDIT RATING AGENCIES

Credit rating agencies have a considerable part in the economy's overall growth. Credit rating agencies have the primary duty to reduce the asymmetry in credit market awareness by their skill evaluation. It also helps debt distributors to value their problems acceptably and to reach pioneering investors. This encourages investors to start new businesses, which in turn boosts the country's revenues. The primary aspire of the research is to understand the responsibility of a nation's credit rating agencies on the financial market.

WHY CREDIT RATINGS ARE USED?

Credit ratings have a beneficial role in serving businesses and governments raise funds on the capital markets. Sometimes, they borrow money directly from investors by selling bonds, instead of taking loans from a bank. These debt instruments like public bonds are purchased by investors planning to

obtain interest along with their principal at the maturity of the bond, or in the form of monthly payments. Credit ratings can facilitate the practice of issuing and purchasing and erstwhile debt problems through a reliable, generally renowned, and long-lasting estimation of credit risk. Investors and other market contributors can make use of the ratings to test for their threat acceptance or credit risk requirements for investment and business decisions in line with their relevant credit risk issues. The investor, for example, should check to decide if its credit rating is in line with the degree of the credit risk it would take concerning the purchase of a municipal bond. At the same time, organizations may use credit ratings to fuel growth and/or fund research and development, along with public initiatives in governments, cities, and other classes.

OBJECTIVES OF THE STUDY

- To study the overview of credit rating agencies in India.
- To know how Credit Ratings help in a country's development.
- To assess the users of the credit rating.
- To observe the impact of credit rating agencies on Indian financial markets.

SCOPE OF THE STUDY

The theoretical dimensions of credit ratings in the developing world are demonstrated by their scale. The study was performed on diverse aspects of the efficiency of credit rating agencies. The analysis considered the national and international journals for studying credit rating and credit risk of the Indian banking sector, such as public and private sector banks. Secondary data was utilized for the study in the form of a literature review.

REVIEW OF LITERATURE

Studies in the past have compared various parameters related to bank performance including credit risk measurement and management between Private as well as Public Sector Banks. A review of the literature on this topic shows that there is no agreement on the ownership of banks and their performance. Some studies have revealed that bank performance improved when state-owned banks were either fully privatized or partially privatized. Other reports suggest that public sector banks performed better than private sector banks.

In this paper, Partnoy (2017) addresses three problems faced by credit rating agencies due to the government of Congress. In this the author presented solutions for certain problems. The author strongly placed pressure on all sides, i.e. credit rating agencies and investors, to fix the ongoing issue. Owing to the methodologies practiced by the rating agencies, the credit rating pattern is missing. The problem of unfair and mechanistic dependency on credit scores was also highlighted by him. He found there were no standards for credit rating agencies and introduced some legislative changes to address this issue. He addressed the methods of action and different types of threats. But the patterns in credit rating are missing in this paper.

A rivalry between credit rating agencies is addressed with authors Bolton et al. (2012) via a model to decrease the efficiency of the industry. Briefly, they clarified the features of rating agencies. The study was structured by explaining the author's comparison and extension of credit rating agencies. They have also made some assumptions that indicate an investment perception. The analysis was clarified by assessing the game with the rating agencies' monopoly. They explained the rivalry and its empirical implications among credit rating agencies. As a future enhancement few more assumptions can be made.

Approaching the fundamental concepts in the flow of investment information by credit rating agencies and analyzing the critical position of the credit rating agency, Lynch (2009). The author has assessed the function of credit rating agencies on the capital market and speculation policy. He clarified how private contractors submit credit rating details. He added to the divisive problems faced by credit rating agencies. He complained about the credit rating agencies' credibility protections. The

report analyses many of the issues concerning the established regulatory system. The problems of the issuer-paid interest dispute were also highlighted.

The authors examined numerous articles and evaluated the theory using statistical techniques such as regression analysis. As per that report, presently no pragmatic proof that the report is based on a bivariate or multivariant analysis that supports the association among the capital strength and the Jordanian company's credit rating. The number of fixed assets was defined as fairly small. The authors concluded that the study supports different approaches used to test the internal model of credit rating, suggesting that certain variables influence credit ratings significantly. The results of the study show that positively high credit scores are also linked to size and growth potential. The study is addressed by the author and considers the degree to which bank ratings represent banks and the features of accounting data to estimate the issue. Using descriptive analysis by taking samples from the US and the United Kingdom, the author clarified the study by Hassan and Barrell (2013). To validate the study, statistical methods like correlation matrix and the consequences of regression are used. The findings revealed the success of the model, which required proper credit ratings to be assigned by 74 percent to 78 percent of banks. Banks were rated as top-rated banks and the lower-rated banks based on their scores.

Elkhoury (2009) the author addressed the knowledge break through the use of qualitative and quantitative approaches in the global monetary system as assessment processes and methods. The author has established the Normal and Weak methodological profile. Both the developed and developing markets are explained by the credit rating determinants. The author discussed the other two different topics separately. The rates of international interest and the export structure are being increased. He talked about the shortcomings arising from the regulatory initiative. Credit rating agencies evaluate several variables that have been explained in the study for the allocation of ratings. The author's view on the credit rating agencies is expressed in the study. This analysis advanced my research to appreciate the methodologies employed by credit rating agencies and helped me further explore the topics discussed in the review.

In a study conducted by Sinkey and Greenwalt (1991) In the United States of America it was found that on the experience of credit loss and risk-taking actions of commercial banks credit risk emerges primarily from weak credit policies and poor macroeconomic conditions. Caprio and Klingebiel (2000) recorded that, due to poor management and politically influenced loan disbursements, many state-owned banks demonstrated poor financial results. Bratanovic and Greuning (2000) proposed that credit risk ratios could be used as a measure of the credit risk connected with the banking sector, demonstrating the importance of such ratios for banks to reduce the ratio within and prevent any terrible failures.

In this paper, Bhattacharyya (2009) evaluated and highlighted that the PBIT & Debt plus networth ratio, current ratio, and growth in the net sales acts as an imperative part out of the 10 variables used by ICRA for issuer ranking, but at any point of time the dependent elements can also change ratings.

Bheemanagauda (2008) have attempted to estimate the presence of CRA's in India, counting CRISIL, ICRA, CARE, and FITCH, both in the country and out of the country, other than the notice of current writings shows that in spite of the escalating significance of CRA's as data agencies, credit rating agencies are becoming increasingly important as knowledge providers for credit-related opinions The majority of researches managed in India to date have largely focused on the theoretical and conceptual credit rating system of India.

The two leading Indian CRA's have attempted to test the business supremacy rating methodology used by Achalapathi and Rajani (2004), namely ICRA and CRISIL. The researchers attempted to relate the principles of accountability, revelation and ranking technologies to explore the business authority information of different entities and attempted to figure out regardless or not a good number of firms complied with regulatory requirements. Compared to financially weak companies, it was noticed that much was disclosed by financially better-performing companies. Similarly, businesses with restricted proportion of investors in Foreign Institutions in the shareowner model

reported further with reference to their corporate governance when differentiated to organizations with a lower share of FII's. While business reports were constantly at a cost borne by the investors, they were expected to be disclosed by the shareholders. Many corporations act in accordance with the regulatory criteria as commercial divulgence strengthens the corporate integrity of the corporation.

Poon and Firth (2005) discussed the lack of dissemination of the requested or unrequested results in their research paper. Consequently, Fitch's bank ratings were analyzed for this point in 82 countries. Authors also analyzed if the financial details of the 52 banks with the requested ratings were different from those with the unrequested ratings. The authors established that, since only public data was the basis of unrequested assessments, the ratings requested were typically higher than the ratings requested. In comparison, companies with unwanted ratings have lower financial profiles than those with the submission of ratings. This could also explain why some banks can apply for scores, according to analysts, but others can't.

Tang (2009) has examined the effect of refined rating information on credit market admission to businesses, monetary decisions, and speculation policy by using Moody's 1982 loan evaluation design improvement. The writer pointed out that the companies that were strengthened as an effect of the more sophisticated gradation saw a large decline in their borrowing rate in contrast with companies with decreased scores. Furthermore, businesses with a rating refining upgrade have issuance, which confirms that improved access to the capital market allows upgraded firms to replace the funding of equity debt. This has shown that higher corporate rate refinements are linked to higher capital spending, lower cash gathering, and growth in the assets than lesser ratings. The paper, therefore, explained the part played by credit ratings in deciding the company's capital configuration in conditions of both lending costs and the debt amount.

Reddy and Gowda (2008) explained in their article the relevance and troubles of the credit rating system existing in the country. Also gave priority were the foundations of credit rating and credit rating practices in India. The views of the Hyderabad investors sample were then adopted. The study's findings showed that most participants are aware of the existence of diverse credit rating agencies, like CRISIL, CARE, ICRA, etc. Roughly 40% (80 of 200) of the people who answered rely on the credit rating for investing in debt instruments, but 50% (94 of 180), more than most credit rating agencies depend on CRISIL to make their investment. The study accomplished that, while numerous investors are confused with more than one credit rating agency, most of them are happy with credit rating agency supervision.

Kumar and Rao (2012) in their report red Credit Rating – current monetary structure, indicated credit rating for the security of small investors who are the key targets for unlisted corporate debt in the form of fixed deposits with enterprises. Classification is generally used as alphanumeric symbols and is based on the rating agency's judgment.

Matthies (2013) proposed some ideas for credit rating in his paper. He reports on the current state of analytical examination in the area of corporate ratings and its connection with the ratings of several other organizations and different previous important data. The results from three research lines, such as the connection stuck between credit ratings and corporate defaults, the influence of loan ratings on financial markets, credit rating variables, and credit rating adjustments, are considered in particular. The results from each line are relevant and essential for the construction and analysis of studies in the remaining two areas. Besides, the design and development of credit ratings and the rating scale are important for explaining all empirical findings.

A paper titled by Saluja and Drolia (2015) published the effect of loan rating on cash and earnings performance of Indian companies. In the special article, the authors reiterated that the load rating is a probabilistic estimate of the default in debt instrument payment. The firms that have good growth hold more cash. In addition, businesses with substantial profits and sales retain 10% to 20% of the total assets in cash. The author also described the term earnings momentum. They accept that borrower private data also plays a most important part in decision-making on the structure of maturity of corporate debt. The study is, however, intended to measure the effect of the loan rating on the cash assets of a business and to calculate the collision of the credit rating on the income momentum of a

company. A random sample of 30 Indian companies included in the BSE 200 index has been attempted. For these firms, their respective annual reports and BSE have provided the quarterly data from 2006 to 2014. CRISIL collected credit rating information. The 36 effects of the credit rating on cash holdings and income momentum were assessed using the classical linear regression model. Credit scores have a direct effect on the decisions taken by managers about the capital structure. The results can be used for enhancement and downgrading, as well as for small and large companies.

CONCLUSION

It is found that the credit background of investors is good after reviewing the above national and international literature, so their credit score will be stronger and optimistic. It would also be incredibly convenient to collect loans. Investors may spend in diverse companies that increase jobs when loans are allowed. When companies get positive ratings, loans are issues, companies can start and expand their business and provide employment opportunities to many people. This results in an increase of the country's national along with the GDP. A country's expansion depends on the country's GDP. As per the report, the GDP shows a positive increase which shows the growth of the country. If all the industries are improving, then the country's growth is very easy. Finally, it is concluded that the credit ranking has a constructive effect on the credit risk of the banking sector in India. Further study can be done on analyzing the public, private, commercial, and cooperative banks.

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