A Knowledge Report on

Factors Determining Credit Rating

Good governance practices do not, in isolation, positively affect a credit rating. However, poor governance practices, including issuer-specific corporate governance matters, can result in lower ratings than typical quantitative and qualitative credit factors may otherwise imply.

Before getting into further details about the criteria of credit rating lets first know who is an issuer. An issuer is a legal entity that develops, registers and sells securities to finance its operations. Issuers may be corporations, companies, investment trusts domestic, foreign or government. Issuers are legally responsible for the obligations of the issue and for reporting financial conditions, material developments, and any other operational activities as required by the regulations of their jurisdictions. Issuers commonly issues preferred stocks, bonds, notes, debentures, bills and derivatives. Issuers also aggregate funds from a pool to issue of investors to issue shares, mutual funds shares, or exchange traded funds.

Now let's look at what exactly affects ratings. The extent to which ratings are affected depends on the extent and pervasiveness of the governance matter(s) identified and the relative strength of an issuer's credit factors within its rating category, balanced against/with the absolute level of its issuer or debt instruments ratings.

Key Rating Drivers Issuer-Specific Assessment: In its review of issuer-specific considerations, Credit Rating Agency like India Ratings (Ind –Ra) focuses on the characteristics shaped by the industry in which the issuer operates, and the relationships between its stakeholders.

Issuer-Specific Factors: Board independence & effectiveness; management effectiveness; transparency of financial information; related-party transactions and corporate structure.

Creditor Protection Assessment: Governance characteristics may be evaluated so as to assess how they contribute to protecting the interests of debt-holders and other creditors. Issuer specific characteristics are each divided into three categories: ratings neutral; those that may be ratings negative and put downward pressure on ratings; and those that may constrain ratings.

When looking at issuer-specific governance characteristics, rating agencies may focus on board and management effectiveness, transparency of financial information, and related-party transactions. Board Independence & Effectiveness Assessing an issuer's governance practices begins with a review of its board of directors. High performing boards are important if executive management is to be challenged. This means that effective boards must include non-executive members with diverse skills, views and professional experience. Members must be prepared to invest sufficient commitment and time into the work of the board. The role of the chairman of the board is particularly important. The board of directors, in its oversight role, plays an integral part in how management is both rewarded and disciplined as it fulfills its fiduciary responsibilities.

A board that is independent, active, knowledgeable and committed generally signals a robust governance framework. A board that is not committed to fulfilling its fiduciary responsibilities can open the door to ineffective, incompetent, and, in some cases, unscrupulous management behaviour.

In evaluating board effectiveness, rating agencies looks at the composition of the board, qualifications of board members relative to their assigned committees, and how the board operates. Analysts also focus on the resulting actions and policies set by the board, including selection of management and related succession planning, setting strategic direction, including risk targets, using compensation to reinforce strategic objectives, and oversight of financial reporting. Board members are evaluated for their areas of expertise and independence from executive management. The board should be comprised of individuals with expertise in related or similar industries, or audit, financial or regulatory experience. Listed companies should also be in compliance with listing or jurisdictional rules related to corporate governance.

The board typically determines incentive compensation and remuneration of executive management. This poses a governance concern to the extent that potential for inappropriate incentives exist, such as a focus on short-term performance criteria that may have a negative influence on the long-term sustainability of the company. Inappropriate remuneration policies may also give rise to conflicts with creditors' interests if the issuer's financial resources are strained as a result. More fundamentally, poor remuneration policies and incentive structures may be indicative of a lack of financial discipline and accountability operating generally throughout the company.

IndRa recognises that incentive and compensation information may not be disclosed in many closely held companies. Analysts may exercise judgement in these cases and determine whether lack of disclosure in itself may be a negative rating factor. Management effectiveness is evaluated based on whether the issuer fulfills the objectives set out by the board with regard to strategy, risk tolerance, policies and controls. Transparency of financial Information timely, transparent and accurate accounting statements are critical in ensuring that investors are in a position to assess an issuer's financial condition and fundamental risks. High-quality and timely financial reporting is considered by rating agencies to be indicative of robust governance. Likewise, publishing intentionally inaccurate or misleading accounting statements is symptomatic of deeper flaws in an issuer's governance framework. The public exposure of techniques that subvert the spirit of accepted accounting standards or, worse yet, are designed to mask fraudulent activity can undermine investor confidence and destroy value. Similarly, if an issuer does not provide timely business and financial updates to the agency and also delays filing regulatory public updates– e.g. to the Ministry of Corporate Affairs website or to

stock exchanges or on its own website, rating agencies will not be able to provide a credit view on the issuer. The agency may also consider this as symptomatic of a possible disruption / distress in the issuer's business, which may result in any existing rating being moved to the Non-Cooperative (NCO) category and on continuation, to the sub-investment grade.

Governance of the internal audit process is an important safeguard for the integrity of an issuer's financial reporting. An independent audit committee is a requirement for listed companies in India. The audit committee plays an important role in governance of the financial reporting and audit processes. It is the responsibility of the audit committee to promote a sound internal financial control environment, to monitor the work of the internal auditors and often to appoint external auditors. It is a desirable feature of good governance to ensure that internal audit reporting is delivered directly to the audit committee and/or to the board rather than to senior management, as this could give rise to conflicts of interest. Similar considerations apply with respect to external auditors. However, none of these procedures will be effective unless the audit committee, and/or the board, includes independent members with appropriate financial expertise to be able to understand the ramifications of different accounting treatments and any potential risks or vulnerabilities in the issuer's audit process.

Many listed companies are required to publish an evaluation of the internal control environment and procedures. The presence of material weaknesses highlighted in the disclosure could be a negative ratings factor. Other factors that could also be viewed negatively include the late publication of financial statements, frequent changes in independent auditors, multiple restatements of financial data and aggressive accounting positions.

Related-Party Transactions: Transactions between senior executive management, major shareholders or those close to them and the issuer (related-party transactions) merit close review in governance analysis. Related party transactions give rise to potential conflicts of interest for a rated entity. More specifically, the related party may be faced with a competing set of incentives and not act in the best interests of the issuer. In some cases, the primary motivation of a related-party transaction is to enrich the executive or related-party at the expense of the corporation. An important safeguard against potential abuse is for the issuer to have mechanisms or policies that ensure such transactions, should they occur, are negotiated at arm's length, are priced on competitive market terms, and serve a viable economic purpose. Some related-party transactions are conducted for legitimate business reasons and are not based on exploitative or fraudulent rationale. Rating agencies tries to understand the nature, purpose, and terms of related-party transactions, particularly when these are large. The agency's analysis may consider the board's role in reviewing or approving related-party transactions and the level of detail disclosed in public filings. A lack of thorough board review of such transactions can be a sign of inactive or passive board oversight. Similarly, scant or vague disclosure of the facts surrounding the transaction may require examination. Rating agencies may consult the management regarding whether the board was briefed on the key terms of and motivations for the transaction.

Companies with a complex corporate structure would involve an in-depth analysis of the corporate hierarchy. An opaque structure or entities with significant cross-holdings may potentially indicate governance risks. The rationale for the presence of multitude of entities operating under the rated entity and/or above as a holding company and the interplay among them forms an important part of the analysis.

As for systemic characteristics, the issuer-specific characteristics have each been divided into three categories. Rating agencies will determine the category an issuer belongs, based on a "weakest link" approach (i.e. an issuer's weakest governance characteristic will determine the category). Limited corporate governance codes and frameworks are generally applicable only to companies that issue shares, admitted to trading on regulated markets ("listed" companies). In addition, corporate governance principles are not always legally enforceable and often are implemented through recommendations and best practice codes. The applicable principle may be, for example, that companies either comply with broad recommendations or explain, through public discourse, why they are unable to do so. Rating agencies assign ratings to listed, non-listed companies, dependent public sector entities, not-for-profit trusts and societies of all sizes and recognises that some governance codes may not be applicable across the full spectrum of rated entities, corporate governance for trusts/special purpose vehicles (SPVs) in structured finance and infrastructure projects is factored into the corporate governance evaluation of the originator/servicer and sponsors, respectively. Rating agencies may also evaluate the legal and regulatory risks of the individual trust/SPVs to establish their bankruptcy remoteness and assess the robustness of the ring-fencing and payment mechanisms.

Positive points:

- The board has independent members; board members are familiar with the business of the company
- The board has selected a strong management team.
- The board has a well-thought-out succession plan and a deep bench of talent.

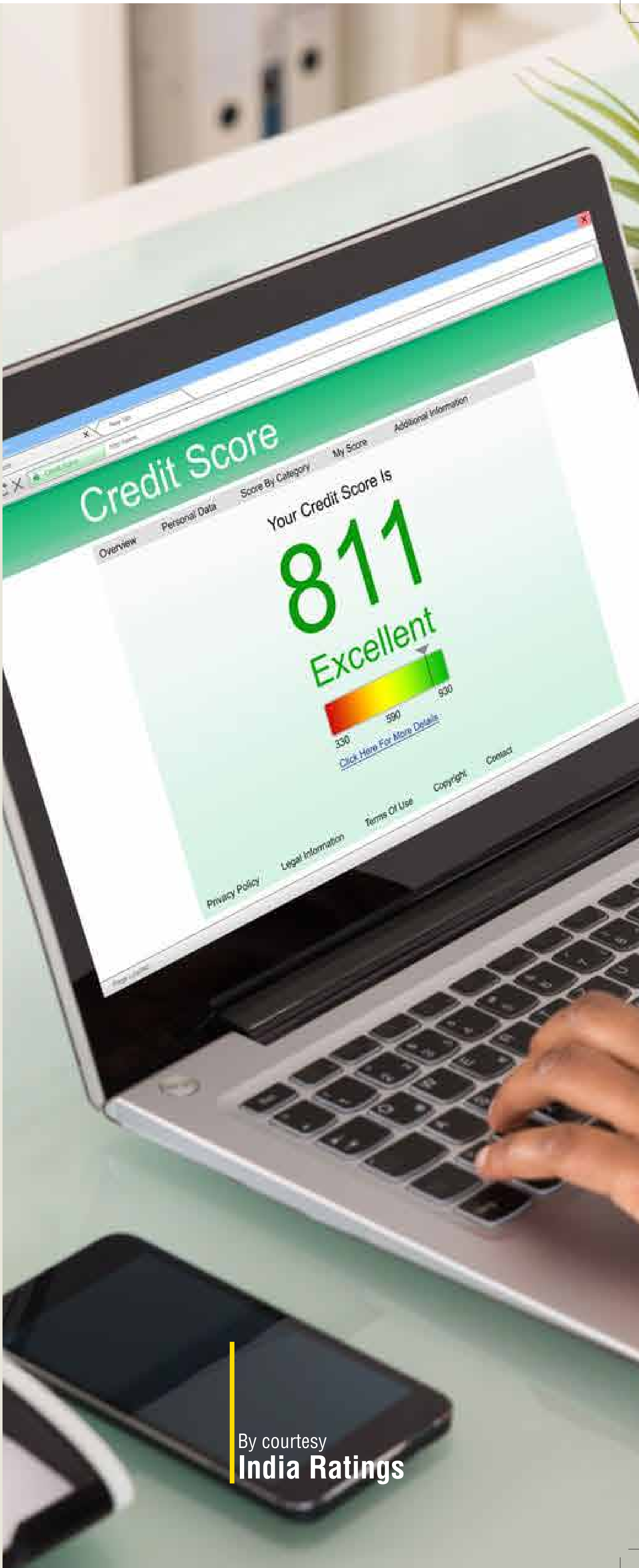
- The board is perceived to be setting a proper strategic direction.
- The board sets appropriate risk management targets.
- The board balances short-term and long-term perspectives through compensation and management direction.
- Proper oversight of the financial reporting function exists.
- Financial statements are prepared on a timely basis.
- Financial statements are audited annually and interim results are available.
- External auditors are selected by an independent audit committee.
- External auditors are considered experts in the company's industry.
- Disclosures are informative, robust, and not boilerplate.
- Information provided by management is consistent with financial statements and third-party sources.
- No weakness has been identified in internal controls.
- Willingness to share required information and participate with the agency in management discussion periodically Issuer-Specific factors for financial information transparency
- There is very limited related-party transaction activity. Any related-party transactions are transparent at arm's length, and receive proper oversight by the board.

Negative points

- The board has inadequate independent members.
- Board members are not familiar with the business of the company and/or back ground information is unavailable.
- Board members are stretched, with multiple board memberships and unable to attend to oversight risk.
- The board has set compensation targets to reward short-term behaviour over a long term focus.
- Succession planning is not transparent, or key man risk is not addressed by the board.
- The board has not created a strategic plan.
- The board has no independent members.
- The board has no independent audit committee.
- The board has not developed a succession plan.
- Management is perceived to be implementing well the strategic direction set by the board.
- Risk appetites are consistent with board directives.
- Management compensation is considered excessive in relation to peers.
- Local management in a single instance has been found in violation of anti-bribery and/or corruption statutes or subject to criminal or civil proceedings in connection with work-related actions.
- Key man risk has been identified; overreliance on one or a few individuals for the success of the issuer. • Management's stock holdings may encourage shareholder-friendly actions that run counter to creditor interests, such as issuing debt for stock repurchases.
- Management has overridden board directives or risk targets.
- The management team is perceived as weak or ineffective.
- There is management team infighting.
- Local management in multiple jurisdictions and/or senior management has been found in violation of anti bribery and corruption statutes or found guilty in criminal or civil proceedings in connection with work-related actions.
- Management poorly manages risk or has

overridden the board's risk tolerances on multiple occasions.

- Auditors have identified material weakness(es) in the internal control environment, or no audit of the internal control environment has been performed.
- There have been multiple changes to audit providers over a short period of time.
- Financial statements are late (based on regulatory or covenant requirements).
- A restatement of financial data is required.
- The auditor was not selected by an independent audit committee, or the audit committee appears to lack a "financial expert".
- Auditors have identified multiple material weakness(es) in the internal control environment.
- Auditors are unable to express opinion or have an unfavourable opinion on financial statements.
- There is a change of auditor due to a disagreement in accounting treatment.
- Financial statements are consistently late.
- There are multiple restatements of financial data.
- Financial data is irregular or may not share relevant information and participate with the agency in management discussions.
- There is a lack of transparency on related-party transactions. There is ineffective board oversight for related party transactions.
- Related-party transactions are considered excessive.
- The extent of related-party transactions is unable to be determined. There is no oversight by the board for related-party transactions.



By courtesy
India Ratings