

### **How are bonds rated?**

*Bonds are rated by various credit rating agencies in accordance with the level of safety they offer to investors.*

A bond is essentially a loan given by an investor to a company or a government for a specific period. The investor earns regular, predetermined interest on this amount, and receives the initial amount back at the end of the specified period.

One of the most important reasons why investors are attracted to bonds is the interest they earn over time. Some bonds offer higher interest rates than others. However, before investing in any bonds, you need to first know how safe they are.

Rating agencies like CRISIL, ICRA and CARE rate these bonds based on the level of safety, that is, the ability to repay the amount on maturity, offered by the bonds. Some of the factors they consider while rating bonds are mentioned below.

#### **Internal factors**

Bonds are issued by various companies to finance their business operations. Apart from paying interest to the investors, these companies promise to repay the principal amount on a future date. However, whether or not the companies keep their promise depends on their financial strength. Therefore, rating agencies analyze fundamental business factors like strength of the balance sheet, profitability, revenue sources, growth potential, etc. in order to rate bonds. The greater the financial strength, the higher the rating the bond will get.

#### **External factors**

Rating agencies also look at several external factors while determining the rating of a bond. Factors like parentage, government intervention, industry outlook and competition also play an important role in analyzing long-term prospects of the company. If these factors portray a favorable picture, bonds get higher ratings.

The rating scale used by most Indian rating agencies is as below:

- AAA – Highest safety
- AA – High safety
- A – Adequate safety
- BBB – Moderate credit risk
- BB – Moderate default risk
- B – High default risk
- C – Very high default risk
- D – Default

While investment grading methods of different agencies might differ slightly, most of them use the above mentioned rating scale to categorize bonds.