Emerging Challenges for Credit Ratings

R.Ravimohan
Managing Director & CEO
Credit Rating Information Services of India Ltd.,the

Credit Ratings in India began in 1987, with the establishment of CRISIL. At that time there was no secondary market for corporate debt securities, and therefore no perceived need for ratings as a driver of pricing for these securities. CRISIL as the pioneer took on the task of building the market. It has been a long journey, which began with credibility -building and issuer and investor education, and gradually matured into leading the market towards increasing diversity and sophistication. Credit rating is now a 90-crore market, with four agencies providing rating services, and substantial demand from investors for the product.

A historical perspective

The evolution of the ratings business in India can be divided into three clear phases. During the first phase, CRISIL started off from a zero base as far as awareness and experience about credit ratings were concerned. The first task of CRISIL therefore was to create awareness of the concept, and build up its credibility in the market, with issuers, investors and regulators. The consistency and quality of CRISIL's work led to increasing levels of issuer and investor acceptance, and gradual establishment of its market position. This phase lasted till about 1992.

The second phase saw the beginnings of regulatory support for credit ratings. This occurred with the introduction of regulations covering the primary markets for debt issues and also fixed deposits. Conceived with the objective of protecting smaller investors, these measures also provided some measure of regulatory recognition of the role of credit ratings and the quality of the effort put in till then. All of this also resulted in credit ratings becoming more of an everyday concept for the individual investor.

Among other things, this phase saw the advent of competition, with other domestic agencies entering the market.

Recent years have seen a third phase of the market's development. With less and less debt hitting the primary market through public issues, almost the entire volume of corporate debt placed in the market today goes through private placements. Although there is no legal requirement for rating of privately placed debt, almost all the privately placed debt issued in the Indian market is rated. This is because of a shift in investor perception, which in turn signals a qualitative maturing of the market. Investors require a rating, not as a compliance issue or a mandatory certificate, but as an opinion on credit quality, demanded by discerning buyers.

The way ahead

In the near to medium term, we see a more intensive use of ratings by investors, and an increasing sophistication in use of ratings. As a result, credit ratings will graduate from being used mainly as a decision support for investments, to the higher plane of being a pricing tool. The correlation of yields and ratings, already strong, will deepen as the bond market evolves further.

Measures increasing the sophistication of the market, such as the introduction of credit derivatives, will add a further dimension to the use of ratings.

We expect these trends to steadily drive demand for credit ratings as they presently stand. However, there is also a strong case for diversifying the sources of growth in the ratings market. Not only does this free the revenue stream from dependence on debt issuances (which are in turn dependent on a number of factors including economic conditions, investment and interest rates), it also helps tap the possibility strong growth by pioneering entirely new segments, some of which could turn out to be long-term blockbusters.

The CRISIL roadmap

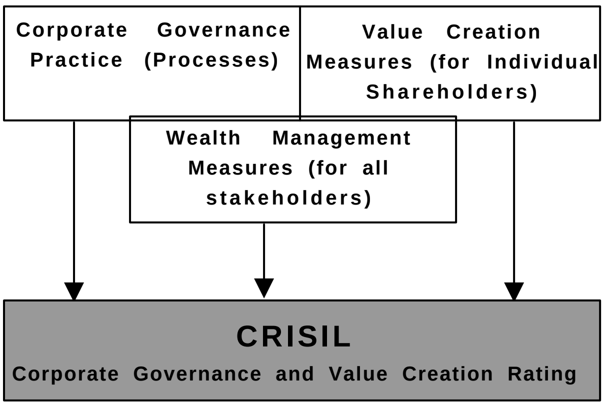
We will now, by way of illustration, look at some of the measures CRISIL has been taking in its quest for diversification via hitherto unexplored areas of Ratings. While strategies would differ amongst organisations, the following are some of the broad means of seeking to diversify in related areas:

- As CRISIL pioneered credit ratings in India, its initial effort was to develop rating methodologies and criteria fine-tuned to the nature of the Indian market, and the specific industries covered. In course of time, it branched out into more diverse areas, where it brought the analytical approaches developed during the evolution of CRISIL ratings, to evolve means of understanding and evaluating players in many sectors and industries. Notable successes among these have been:
  - CRISIL GVC Ratings, a rating of companies on Corporate Governance and Value Creation. This

methodology – which CRISIL was globally the first to develop – measures three parameters:

* Corporate Governance Practices – measuring the processes in place to ensure that high standards of corporate governance and transparency are maintained, and adequate measures taken to protect the integrity of decision-making. Companies are judged on:
  - Equitable Treatment of Shareholders
  - Ownership rights of shareholders
  - Transparency & disclosure
  - Composition of the Board
  - Functioning of the Board
* Value Creation and distribution – to evaluate this, CRISIL takes into account the company's performance in creating value for:
  - Shareholders
  - Debt Holders
  - Customers
  - Employees
  - Suppliers
  - Society
* Wealth Management Practices – taking into account:
  - Success of strategies
  - Ability to re-strategise
  - Track record of innovation
  - Experience of management

A schematic of the method is shown below:



* CRISIL's Grading for Healthcare Institutions, an opinion on the relative quality of healthcare delivered to patients, applicable to specific healthcare facilities. A healthcare grading assignment involves a detailed assessment – in conjunction with a team of medical experts – of a healthcare institution's processes. The assessment is carried out speciality-wise, as well as for support services. Other inputs into the grading include the hospital's regulatory compliance, financial performance, management quality, hospital mission and policy, patient rights and nursing care.

  The output from this process is a final grading with two components. The first is the hospital classification (to ensure comparability between grades given to different institutions) while the second component denotes CRISIL's opinion on the quality of delivered patient care from the institution.

  We expect demand for healthcare grading to be driven by users demanding an assessment of the quality of healthcare delivered by institutions, and also as part of the managed healthcare process.

* Rating Micro-Finance Institutions: A tool to overcome the problems with availability, reliability and quality of information on the risks and performance of Micro-Finance Institutions (MFIs). MFI ratings are expected to be an indispensable tool for small micro-finance institutions seeking to raise aid funds in international markets where they may not be well known. A rating from an accredited agency acts as an easy tool, enabling aid institutions to get a credible assessment of the quality of an MFI, without having to deploy scarce money and resources in the process of gathering information and evaluating individual micro-finance institutions.

  CRISIL has designed the MICROS framework to rate MFIs. This framework involves an evaluation of:
  - Management
  - Institutional Arrangement
  - Capital Adequacy and Asset Quality
  - Resources
  - Operational Effectiveness
  - Scalability and Sustainability

  CRISIL is empanelled with the Consultative Group to Assist the Poorest (CGAP) for rating of MFIs, and was the first formal ratings agency to be so empanelled.

* Rating real estate developers on project execution capabilities, Rating insurers on financial strength, Rating of Superior Kerosene Oil (SKO) parallel marketers under mandate from the Ministry of Petroleum and Natural Gas, are some of the other innovative ratings products pioneered by CRISIL.

The emphasis has been on evolving newer varieties of performance measurement, driven by our anticipation of market needs. We believe that rating agencies wanting to grow beyond the constraints imposed by the traditional credit ratings market will need to look at similar markets to fuel growth. At CRISIL we continue to scan the marketplace for potential areas of creating value for users, and to evolve more innovative criteria for newer products and services.

- Another means is through generating additional business from existing market segments, for example through the promotion of structured finance ratings. These ratings target a new market within an existing customer base, viz. lenders looking to unlock the value of existing assets and deploy funds in other avenues, while potential buyers of instruments would like to look at certain minimal levels of credit quality. While structured finance has been in India for more than a decade, volume started picking up only in the last three years. 90% of the rated structured finance transactions took place in these years and the volume in 02-03 doubled compared to the previous year. This trend is expected to continue for the following reasons:
  * Boom in the retail sector (housing and consumer loans) - increasing income levels and changing lifestyles lead to higher demand for consumer loans. Good past experience with retail lending coupled with the lack of good lending opportunities in the corporate sector have forced the lending community to shift focus to the retail sector. Retail loans are most amenable to securitisation.
  * Flight to safety – large segments of the market are willing to look only at high credit quality papers. Issuers can improve the credit quality of the paper through structuring.
  * Passing of Securitisation Act has also helped
  * Increasing appreciation of advantages of structured finance both among and lender and investor community
  * Increasing need to manage balance sheet in terms of capital, tenure match etc. on the part of lenders
  * Excellent experience of investors with securitised debt in the past
  * Expected entry of PSU banks

CRISIL, which pioneered structured finance ratings in India, is the undisputed leader with over 70% market share. Structured finance continues to be an evolving discipline in India. It is an area where expertise is still being built up, and where the presence of a rating agency is critical to transaction closure; in the short to medium term therefore we see strong growth potential in this area.

- Another opportunity to utilise and leverage the ratings experience is offered by Basel II.
  * Under the standardised approach, banks are allowed to use external credit ratings as a measure of credit risk. There is a substantial incentive built into this as unrated corporate borrowers would in most cases attract a risk weighting of 100%, while the weightage would be mitigated to the extent of the credit quality as estimated by the rating (except in cases where the entity is rated BB- or lower, where the risk weighting increases above 100%). This could lead to a significant increase in usage segments for credit ratings, with greater incentive for higher-quality corporates to get themselves rated.
  * Under the Internal Ratings-Based (IRB) approach, banks are expected to internally assess key risk drivers for calculation of capital requirements. Under the Foundation IRB approach, banks will need to assess the Probability of Default (PD), while under the Advanced IRB approach they are additionally required to estimate the Loss Given Default (LGD), Exposure at Default (EAD) and Maturity (M). Rating agencies have a role to play, not only in assisting banks in evolving their own internal ratings systems, but also in providing expertise and data for the calculation of the parameters listed above.

The Challenges

The previous section traces a potential roadmap for staying competitive and relevant in the ratings industry. While it presents a viable long-term plan for success, in the short term there are a number of very crucial variables to be managed for continued credibility and excellence. A few of these are, very briefly:

1. Maintaining functional excellence. The key to immediate success – in a market where one is subject to continuous and ruthless examination – is the acuteness of one's opinion. This demands:
   * A crystal-clear definition of the key functional attributes which make the agency tick in the marketplace. In the case of a ratings agency, this is primarily the quality of its analytical work. This recognition is reflected in the selection of people and the training they receive.
   * An uncompromising adherence to these attributes once they are crystallised and operationalised. This is largely driven by the team spirit and culture of the organisation

2. Maintaining continuity. Key to a rating agency's continued success is its consistency, for which continuity in processes and standards is necessary. The must-dos here are:
   * Knowledge retention. Information which has reached the ratings process needs to be captured, secured and classified for easy access. The accumulated person-years of knowledge about the economy, industries and companies are a precious resource, and very difficult to replace. Sophisticated means of retaining and managing knowledge will gradually come into play.
   * People retention, which goes hand-in-hand with knowledge retention. A mix of recognition, work satisfaction and values congruence are needed to hold the most valuable employees in place.

3. Maintaining values. The key determinant of long-term domination of the industry: is credibility. In the sense of recognition by the market, credibility is the ultimate touchstone of a rating agency's success, and is built up through a long period of sustained performance. Some key factors feeding into credibility are:
   * Independence and objectivity – signals of the agency's freedom from bias
   * Integrity – freedom from influence, the capacity to stick to the correct decision even in the face of business considerations

As the foregoing would illustrate, credit ratings as an industry has passed through several cycles and phases, and will continue to evolve going forward. While rigour, continuity and values are necessary for continued success in the core ratings area, innovation and diversification will be the key growth determinants going forward. Given the richness of analytical and managerial resources in India, the primary challenge is one of marshalling these abundant resources to generate an optimal growth trajectory.