Emerging Challenges for Credit Rating Industry in India

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Background – A Historical Perspective

The Credit Rating industry in India picked up momentum in the early nineties, though the first few ratings got assigned in late eighties. While the sudden growth was a consequence of liberalization of the Capital Market, the impetus came, in no less measure, from the supportive role played by the Regulatory Authorities in the initial phase.

The Regulators like the Reserve Bank of India as well as the Securities Exchange Board of India made Rating mandatory for certain classes of debt where public investments were involved. The Rating from an "approved" Credit Rating Agency was a password for instant access to funds. As none of the Rating Agencies had a track-record to put the Ratings to any test, the investors and the issuers had little to choose from. Rating shopping did follow, and coupled with limited understanding of post liberalisation, globalised business cycles, Rating migrations were greater than that desirable. Competition, with limited product differentiation, also resulted in pricing pressures.

Maturity Phase

As the leading Credit Rating Agencies, including ICRA, have now had a track-record of more than a decade of Ratings performance, the quality of Ratings assigned can be empirically tested. Rating transition over a one, two, three or more year's period is one such Rating performance metric. As leading Rating Agencies have established their credibility and enhanced their market acceptability, issues like Rating shopping are likely to get addressed by the market forces. Though the pressure on pricing Rating mandates continues, agencies with a track-record of consistent, objective and stable Ratings are likely to get higher preference by the investors and, hence, the issuers too.

Growing Role of Ratings in the Indian Capital Market

The Ratings achieved considerable market penetration in a fairly short time frame; the reach has been across industries and companies- small and big. Though the initial Rating mandates were on account of the Regulatory requirement, there has been subsequently greater market acceptance of Ratings and, currently, the bulk of the Rating revenues come from the privately placed debt issues for which Rating is not mandatory. Substantial use of Ratings for the non-regulated debt issuances stems from demands made by the investor community.

Specifically, the Ratings assist the investors in:

- Reducing uncertainty and information asymmetry between issuers and investors - Judgements based only on market implied Ratings can be more volatile, and Ratings tend to moderate the cycles. Importantly, Credit Risk becomes quantifiable in terms of likelihood of transition and expected loss.
- Quicker decision-making and wider investment opportunity – Myriad investment opportunities that are available come with (short) timeliness, and it is virtually impossible even for the best equipped investors to have expertise or knowledge base to analyse every such option. Objective, consistent and accurate credit opinions, thus, widen the investment canvas.
- Managing credit risk- Ratings enable quantification of risk – not on a case by case basis, but on an aggregate basis. This helps the investors manage their risk baskets. An alternative approach, without well-calibrated inputs, would make it difficult to do 'course corrections' while managing credit risk.
- Pricing credit risk-Ratings provide a benchmark to base the yields on, after factoring in the expected credit loss.

The issuers in India have gained from the use of Ratings in terms of access to wider, alternate and competitively priced funding options. The testimony to the utility of Ratings lies in the larger number of Rating requests for issues that are not required mandatorily to be Rated. The overall debt market, is, however, still characterised by large Government issuers, and again, the bank loans that do not seek a Rating from an external agency, continue to remain the main source of credit. . Some issues that stymied the growth of Ratings in the last few years have been:

- Investors' preference restricted to higher end of Ratings – a fall out of the deterioration in asset quality of many banks and institutions in the late nineties as the economy slowed down after a phase of rapid growth.
- Rating shopping and non-disclosure of unaccepted Ratings often had Ratings of lower quality being used
- Commoditization of Ratings as there was little product differentiation to begin with. However, increasingly, the choice of a Rating Agency is being driven by the performance of Ratings and market

confidence. Predatory Ratings and 'flexible' Credit Rating Agencies are being differentiated against in terms of pricing of the issue.

Enhancement of Analytics – How Rating Methodologies Are Evolving

The advent of Credit Ratings in India coincided with the liberalisation of industry and the financial markets, which brought in its wake, several changes in the way businesses were run and the promoters' approach towards treatment of different stakeholders.

Increasing focus on group Rating approach-economic rationale is the key driver

Despite fervent submissions from managements, whose companies are getting Rated, about arm's length transactions, the credit quality of an entity within a group is not completely isolated from the credit quality of the group as a whole. The group's financial position may be a Rating positive at times, and in a contrary situation, a group with businesses that are in a cash consumptive phase may see funds from the Rated entity being utilised for meeting such cash shortfalls. The availability of quality management time is often a casualty if there are other group ventures that seek greater attention. ICRA is increasingly observing that ventures that are either core, strategically important or key from an economic standpoint for a group, need to be consolidated to assess the group's financial position. The extent to which the stand alone credit quality of the entity being Rated would get impacted would vary from case to case.

Likewise, support from the other group companies, explicitly or implicitly, would depend on the economic rationale of such support from the point of view of the company providing the support. Usually, any financial support to defaulting companies from other group companies has not been timely or altogether absent. Understanding the economic rationale is, hence, a key thrust area in ICRA's Rating approach.

Thrust on cash flow indicators

ICRA's evaluation includes assessment of franchise value, regulatory environment of the industry in which the company operates, management quality, financial statement analysis, and importantly, liquidity analysis. Not all earnings are cash. A company reporting high earnings can still be cash consumptive and the likelihood of that situation continuing could result in a liquidity crunch. Liquidity risk assessment is not done in isolation but has to be seen in the context of the company's business risk – a company with widely fluctuating level of inventory would need to have sufficient unutilised credit lines available, whereas, for a company which is in an industry with short-lived assets, ability to generate cash to fund these investments would be a credit positive. Pertinently, there cannot be static, or absolute benchmarks for a tolerable liquidity level; it depends on the nuances of the industry the company is operating in and is an evolving parameter.

Corporate Governance Assessment

The recent corporate scandals have only underscored the essentiality of corporate governance assessment in assigning Ratings. The credit evaluation rests to a considerable extent on the financial statements provided by the entity being Rated, hence, the integrity of financial disclosure becomes critical. Some important issues addressed are:

- Are affiliated party transactions truly on arm's-length basis?
- Is the management compromising long term stability for short-term gains?
- Are there instances of compromising the interest of some stake-holders?

A perception that the company has governance concerns could restrict access to capital. Increasingly, issues of corporate governance are getting factored in Rating opinions.

Market Implied Ratings – How Do They Compare With Credit Ratings?

Credit Ratings are opinions on the fundamental credit risk of an entity rather than transient risks. The market implied Ratings capture credit risk on a real-time basis. That leads one to a conflicting goal for a Credit Rating Agency – whether to lay greater emphasis on being 'accurate' or being more 'stable'.

Credit Ratings are accurate, too, but they are more stable. The accuracy is being measured on a longer time-span than that for market implied. To that extent market-implied Ratings see far greater 'Rating reversals' than Credit Ratings. Being more stable, Credit Ratings serve as a moderating force and hence reduce the credit spread volatility.

Expectations From Ratings

Ratings are used by diverse set of financial market participants like issuers of debt, investors – both institutional and retail, and financial intermediaries. While the issuer pays for the Rating of the issue as the Rating facilitates wide access to funds, the Ratings are relied on by both the issuer and the investors. The issuer has a greater motivation to get the issue Rated so as to facilitate its marketing, however, the investor would prefer to subscribe to a basket of issues rather than pay for a specific issue. The latter wouldn't mind missing a particular issue.

Understandably, the issuer would expect the highest possible Rating. Investors favour stability in Ratings and would not appreciate sharp downgrades and subsequent reversals. For a Rating Agency to be in the reckoning, it has to be credible, and for that objectivity and accuracy are paramount. Ratings are available in the public domain, and these can be tested and are regularly tested. Only those that have an acceptable predictive content are relied upon by the market.

Regulators often use Ratings to weed out issues below an acceptable level of credit quality, or peg borrowing capacity to Rating level. They may, as in the case of Basel Committee guidelines, specify measurement of risk using Credit Ratings as an input to capital adequacy regulations.

Regulatory Use of Ratings – A Word of Caution

Ratings are often used, particularly in developing markets, to accelerate capital market development. We saw that in India, too, in the early 90s. This remains a short-cut to market evolution, and as it is said in lighter vein, '*a short cut is often the longest distance between two points*', this one, too, has unintended perverse consequences:

- The investors start using Ratings without understanding 'what ratings are not', and also without regard to their accuracy or objectivity.
- As these Ratings are assigned by the Regulator 'approved' Rating Agencies, the investors assume that the Ratings are accurate. A Rating Agency's track-record of accuracy can be the only metric to measure its Rating quality.
- Encourages Rating shopping. Issuers queue up to get the least expensive or the most favorable Rating. The former leads to inadequate investment in research and analysis, and the latter would soon affect a Rating agency's credibility.
- Regulator's reliance on Rating Agencies leads to Rating Agencies 'controlling' functioning of certain aspects of the financial markets, which may prompt the Regulator to increase oversight of the 'Rating process' itself. That hampers independence, which could be a serious issue considering the politically sensitive nature of many Rating actions.

What Ratings Are Not?

That is as important as understanding what Ratings do convey, particularly in a developing market such as ours.

- Ratings are a supplementary tool, and not a substitute. They provide an independent and objective opinion to "enable" the decision-making for the investor. It is a means to take the decision and not the decision itself.
- Ratings are a relative measure of risk and not an absolute measure. The probability of default or the likelihood of transition associated with a Rating is relative, and the higher Ratings signify lower probability of default or higher stability.
- Default probabilities can change over the business cycles. These aren't frozen benchmarks and may change with change in business or economic conditions; however, even with such changes the Rating levels would continue to signify relative levels of risk.
- Ratings have a predictive content at an aggregate level, not on a case-by-case basis. It is similar to an insurance company, where it is not certain which policy holder will draw on the policy. The same way it is uncertain which particular Rating will default.
- Rating is neither an audit of the company's books of accounts nor an investigative process to unearth plausible frauds.

Key Success Factors for a Rating System

For viable and independent Rating systems, it is essential that the following conditions are met:

- Credit awareness. Investors need to understand what the Ratings signify and also what it does not.
- Markets should be opened up. Measures should be taken to broaden the pool of investors and to improve liquidity. Lack of a secondary debt market would largely diminish the utility of Ratings.
- Accounting standards that enable a proper statement of the issuer's financial position and audit quality are cornerstones of a Rating system.
- Improvement in disclosure practices to enable all the stakeholders to get an accurate picture of the company's financial position.
- Freedom of expression. There should be no obstacle for a Rating agency to express its credit opinion, irrespective of whether the opinion is favourable or unfavourable.
- Independence. If the Ratings assigned lean towards a particular entity due to political pressure / commercial considerations, the Ratings would cease to offer any value.

Conclusion

Ratings in India are tending to mature, as the Rating Agencies have gained credibility and market acceptability. Ratings can be tested and are being tested. This would stem commoditisation of Ratings and enable 'product differentiation'.

Increasing use of Ratings in India also calls for greater transparency of the Rating methodologies. Ratings being in the public domain are subject to constant scrutiny by the market participants, and these are measured for the predictive characteristics.

Contrary to the belief that Rating agencies grow by leveraging on regulatory support, independence and objectivity are the cornerstones for the success of any Credit Rating Agency. Regulatory use of Ratings, on the other hand, brings with it the risk of oversight of the Rating process that may hamper independence.

Going forward, the use of Ratings in the Indian Financial market is going to increase manifold, and the Rating Agencies would be playing a significant role in improving the efficiency of the fixed income markets for the benefit of the investors, and all other market participants.