Emerging Trends for Credit Rating Agencies

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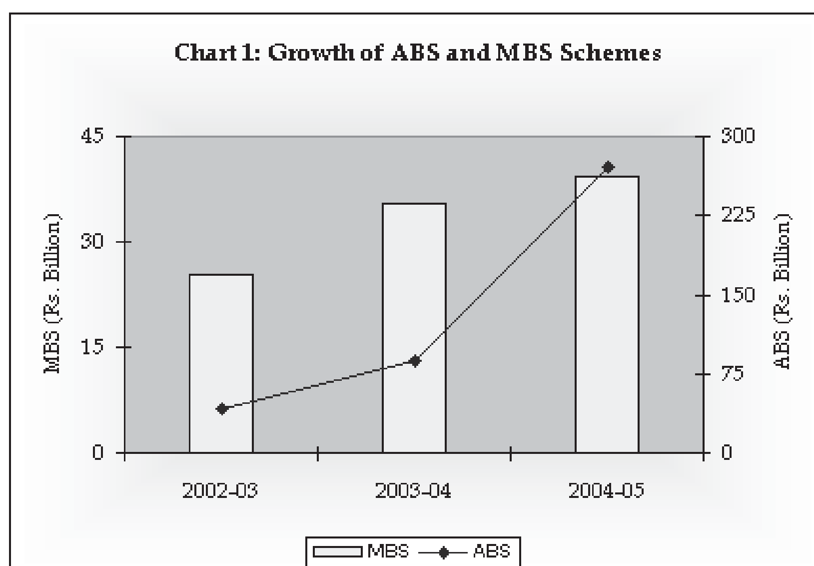
Credit ratings in India began in 1987, with the establishment of CRISIL. At that time interest rates were regulated and there was no secondary market for corporate debt securities. Therefore, there was no perceived need for ratings as a determinant of credit price. CRISIL, as the pioneer, took on the task of building the debt 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 agencies (CRAs) have come a long way since the 1980s. In India today, credit rating is an integral part of the financial markets, with four agencies and substantial demand for ratings from investors. As India becomes more closely aligned with global financial markets, several new trends have cropped up in the ratings scenario. Three such trends, which will centrally shape the evolution of the rating industry, are discussed in this article. These are: the growth in structured finance market, Basel II accord, and publication of default rates.

Structured Finance

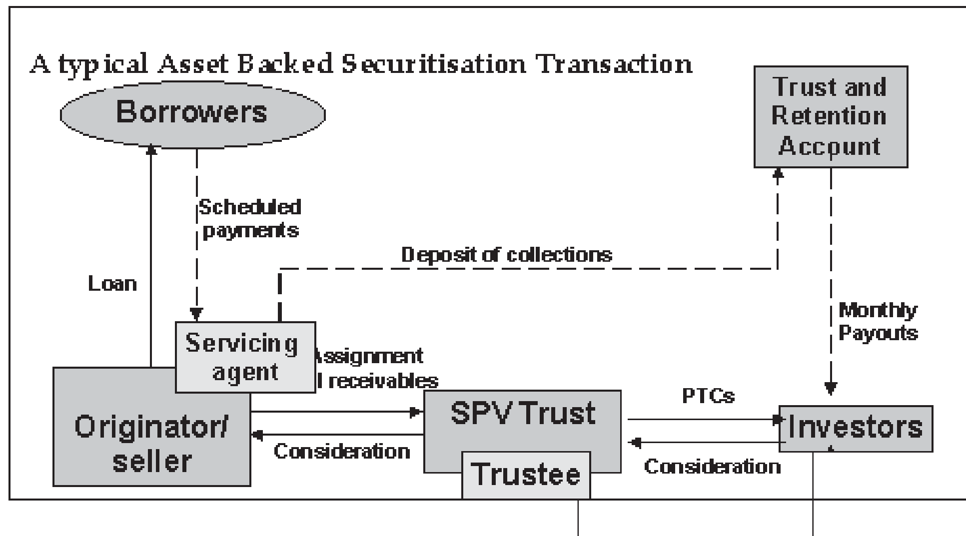
Globally, securitisation has emerged as an important technique for bundling assets into marketable securities. In USA, between 1996 and 2003, structured finance revenue grew at an annual rate of nearly 30%. Structured finance ratings are now among the fastest growing business segments for the three leading global rating agencies – Standard & Poor's, Moody's, and Fitch.

In spite of being at a nascent stage, the Indian securitisation market, in accordance with global trends, is growing at a rapid pace (see Chart 1). In keeping with its pioneering role in the Indian financial markets, CRISIL was the first agency to rate a securitisation deal in the country in 1992. Since that rating, which was assigned to a pool of auto loans originated by Citibank N.A., the Indian securitisation market has come a long way. According to CRISIL's estimates, around 300[1] transactions have taken place so far, with debt of around Rs. 500 billion raised from the markets.



Box 1: Understanding Securitisation

Generally speaking, a securitisation transaction involves sale of receivables by the originator (a bank, non-banking finance company, housing finance company, or a manufacturing/service company) to a special purpose vehicle (SPV), typically set up in the form of a trust (see chart below).



Investors are issued rated pass through certificates (PTCs), the proceeds of which are paid as consideration to the originator. In this manner, the originator, by selling his loan receivables to an SPV, receives consideration from investors much before the maturity of the underlying loans. On the other hand, investors are paid from the collections of the underlying loans from borrowers. Typically, the transaction is provided with a limited amount of credit enhancement (as stipulated by the rated agency for a target rating), which provides protection to investors against defaults by the underlying borrowers.

Refer to CRISIL's Securitisation Handbook for a more detailed understanding of the securitisation process.

CRAs play a pivotal role in the securitisation market. Not only in India but also globally structured finance has largely been a rated market. As in other financial markets, in structured finance markets also, the CRAs act as providers of third party opinions about the risk involved in debt instruments, thereby providing safety to the investor and a sense of efficiency and transparency to the market as a whole. But the work for CRAs does not end here. The complexity of instruments in the structured finance market increases the importance of rating agencies. The rating agencies not only provide credit assessment for the underlying collateral asset pool, but are also involved in designing the structural specifics of these securities. Constant monitoring is also needed to make sure the complex instruments maintain their credit worthiness. This is what makes the role of CRAs more crucial in the structured finance market as compared to the traditional debt markets.

Although CRISIL has rated over 15 asset classes so far, most of the issuances have been concentrated on ABS (cars, commercial vehicles, construction equipment, and personal loans), MBS and single-loan collateralised debt obligations (CDO). Internationally, a wider variety of receivables are securitised. These include credit card, trade and export receivables, financial and mortgage leases, insurance premia, and film receivables.

The securitisation market is ready to take the next leap forward, and is poised to expand beyond the existing set of asset classes and structures, issuers and investors. CRISIL believes that there is a strong possibility of the following asset classes and structures gaining popularity:

- Future flows
- Credit card receivables
- Collateralised loan and bond obligations
- Revolving CDOs for working capital facilities
- Asset-backed commercial papers
- Consumer durables receivables
- Securitisation of non-performing assets (NPA)

Securitisation has only touched a small set of issuers so far. Most of the financial sector entities that can gain from securitisation have not yet entered this market. The following stimuli should help to expand the issuer base:

- Capital management
- Asset liability management
- Liquidity management
- Profit acceleration
- Exposure management (geography, company, and group)
- Meeting regulatory requirements in some cases
- Interest cost savings (securitisation typically assists in improving credit ratings and hence, reduces costs)
- A business model (utilisation of origination skills not constrained by financial appetite)

Basel II Accord

In June 2004, the Basel Committee on Banking Supervision (BCBS) - a group of central banks and bank supervisory authorities in the G10 countries - released the final framework[1] (Basel II) for assessing the capital adequacy in the banking sector. Basel II is a risk sensitive framework that provides new options of assessing both credit and operational risk.

While the existing capital accord implemented in 1988 (Basel I) reinforced the minimum level of capital in the banking system, it did not reflect differing levels of risk inherent in lending to borrowers of different nature and size. Building on this, the BCBS has proposed a new framework, Basel II, for capital allocation that intends to improve safety and soundness in the financial system by placing greater emphasis on the bank's internal control and management (Pillar 1), the supervisory review process (Pillar 2), and market discipline (Pillar 3).

Basel II aims at more efficient capital allocation by developing risk-sensitive capital allocation, which, while providing incentives to individual banks for efficient credit management, would also provide incentives for ongoing improvement in risk management practices at an industry wide level. In order to accomplish the credit risk measurement, Basel II proposed two methods, namely, Standardised approach and internal ratings based (IRB) approach. Under both these approaches 'full-service' rating agencies will be at the forefront of the change.

Standardised Approach

Under the standardised approach, the capital requirement calculation for credit risk is based on ratings assigned by External Credit Assessment Institutions (ECAI), like CRISIL. As per Basel I, a single risk weight (100%) was used for all rated and unrated entities. However, under the new framework, four different risk weights will be provided to the individual borrowers (Table 1).

Table 1: Risk Weights

	AAA	AA	A	BBB and below	Unrated	'Retail'
Current framework						
Risk weight	100%	100%	100%	100%	100%	100%
Proposed framework (based on Basel II)						
Risk weight	20%	50%	100%	150%	100%	75%

Thus, there is a substantial incentive for getting rated, for unrated corporate borrowers will 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 the usage of credit ratings, with greater incentive for higher-quality corporates to get themselves rated. This will put rating agencies in the forefront of this process, with a bulk of unrated entities needing immediate rating action.

IRB Approach

Under this approach, instead of ratings by external agencies, banks will use their internal assessment of the borrowers' creditworthiness to assess credit risk in their portfolios. The IRB approach will only be available to banks that can satisfy regulators on meeting specified minimum requirements in terms of their internal rating systems, risk management processes, and ability to estimate the requisite risk components.

To help facilitate banks understand internal risk management, CRISIL's Investment and Risk Management (CIRM) team has already created several products. One such product is CRISIL's Risk Assessment Model (RAM), which is an internal ratings software, designed to assist a bank or financial institution address issues raised by the IRB approach under Basel II.

Default Rates

In May 2005, CRISIL published its historical default rate statistics. By doing so, it not only continued its pioneering role in the Indian financial markets, but also started a trend that should be followed by others in the market.

For all debt market participants, accurate and robust default and transition rates are critical inputs in the following decisions:

- Pricing of Debt
  Default rates summarise the historical default experience of a portfolio of credits. This is a fundamental input for pricing of a debt/loan. Default probabilities associated with ratings help investors/lenders in quantifying credit risk in their debt exposures, thus providing key inputs on whether to lend, how much to lend, and at what price.
- Structuring and pricing of credit enhanced instruments
  Structuring, rating and pricing of credit-enhanced products depend heavily on the default and transition rates of underlying entities. The rapid growth of the structured finance market has made accurate computation of historical default and transition statistics imperative.
- Critical inputs to credit risk measurement models
  Default and transition rates are key inputs to many quantitative risk measurement models. Investors in rated paper can effectively manage their exposures based on reliable default and transition rates.
- Insights on the rating process, stability and meanings of ratings
  Ratings are an indicator of probability of default. In a well-calibrated rating scale, the default rates should increase as one moves down the rating scale. Default and transition rates could be used to validate rating scales and quantify rating stability.

Moreover, as Basel II takes shape in the Indian banking sector, the Reserve Bank of India (RBI) needs to find a way to map ratings of different agencies onto a single scale. This is an up-hill process, especially if you take into account the fact that rating agencies have two separate ways of defining default. Once again, this will be a case of great discussion and debate in the markets. Since rating agencies tend to use different default definitions (see Box 2), the RBI will have to make a decision of which one is to be used to validate the ratings under the Basel II norms. The publication of default statistics will, thus, emerge as a necessity in the future.

The publication of the Default Study is part of CRISIL's ongoing efforts to enhance the utility of credit ratings through high levels of transparency and disclosure practices, and reflects CRISIL's commitment to the development of the debt markets.

Box 2: Meaning of rating

Fundamentally, there are two broad categories of credit rating systems or philosophies: one based on probability of default (PD), while the other measures expected loss (EL).

The integrity and value of a rating system lies in its ability to generate objective and transparent default and transition data. However, different default definitions can generate significantly different default statistics. Recognition of default on

The Road Ahead

In the near to medium term, we see a more intensive use of ratings by investors, and an increasing sophistication in the use of ratings. As a result, credit ratings will graduate from being used mainly as a go- no-go variable, and will play an even greater role in the pricing of debt instruments. 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.

As new growth areas provide a boost for the ratings business, it becomes equally important for CRAs to maintain their credibility and quality of work. CRISIL's core values – independence, objectivity, and analytical rigour – have helped it become one of the most trusted rating institutions in the country. Our strong commitment to our core values will help us maintain our credibility in the years to come.

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[1] International Convergence of Capital Measurement and Capital Standards, June 2004, Basel