Ratings: Challenges & Opportunities

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Introduction

Credit rating plays a crucial role in providing individual and institutional investors with critical information that assists them in determining whether or not issuers of debt obligations will be able to meet their obligations on a timely basis. A credit rating is an opinion on relative degree of risk associated with timely payment of interest and principal. The analysis for the same is based on past trends and future prospects. Rating agencies play a critical role in assessing the credit worthiness of any corporation or country. The concept of ratings has grown in importance owing to the existence of imperfect markets and asymmetric information.

Historically, companies and borrowers have been taking loans from the banks, wherein the banks have their own mechanisms to verify the credit worthiness of the borrower. However with the opening up of the market and increased financial requirements of the companies, various other sources of funding are now available. This resulted in a boom in IPO market as well as debt issuances such as bonds, debentures and commercial paper. Opening up of the financial markets also resulted in little information available to the investors about the risk associated. Hence, SEBI made it mandatory of the companies to acquire credit rating for any amount of debt raised in the market.

The changes taking place in the domestic and global markets have presented both opportunities and challenges for the credit rating agencies (CRAs). The response to the new environment will largely determine how the industry moves forward. The CRAs have to balance being nimble footed with high quality of ratings as the world is watching closely.

Why do we require credit rating?

A credit rating is an opinion on the creditworthiness or the relative degree of risk of timely payment of interest and principal on a debt instrument. The ratings are a comment on the relative likelihood of default in comparison to other rated instruments. In other words, a rating indicates the probability of default of the rated instrument and therefore provides a benchmark for measuring and pricing credit risk. A credit rating compresses an enormous amount of diverse information into a single rating symbol. A simple alphanumeric symbol, such as AAA or P1, is normally used to convey a credit rating. Currently rating agencies have standardized rating nomenclatures for long term ratings, short term instruments, medium term ratings, fixed deposits, corporate/issuer credit rating, long and short term debt fund portfolios, IPO grading etc. However, it must be reiterated that it is only an opinion and that investors need to use their own judgment as a rating is not a recommendation to buy.

Credit rating assesses risk in the financial system. The main purpose of a credit rating is to bridge the information asymmetry between the issuer and investor of any financial instrument. While the issuer might know that it may or may not be able to service the instrument, the investor may not be in a position to take an informed decision. This is where the CRA provides an unbiased view on the state of the entity and its ability to meet its commitment on time. While some large firms may have in-house expertise to do so, most investors would need this opinion from a neutral party. However, even large investment houses with in-house expertise would like to have an additional credible and independent opinion before taking investment decisions.

Credit rating is a necessity in today's world as there is no alternative signal available to the market about the credit worthiness of a financial instrument. Such signals are used by multitude players for taking decisions. Several investment houses like provident and pension funds make their investment solely on the basis of this rating as their by-laws do not allow them to take on high risk investments. At the retail level too, credit rating does perform a very useful task of bridging this information asymmetry.

The USP of a rating for the investor is that once a rating is accepted, the company has to perforce have a surveillance conducted by the CRA until the debt is repaid fully. This way there is complete tracking of the performance of the company and its servicing record.

Evolution of rating business in India

In India, credit ratings industry was born in the year 1987**.** Credit Analysis and Research Limited (CARE Ratings) whose major shareholders include IDBI Bank, Canara Bank, SBI among others, was established in 1993, and was the third credit rating agency to enter the market. Credit rating is a fairly sticky business with the early mover advantage being present as companies seldom to change their CRAs. However, over the years, CARE has established its credibility through its independence, professionalism, research, consistent efforts and robust ratings to become the second largest rating agency in the country based on rating income even though it was the third CRA to start operations.

CRAs in India rate a large number of financial products such as bonds, commercial papers, structured finance products, bank loans etc. CRAs also undertake customized credit research of a number of borrowers in a credit portfolio, for the use of the lender. CRAs use their understanding of companies business and operations and their expertise in building frameworks for relative evaluation, which are then applied to arrive at performance grading.

As a regulatory requirement by SEBI, any amount of debt raised by companies has to be rated by a credit rating agency. Although only public issues are mandatory to be rated, it has been observed that private placements are also seeking rating, proving that CRAs indeed add value and provide unbiased opinion. Companies do see inherent value in such ratings as it helps in pricing of the instrument as well as assures the investor.

The year 2007 – 08 witnessed lots of development in the banking sector. BASEL II banking norms were also implemented. The Basel II guidelines, as they are called, require banks to provide capital on the credit exposure as per credit ratings assigned by approved credit rating agencies. Thus, banks need to get their portfolio rated under bank loan ratings for loans of above Rs 10 crore. The bank loan business has added a major layer to the credit rating business and has in a way compensated for the low level of bond market activity in the last couple of years when infrastructure growth in particular slowed down due to low growth.

Challenges for rating agencies

Rating agencies are of late constantly subject to scrutiny, evaluation and questioning by investors, media and regulators. This was an outcome of the financial and sovereign debt crises in the west where the structures and actions of CRAs was questioned. Since ratings are opinions, it is important that markets are convinced about their robustness before acting on them. Rating agencies therefore publish extensive data on rating default and transition statistics, and metrics on predictive capability of ratings vis-a-vis macro-economic and corporate performance. There are basically three challenges that the industry faces in the changing environment.

The first challenge faced includes maintaining credibility for a credit rating agency. There have been issues raised on the conflict of interest of rating agencies which can cloud the rating opinion. The test for any rating agency is ultimately the willingness of an investor, who is the user of the rating, to be satisfied. A metric which is often used to check on the robustness of ratings is the cumulative default studies, which shows the default rate for various cohorts of ratings over a period of time. Similarly transition studies put out by rating agencies analyze the migration of ratings across various bands.

Any change in the business environment or the financial risk profile of the issuer need to reflect in the rating assigned. Users of rating invariably check on these factors before going to a rating agency. Hence it is essential that the ratings need to have a very high degree of accuracy and predictability. The process of ratings is a dynamic one where ratings analysts need to continuously hone their skill sets by keeping up to date with all the developments taking place. Quality control and criteria management becomes important for CRAs

Secondly, credit rating agencies these days face tough competition from other peer agencies. What started off with 4 agencies is now an industry with 6 players. Each rating agency is working towards providing more accurate information and ratings assigned. Rating agencies need to continuously upgrade their own business strategies to gain market share which works finally on the basis of credibility established. Competition matters when the economy is in a downswing and the debt market is subdued. Agencies have to hence work on customer acquisition and retention without compromising on quality to stay ahead. As competition increases, rating agencies have to continuously strive to be ahead of the curve in terms of doing business and launching of newer products.

The third challenge faced by the CRAs is one of regulation where any change in this stance could affect the business. More recently, SEBI had made IPO grading, which hitherto was mandatory, optional for companies. Therefore, a regulatory risk continues to exist for this industry where an entire business line could come in (like banks loan ratings) or move out (IPO grading).

There has also been a roadmap drawn by the RBI for banks to migrate to an internal ratings based (IRB) approach for the purpose of calculating capital under the Basel II norms. The RBI gave directives to the banks to shift from standardized approach to IRB approach for measuring credit risk. Under the new framework, banks will be allowed to use their own estimated risk parameters for the purpose of calculating regulatory capital. However, only banks meeting certain minimum conditions, disclosure requirements and approval from the RBI would be allowed to use this approach. Even after getting the approval, there would be a transition period during which banks need to measure the credit risk based on both approaches. This is a challenge for CRAs as a major boost to the rating business emanated from the bank loan rating section since 2008. Theoretically, at some point of time banks would be doing their own ratings based on approved models that have been back-tested which would mean that one line of business for CRAs would dwindle over a period of time.

However, the general sense is that with banks already under pressure owing to rising NPAs, only a few banks would be able to meet these requirements. Others would have to wait for more years to have their models and systems in place to move to the new approach. Therefore, the bank loan business would continue to prevail for another 4-5 years. It has also been observed that while the RBI has mandated for all loans above Rs 10 crore to be rated by CRAs, banks have asked clients with even lower exposures to get a rating. Quite clearly, they do see value in credit ratings which goes beyond the conventional capital adequacy requirement. Quite evidently, CRA’s views would matter.

Opportunities for the rating agencies

The Indian financial market is evolving but still not fully developed and hence offers opportunity. Further, global thinking has also changed over the years with the world being more open to having more players in the arena to provide competition to the existing players as it is believed that this will enhance efficiency.

Firstly, the corporate bond market in the country remains under developed. The regulator has shown serious intent to deepen the corporate debt market, through announcements with regard to increasing investor participation in the corporate bond market by enhancement in the FII limit in G-Sec and corporate bonds, inclusion of short-term money market instruments for repo, introduction of Credit Default Swaps (CDS) for corporate bonds, and measures to enhance the role of standalone primary dealers in the corporate bond market. Also, given the $1 trillion estimated investment in infrastructure sectors in the 12th plan, the demand for investment will increase substantially necessitating the parallel growth of the debt market as the private sector will have an important role to play here. The increased penetration by the pension funds and insurance companies will provide boost to the bond market.

The corporate bond market acts as alternative source of funding in times when banks' balance sheets are weak and when they are rationing credit given alternative avenues for deployment. Besides, given the asset liability mismatches it is not possible to finance on a standalone basis long term projects. With banks' asset quality already under severe stress, and as they being very cautious in taking any further risk by lending to risky projects or sectors, corporates would have to resort to the either domestic bond market or overseas market for their funding requirements. Banks too would be raising capital for shoring up for Basel III and would necessarily have to be in this market as a seeker of ratings.

Secondly, the bank loan ratings market is still under penetrated. Bank loan ratings have been a major pillar for the rating business ever since the introduction of Basel II ratings. Presently not more than half the market has been rated and there is still a long way to go. Further, the progressive growth in bank credit will mean that this canvas will widen further. New banking licenses will also result in increased business.

Thirdly, MSME would continue to be the main focus of CRAs since scope of growth is high as out of the 1.5 million functional SME units only up to 1,00,000 have been rated. This sector still remains untapped. MSME segment is an integral part of the economy. MSME sector consists of around 26 million units and produces more than 6,000 products, providing employment to around 70 million people. 45% of the manufacturing produce comes from this sector. Performance & Credit Rating Scheme for MSEs implemented by NSIC is expected to drive ratings. Good rating would enhance the acceptability of the rated unit in the market and also enables it to access cheaper credit. It has been established that a rating for the SME helps in obtaining credit on more advantageous terms from banks and therefore this segment offers plethora of opportunity to CRAs.

Fourthly, owing to the presence of asymmetric information in various areas and to expand their rating portfolio into other related areas that go beyond conventional debt or bank loans. Fields like real estate, education, equity etc. have several players some of which are well established while others are relatively unknown. This is where credit rating agencies can make a difference by grading these entities based on the relevant parameters which provide a snapshot to the users of these products/services. CARE for instance has launched products such as Edu-grade, Equi-grade and Real Estate Star Ratings etc. and this perimeter can be extended to other fields too .

Fifthly, companies which do not have global affiliation would have an opportunity to expand globally. In this regard, CARE has entered into Joint Venture with 4 foreign companies – S.R Ratings Brazil, CPR Ratings Portugal, MARC Malaysia and GCR South Africa, for formation of a new credit rating agency called ARC Ratings SA which has been incorporated on 16th January 2014. ARC Ratings (ARC) is an international credit rating agency based in Europe with global reach and profile. ARC addresses the global markets' need for a new approach to rating risk which will, empower investors to take better informed investment decisions thus optimizing the efficient allocation of global capital. There is clearly space for expansion into global markets for agencies which are exploring new frontiers.

Concluding remarks

The ratings industry in India is going through interesting times. From a rather steady phase up to 2007-08, the industry received an impetus with bank loan ratings providing a new dimension to the business. The multiple global crises as well as clamor for competition have opened the doors for global forays and alignments for domestic CRAs. At the same time the economic downturn in the country has affected the debt market with investment falling which has forced CRAs to look at new areas. With regulatory changes around the corner, CRAs would have to necessarily reinvent themselves continuously to remain in the forefront going ahead.