# Impact of new regulations for rating agencies

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The regulatory process in the financial sector has been evolutionary and has to necessarily change with the evolution of the market. One of the reasons for this is that there are constantly changes taking place in the market structure in the form of challenges and disruptions which were not anticipated to be taken into account by the existing regulatory structure. Innovation has been the hallmark of the financial sector where institutions, instruments, modes of finance etc. constantly change. Also in this highly globalized world the transmission of new ideas is instantaneous which calls for regulators to be on the alert. This calls for a constant review and change so that the system is on a firmer footing.

This held for the financial crisis too in the USA when a sea change was seen in the way in which the SEC reacted. Financial engineering was hailed as a masterstroke as complex products were devised to meet the funding requirements. A lesson learned however was that regulation should always keep pace with innovation as the journey is always into the unknown. To its credit, India had always a regulatory framework for credit rating business which was in many ways ahead as compared to other markets.

The regulatory framework for the rating business has two main pillars – transparency and processes, which in a way are interrelated as they seek to ensure that the contours of operation are robust and credible. Trust is very important in the credit rating business as the simple use of the letters of the English Alphabet is seen seriously by potential investors when taking investment decisions. Therefore all the processes that go into arriving at the credit rating and its limitations needs to be well understood by investors.

In the past few years the regulation for credit rating agencies has been strengthened which also progressively improves the confidence level of investors. This is important because at the end of the day it is the investor who uses the rating of the CRA and needs to believe in them as a large volume of investments use the credit rating of the instrument as the starting point.

The most recent regulation relating to the CRAs is on benchmark default rates. This is a very important bit of information that investors look for as it tells one about how well have the ratings fared over a period of time. Typically the probability of default for an 'AAA' rated paper should be close to zero or minimal over a period of time. This increases as the rating moves downwards. By establishing benchmarks investors will actually get to judge the robustness of the rating agency. Similarly there are disclosures on liquidity indicators and rating sensitivities that will provide more information to the users of these ratings. The sensitivities aspect is useful for investors as they would talk of the potential triggers that could affect the rating going forward. Therefore fund houses or individuals tracking their investment would be aware of what could change the rating and would hence be more cognizant of such action when it is taken. CRAs too would be putting on the table the risk factors that could notch the rating were they to materialize.

Having such disclosures does put pressure on the rating agencies to perform consistently as the viewers can actually compare across CRAs these ratios. In a way it is a reputation issue for the CRA which has to strive to maintain the highest standards of rating processes and outcomes. For CRAs reputation is the most important risk as both clients and investors judge the rating based on the reputation of the concerned CRA.

Also more transparency actually works both ways. CRAs are upfront with their approach and the factors that have caused the rating to be assigned while the investors have all the information available on the instrument and can take an informed call on their investment.

SEBI had earlier brought in a regulation relating to unaccepted ratings which now have to be disclosed to the public and put on the web site of the rating agencies. This is significant as it eliminates the incentive to look for better ratings if the company is not satisfied with the one assigned by the first CRA. While even today the company can choose to get a rating from another CRA there is a trail of how other agencies have evaluated the same. By making it public the client can judge the rating which one is using after juxtaposing with those given by other agencies. This was a very important development which also helped to address the issue of what is called 'rating shopping'. In fact with this regulation in place the second credit rating agency would have to be doubly sure of the rating being given as the investing community would keep benchmarking the final rating with those that have not been accepted. This was probably one of the more significant changes brought in by SEBI.

Transparency of processes and actions is very important in the rating business and hence the CRAs are required to disclose detailed processes as well as criteria which are used as well as provide a rationale for the rating action. This is essential to understand how the rating was arrived at. Rating is actually a public good in the sense that though the company getting its paper rated pays for the rating, it is used by everyone without a cost. Therefore it stands to reason that the user should be able to have all the information on the rating and the criteria that is used before forming an independent judgment on the same. Today, credit rating is mandatory for all public issuances of debt as well as bank loans for the purpose of assigning capital weights as part of the capital adequacy reckoning process. Rigorous operational audit is now also part of the regulatory compliance which just helps to strengthen the belief in the system.

An area which requires specific mention pertains to non-cooperation from the client. The credit rating mechanism is quite singular in terms of how it is conducted. There is an initial rating assigned by the CRA which is normally a smooth process once the mandate is signed between the two parties. However regulation requires that the instrument be rated on an annual basis until such time that the debt paper is redeemed. It is in the t + n time periods that the CRA could run into a problem of completing the surveillance exercise if the company is unwilling to cooperate.

While companies do talk to the CRA and provide all information that is called for at the time of getting a rating, at times they are not willing to do the same when it comes to the surveillance exercise for several reasons. It could be that they are going through a bad phase or that they do not want to reveal the true situation of the company. The rating is based typically not on just the audited reports publicly available but also continuous dialogue with the client to assess prospects, problems, strategies, and financial plans etc. as all these elements go into the credit evaluation.

This does pose a conundrum for the CRAs as the rating is based not just on publicly available information but also intense discussions with the client on the business factors, future plans, headwinds and tailwinds, industry related issues etc. As a CRA we have to look deeper and meetings with the management are paramount as this is where the analysts are able to gauge the true picture. For non-co-operating clients, SEBI in its wisdom requires that the CRA should do the rating based on the best available information that is available with a suffix that the client is not cooperating. This will ensure that the user of the rating would know the background as well as gauge the company better as non-cooperation normally does not have positive connotations.

Surveillance is a very important activity as it tracks the company and financial paper over the entire life until it is repaid. This information is crucial for the investors as they take decisions based on the creditworthiness of the company which can change over time. Surveillance is as important as the initial rating and CRAs have to monitor closely and identify potential defaults much before they happen. All material news that comes along has to be analyzed and assessed in terms of how it affects the credit position of the company and has to be reported. This is one way of warning the investors that something could be amiss in the company. Further status of defaults, if any, updates are required to be obtained on a monthly basis so that the investors are able to get quick updates on debt servicing.

Formulation of regulation is a two way process between the regulator and the regulated. Both the parties are interested in ensuring that the market functions well and that there are no shocks as they have serious linkages with the rest of the economy. Regulation has to be proactive and the ongoing dialogue which would make the credit rating business stronger and resilient as the market players cement their trust in the system. This is the ethos behind the process of evolving regulation that is essential to keep pace with the changes that are taking place in the financial system.