Rating Agencies and Capital Markets

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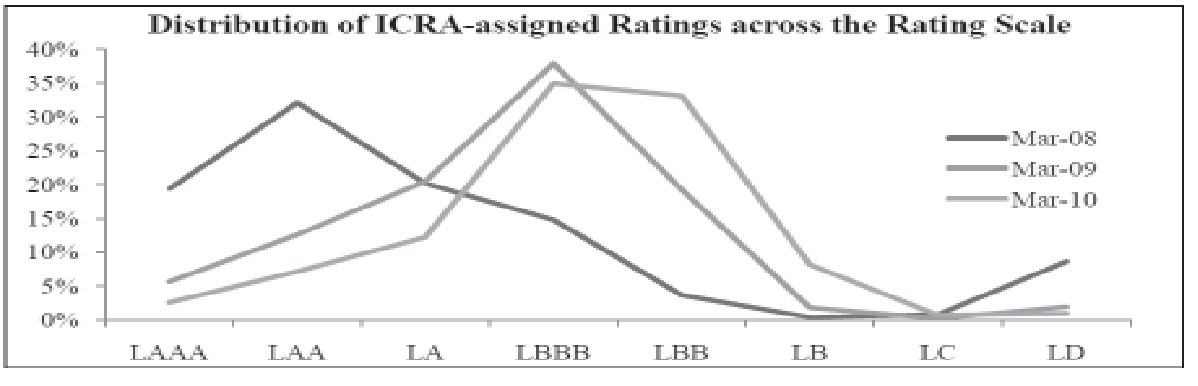
The credit rating industry has firmly established itself as an integral part of the debt market in India over the course of its two decades of existence in the country. Ratings, which express the Credit Rating Agency's (CRA's) opinion at a point in time regarding the ability of the rated entity to honour its debt servicing obligations in the future, are a key requirement for issuers seeking to raise funds from the debt market. Ergo, ratings have played a critical role in enhancing issuers' access to finance. Additionally, the coverage of Bank credit rated by the CRAs has grown considerably over the last few years, thereby expanding the universe of rated entities significantly—a phenomenon that ICRA believes has the potential of deepening the debt market in India. Further, the recent mandatory requirement for equity issuers to get their Initial Public Offers (IPOs) graded carries the possibility of improving the access of previously unlisted issuers to funds from the equity markets, while at the same time helping retail investors arrive at an informed decision on the options available to diversify their portfolio.

Broadening of Distribution of Ratings Holds the Possibility of Deepening Debt Markets

Notwithstanding the sizeable volume of rated debt, the number of rated issuers was limited until a few years ago. A significant development that has taken place during the last two years has been the increase in the types of instruments for which ratings are customarily sought. The universe now includes Bank loans, besides the traditional debt market instruments. This has led to a significant increase in the number of rated issuers, which has in turn broadened the distribution of assigned ratings across the rating scale and shifted the median towards the lower end of the rating spectrum—developments that hold the possibility of adding depth to the debt market in India.

Unlike Bank loan ratings, which are primarily regulator driven, debt ratings are mainly investor driven in India. The Securities and Exchange Board of India (SEBI) requires public issues of debt securities and listed instruments to be rated. On the other hand, the requirement for rating of privately placed debt, which accounts for a considerable portion of the total debt issuance, is predominately investor driven. Mutual funds and pension funds invest only in rated paper, while some market participants insist on dual rating of debt; Banks also invest largely in rated debt. All this highlights the critical role that ratings play in enhancing the access to debt. The possibility of funding infrastructure projects, in which substantial investment is expected to take place over the coming years, through debt instruments suggests that the volume of debt issuance in India is likely to grow at a steady pace, going forward.

With access to capital hitherto restricted to the higher rated entities in the Indian debt markets, issuers who thought they would be rated at the lower end of the scale either did not seek ratings, or even if they did, they did not eventually accept the lower ratings assigned. With Banks required to maintain a minimum level of capital adequacy in line with the underlying riskiness of their portfolio under the Basel II requirements, instruments such as Bank loans are now being rated extensively. As a result, there has been a significant increase in the number of entities rated by ICRA, while at the same time acceptance of lower category ratings has also increased. A larger number of data points within various rating categories is also desirable from the point of view of ratings stability. The presence of a limited number of ratings in a particular category, as was the case earlier, can lead to distortion of statistics related to rating migrations. This diminishes the utility of such statistics in enabling market participants gauge changes in industry and macro-economic fundamentals.



Within ICRA's portfolio, the proportion of issuers rated at the lower end of the rating scale has increased significantly over the last two years. The proportion of entities rated in the LBBB or lower rating categories by ICRA increased from 28% as on March 31, 2008 to 78% as on March 31, 2010, improving the representativeness of the sample of ICRA rated issuers, with respect to the underlying universe of entities accessing credit from various sources in India. The increase in the number of rated issuers and the shift of the median ratings towards the lower end of the rating scale are factors that can enable deepening of the debt market in India to include issuers beyond those featuring at the higher end of the rating scale.

Enabling Factors for the Development of Capital Markets in India

Several factors, related to both supply and demand, have constrained the development of the bond market in India so far. Shorter procedures and less arduous paperwork have encouraged borrowers to harbour a preference for Bank credit. On the demand side, Banks are less inclined to invest in debt paper compared with loans as the latter are not required to be marked-to-market. Additionally, Banks, pension funds and insurance companies are required to invest in Government securities, which also restricts the appetite for corporate debt. Besides, under-pricing of credit risk by Banks in the case of loans has also contributed to the predominance of loans as a funding vehicle and restricted the supply of debt by lower rated issuers, with the result that the debt market is dominated by high-rated paper. Credit ratings help in the appropriate pricing of credit risk, and are likely to assume greater importance with the development of the secondary market for corporate bonds in India. A movement towards risk-based pricing by Banks would lead to greater alignment of economic capital with regulatory capital and may encourage lower rated issuers to consider the debt market as a viable option for raising funds.

An increase in the number of foreign investors actively participating in the Indian debt market would improve the overall demand for corporate debt in India, which may also help in deepening the debt market, provided such investors also have an appetite for lower rated instruments. A change in the norms related to investments by insurance companies, which are currently allowed to invest only in higher rated debt (while ensuring that such companies remain adequately capitalised relative to the underlying riskiness of their portfolio), would also stimulate demand for lower rated paper. The introduction of credit-default swaps in India may also provide a boost for such paper.

In addition to traditional debt ratings, a new service that was introduced by CRA's in recent years is grading of IPOs, which seeks to facilitate assessment of equity issues offered to the public. Under SEBI guidelines, it is mandatory for issuers proposing to offer shares through an IPO to get the same graded by at least one CRA and disclose all gradings obtained in the Prospectus. ICRA-assigned IPO gradings seek to convey its assessment of the "fundamentals" of the issuer concerned relative to other listed securities; the gradings are however not a comment on the valuation or pricing of the issue that is being graded or on the returns it may generate. ICRA-assigned IPO gradings capture its opinion on the relative competitive strengths of the issuers concerned, their financial position, management strengths and weaknesses, and their corporate governance standards, besides the industry prospects. The availability of limited information on unlisted companies makes it difficult particularly for retail investors or market participants who have entered the equity markets recently to appropriately assess the business prospects of the issuer concerned and the risks associated with the IPO. In this regard, IPO gradings serve to provide valuable investment guidance. By allowing new issuers access funds from the equity markets while simultaneously enabling less sophisticated investors diversify their portfolio across a range of fundamentals, IPO gradings can contribute significantly to widening and deepening the equity market.

Overall, the recent increase in the number of rated or graded entities is a positive development, one that has the potential of increasing the options for raising funds beyond Bank loans for a large number of entities and deepening both the debt and equity markets in India.

Maintaining Rating Standards and Objectivity of Ratings

Over the 20 years for which the CRA industry has been in existence in India, the number of CRAs present in the domestic market has increased to five, as allowed by the regulator, that is, SEBI. Although the regulatory view is that increased competition would benefit consumers, it is imperative to ensure that dilution of standards does not take place in order for new entrants to gain market share, as such dilution would ultimately be undesirable from the point of view of the users of ratings, viz. the investors.

The objective of preventing dilution of rating standards could be achieved through a number of ways including refining the entry criteria for a credit rating agency to ensure that only genuine applicants who would be able to adhere to the established standards and ethics of the industry can set up a CRA. According to the present entry criteria, SEBI considers only applications (for setting up a CRA) backed by a promoter belonging to one of the following five categories: a public financial institution; a scheduled commercial Bank; a foreign Bank operating in India with the approval of the Reserve Bank of India (RBI); a foreign credit rating agency recognised by law in its country of incorporation and having at least five years of experience in rating securities; and any company having a continuous net worth in excess of Rs. 100 crore as per its audited accounts for the five years prior to filing the application with

SEBI. The net worth criterion for promoters remains unchanged since 1999, although the size of the Indian economy has increased by over three times during the intervening period in nominal terms and the number of companies meeting this criterion for promoters of a CRA is likely to have grown significantly since 1999. Additionally, the applicant itself is required to have a minimum net worth of only Rs. 5 crore, which too remains unchanged since 1999. Overall, there is a strong case for the eligibility criteria for promoters and applicants to be made stricter by SEBI so that there is no proliferation of CRAs in India.

Issues regarding conflict of interest are being dealt with by the credit rating agencies and the regulator, in terms of ensuring complete separation between analytical and business development teams and disallowing employees involved in the rating process as well as their dependants from owning shares of issuers, which will serve to reinforce the commitment to provide objective ratings. Additionally, regulations requiring agencies to disclose income earned from non-rating services will bring in greater transparency and minimise conflict of interest arising from the same.

SEBI has introduced the requirement for all CRAs to disclose the following: the movement of ratings of all securities outstanding during the past six months and also on an annual basis; the list of defaults by rating category; and the average one-year and three-year cumulative default rates for the past five years for each rating category. Rating transition statistics and default studies help market participants assess the performance of ratings. As the bond market and the rating industry evolve, investors and other market participants would evaluate the quality of a CRA using such tools, instead of implicitly assuming that all ratings are accurate since they are assigned by rating agencies “approved” by the regulator.

Timely furnishing of accurate information by issuers, regular monitoring of the rated entities by the CRAs concerned, and appropriate and timely revision of ratings help maintain the quality of the assigned ratings, besides enabling capital market participants to make appropriate investment decisions in the face of changing industry dynamics and an evolving macroeconomic scenario