Increasing challenges for the Ratings Industry

Madan Sabnavis
Chief General Manager & Chief Economist
Credit Analysis & Research Ltd.

Ever since the financial crisis struck and distorted markets, the credit rating business has become controversial. There was an allegation that the crisis was engendered either because of an inherent conflict of interest in their business models or sheer incompetence with the tilt being on the former. The euro crisis aggrandized the situation further as it was revealed that the rating agencies had erred in judgment even on sovereigns. This appeared to be more serious than the former which could be still justified on grounds of structured products being a Greenfield which was an enigma at that time, which though not a justification could still be used as explanation. Subsequently the focus of all regulators in all the affected countries, especially the USA, was on having better and more stringent regulation. The industry has progressed since then with several changes being invoked in the business model to make sure it is robust.

The period following the financial crises has also been a period of muted economic activity as financial markets in particular have been jolted by the dual events. The emerging markets have been relatively insulated and have posted higher growth rates with their financial sectors also being fairly robust. The Indian financial sector has been well behaved till 2015 when the NPA issue surfaced and cast a shadow on the quality of assets. It is against this background that the challenges which confront the credit rating industry can be evaluated. In a way their judgment would be put on the same table as that of banks and compared all the time.

The first challenge for the industry is the issue of credibility. While this has not been in question in India given that the ratings have been well behaved, going forward it is essential to ensure that the ratings are of the highest quality as the market is almost always forgiving. It is for this reason that the rating agencies have to work hard to ensure that their ratings perform at all times, which becomes an issue when there is an economic slowdown. In fact, often when there is a default the rating agencies are blamed more than the defaulting company and hence there is a major reputation risk. Interestingly, even when the rating agency provides such signals by downgrades, the question asked is either – 'why was this not done before' or 'why was a higher rating given to begin with'.

The issue is more with the bank loan ratings segment rather than debt market. In the latter, normally it is generally only the better rated papers which get into the market as a lower rating does not quite attract investors. It is for this reason that the default probability is also very low here and the market is well behaved. But when it comes to bank loans, the integrity of the system has been mixed, and it is here that the rating companies have to ensure that their ratings are right. So far, it has been observed that the cumulative default ratios and transition matrices of the industry as revealed on the web sites, which has been made mandatory by SEBI, have been comparable with general standards. They however cannot still be compared with those of S&P or Moody's' as they have a longer history and hence larger base which keeps the ratios low.

The second challenge for rating companies is external where the mass of ratable universe has to increase. The corporate debt market is the raison d'être for the rating business. The industry can rate as much as that comes to the market. The debt market has shown some growth over the years, which however has been concentrated in the financial sector where funds are the raw material for these firms.

There is evidently need to have manufacturing and infra companies borrow more to ensure that there is buoyancy in the market. The manufacturing sector is not borrowing due to surplus capacity as well as preference for bank lending where conditions are easier. For debt issuances, the procedures are rigorous and also cumbersome and given traditional relations with the banks, companies find it easier to borrow from them. Also given that the lower rated paper is not sellable in the debt market, banks are willing to provide the funds as their considerations are different as they also take into account collateral provided which does not go into a credit rating.

The infra companies will be the future of the industry and hence will also track the growth potential of the economy. However, there are some issues here. The funding is for long term where the main investors would be long term players like insurance companies and pension funds which would like to match their portfolios with these tenures. However, they have so far preferred to invest in AAA rated paper and while there is talk to move down to AA rated paper, given their objectives of providing secure returns, the pace of such investment is limited.

Second there are not too many such projects coming up and while it is expected that future growth in the economy will be contingent on such evolution, the rating business dependent on the debt market growth will be under pressure. In fact it has been observed that ever since the nation went through a phase of impasse in policies which in turn led to several projects getting stalled there has not been much momentum in this sector.

It is important to point out that today the debt market values ratings as can be seen that while private placements do not require a rating if not being issued to the public, almost no paper is in the market without dual rating; and often there are three ratings as investors feel reassured when there are multiple ratings. But for sure there needs to be more issuances from non-financial companies to maintain growth in the ratings business.

The third challenge for Indian rating agencies is on the bank loan ratings segment which is twofold. The first is the risk of internal ratings being introduced in the banking sphere. The ratings business has expanded exponentially when the RBI mandated in 2008 that it would be following. The standardized approach under Basel II for reckoning capital risk weights for banks under the capital adequacy framework where all bank loans need to be rated by external credit rating agencies. This opened up a new segment for the industry. As all loans that are above Rs 10 crore need to be rated, the business volumes of the rating industry increased.

The IRB (Internal Ratings Based) approach talks of banks doing their own ratings which is part of the advanced approach pursued by several countries from the start. The RBI had mandated that we would be migrating to this system over time and this was to have started from 2012 onwards and banks could apply for the same. Several banks have made submissions and the RBI has been in the process of examining these models to analyze whether they work well with historical data. While it has been more than 3 years since banks were given this option, the process is still on as the NPA situation in the system has made the RBI doubly cautious. But this is only an issue of time, and once banks are in a position to do their own ratings, then the rating industry will become less relevant unless banks sub contract the same to them, which can be specific to some banks and not all of them.

The other related issue is that while IRB could still be some time away, growth in bank credit has also slowed down which creates problems for the industry, which has built up its human resources for the same. In the last three years, the main growth driver of bank credit has been the retail segment which is not in the ratings fold. Therefore, the loans to manufacturing and services have to grow to widen the canvas, which has been just around 5% in FY15 and FY16. This challenge, like the debt market, is related to external use factors. Continued slowdown in growth in bank credit can slow down the growth of the credit rating market too.

The fourth challenge is more on the regulatory front where business is concerned. The SME business has been a new avenue for their rating business with the introduction of the subsidy scheme under the NSIC (National Small Industries Corporation). Here SMEs were given a one-time subsidy of 75% of the fee by the government which helped these units to become more transparent in operations, and more importantly gave some indication to banks about their credit worthiness. It was a preliminary screening mechanism which was done by the rating companies through a due diligence process approved by the Ministry of MSMEs. In FY16 the government had lowered this subsidy by around Rs 60 crore in the Budget which was subsequently revised by a higher allocation of Rs 20 crore. But this was a major blow to the ratings industry where structures were built to tap this segment of 15 to 20 million MSMEs which involved both human resources and technology systems. The same has been revived by the government to a level of Rs 200 crore for FY17, which is good for the rating industry. However, the threat of a scale down or withdrawal in future cannot be ruled out which is another imponderable for the industry.

Also, one may recollect that SEBI had made IPO grading mandatory to begin with and then withdrew the same by making it optional. This was another regulatory risk carried by the industry where any 'mandatory' clause is made 'optional' in which case the growth in business is impacted.

The fifth challenge is to create alternative products and make them important to the system. Thai is probably the toughest challenge because to convince the users of any product that the rating gives them value is difficult given that most of these services go to the retail level in terms of consumption. Education is one area where ratings or grading will be relevant. However, for it to work, students have to see value in the rating. Presently various media publications provide such ratings which provide some benchmarks. Similarly hotels get stars in terms of grading. But there are several restaurants and resorts which are not well known to the users who go by reviews of other users before deciding on whether or not to buy the service. Having a grade given by an external agency would be useful. But there needs to be some initiative taken by the government to ensure that this becomes a part of the regulation. The government of Karnataka for instance has backed the rating of tourist facilities where sops have been provided to resorts which get graded and achieve a minimum threshold. The rating companies have to keep convincing the government authorities to link these grades with benefits to make this a win-win situation for all concerned participants.

The sixth challenge for the rating companies is competition. While competition is always good for the industry, the proliferation of the same in the face of limited growth in the cake means that the rating companies will fight harder for a larger slice. While this holds in all industries, this is one of the few cases where there are constraints in growth unlike banking, insurance, broking etc. where there are no limits. A fallout here would be that on account of high levels of competition the quality of ratings can be affected, something which has often been spoken of in the media. Rating shopping as it is called is a possible fallout where there will be an incentive to charge lower fees to garner business or give a better rating for a lower fee. However, while this can happen at the margin, it cannot become a habit as in the rating business; the investor decides which ratings matter. In case the perverse incentive to give easy ratings is pervasive, then the agency gets ostracized by the investors. As all companies have both bank loans and debt market exposures - even if no bonds are issued there would be commercial paper, investors will see through the shopping game and will not accept such ratings (there is normally a common rating for all instruments).

In India the rating industry has seen the boom time when bank loans ratings window opened up. With this segment moving towards the saturation level there is now a case of a thrust required from outside to keep the industry moving in terms of buoyancy in growth. At the same time the entry of more players has added to competition where all are competing for a limited radius of the rating circle. Looking for alternative products has to be an ongoing process as it will add depth in course of time. Regulation does not permit advisory or consultancy activity to be combined with rating as it creates serious conflict of interest that has to be addressed. Doing it through a subsidiary or acquired company route is options but would still be outside the periphery of rating business.

If these issues are not addressed, the industry would have an issue in growth and the 20% plus mark witnessed earlier would be beyond the horizon.

Views are personal