Rating Agencies and Corporate Governance

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Introduction

Given the nature of credit rating business, where ratings are provided to potential investors who would like to invest in debt instruments, the issue of corporate governance is of paramount significance. It is absolutely essential that these exercises are carried out in the most transparent manner without any bias so that the opinion provided is based on only business judgment and no other consideration. This is why corporate governance becomes the centre piece of all such business. The financial crisis in 2007-08 exposed the perils that pervade this business in terms of inherent conflict of interest between the agency and the company issuing an instrument. While regulators all over have been working around making this business more transparent, the core principles have to come from within the agency.

Concept of credit rating

Credit rating is the opinion of the rating agency on the relative ability and willingness of the issuer of a debt instrument to meet the debt service obligations as and when they arise. Rating is usually expressed in alphabetical or alphanumeric symbols. Symbols are simple and easily understood tools which help the investor to differentiate between debt instruments on the basis of their underlying credit quality. Rating companies also publish explanations for their symbols used as well as the rationale for the ratings assigned by them, to facilitate deeper understanding. These symbols have been made similar for all agencies by SEBI so that it is easy for the investor to compare the ratings accorded by various rating agencies.

Rating plays a crucial role in providing individual and institutional investors with information that assists them in determining whether issuers of debt obligations will be able to meet their obligations. A credit rating is an opinion on relative degree of risk associated with the 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. Ratings are important owing to the existence of imperfect markets and asymmetric information where the company knows better than the investor whether it will be in a position to service its commitments.

Historically, companies had been resorting to taking loans from banks, where the latter have their own mechanisms to verify the credit worthiness of the borrower. With the opening up of the market and increased appetite for finances by the companies, various other sources of funding are now available. This resulted in a boom in debt issuances such as bonds, debentures and commercial paper. However, new ways of funding also meant limited information available to the investors about the risk associated with new funding prospects. Hence, SEBI made credit rating mandatory for the companies to raise any amount of debt in the market.

A credit rating evaluates the credit worthiness of an issuer of specific types of debt, specifically, debt issued by a business enterprise such as a Corporation or a government. The credit rating represents the credit rating agency's evaluation of qualitative and quantitative information for a company or government; including non-public information obtained by the credit rating agencies analysts. 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. 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.

Role of Rating

As a regulatory requirement by SEBI, any amount of debt raised by companies have to be rated by one of the credit rating agencies. Credit rating assesses risk in the financial system and plays a key role in enhancing the market.

Reducing Information Asymmetry

Credit rating helps reduce the knowledge gap, or information asymmetry between borrowers (issuers) and lenders (investors). The essential subject matter of this information asymmetry is borrower's creditworthiness. A borrower knows its own creditworthiness better than a lender does.

Improving Market Function and Efficiency

Essentially, credit ratings reduce the ability of one investor to outperform another by making better judgments about creditworthiness. In this view, ratings act as an equalizer in the fixed-income capital markets, helping to put investors on more equal footing, thereby minimizing variations in returns that can arise from differences in the ability to make sound credit judgments.

Advantage to investors

Credit Rating provides objective, independent and reliable opinion on credit quality which facilitates an informed investment decision. It gives superior information about the rated product and that too at low cost, which the investor otherwise would not be able to procure so easily. Thus the investor can easily recognize the risk involved and the expected advantage in the instrument by looking at the symbols.

Marketability of securities

Issuers seek ratings for a number of reasons, including to improve the marketability or pricing of their financial obligations, to improve the trust of their business counterparties or because they wish to sell securities to investors with preferences over ratings.

Benefits for the issuer

Credit rating enhances the ability of the borrower/issuer to access the money and capital markets for tapping larger volumes of resources from a wider range of investment options. It helps in procuring funds at a better interest rate and helps establish credibility among investors. Credit ratings also helps in imposing healthy discipline on corporate borrowers and encourages financial discipline

Challenges faced by Rating Agencies

One of the major challenges faced is that the credit rating is based on an issuer pay model. Rating agencies are said to have an inherent conflict of interest arising from the issuer-pay fee structure. The issuer pays the fee for the credit rating service, rather than the bond investor or a subscriber to rating information. Issuers and investment bankers can 'shop' for ratings, and this competition for business can compromise the objectivity of rating agencies.

Alternative models such as as investor pays or government or exchange pays are considered as not being feasible. With the investor pay model we run into the problem of higher cost and also some bias is seen towards smaller issuers. The exchange pay model would work only for the listed securities.

The issuer pay model is adopted by most rating agencies in various countries. With this model, the only check is reputation. The question that now arises is how can the problem of conflict of interest be addressed?

External Rating Committee and the Rating Process

One way to tackle the problem is to appoint an External Rating Committee. The External Rating Committee should comprise of experts from various fields with vast industry experience and people who are not involved in any way with the company being rated. The existence of an External Rating Committee thus ensures that ratings are unbiased and objective.

In CARE, for instance there is an External Rating Committee with five members of which 4 are independent and only 1 internal that is the MD & CEO. It is headed by Mr Y H Malegam, former Managing Partner S.B. Billimoria & CO, Mr P.P. Pattanayak, former MD of SBM, Mr V. Leeladhar, former Deputy Governor, RBI and Mr V.K. Chopra, former whole time member, SEBI. These members have nothing to do with the shareholders or the balance sheet of the company and hence bring in a superior governance structure to the rating process.

Procedures in CARE

In general, the rating process starts with the rating agreement between the company and the rating company called the mandate, which states all the clauses, fee structure etc. Based on the preliminary information received from the company, the rating team prepares a query list for discussion with the management. There are several checks starting with the analyst, group head, rating head and the quality control team. The rating note then is evaluated by the Internal Committee which passes it on to the external committee when the instrument is investment grade.

In case of an initial rating, final ratings are assigned by external rating committee (ERC), however in case of surveillance, the ratings are mostly assigned by the internal rating committee (only if the rating recommended changes the initial rating band it is taken to the ERC for final approval).

Separation of Consulting and Advisory Services

Most of the rating agencies also provide advisory services in addition to the core business line of credit rating. The concern with respect to advisory services is that the rating agency may issue a more favorable than warranted credit rating in order to obtain business from the rated entity for these services.

The provision of consultancy services by credit rating agencies is also a source of conflict of interest that may harm issuers. In a way, rating decisions of agencies may be influenced by an issuer's decision whether or not to purchase additional services offered by them. Issuers may be pressured into subscribing to such services simply out of fear that their failure to do so could adversely impact their credit rating or conversely, with the expectation that purchasing these services could help their credit rating.

Rating agencies need to establish extensive policies and procedures to manage potential conflicts in this area. Keeping rating business and advisory services separate helps in addressing this issue. Rating business should not be linked to the advisory in anyway. If the rating agencies want to venture into advisory services, it should do so through a subsidiary. CARE Ratings undertakes advisory assignments through CARE Kalypto, thus ensuring substantial firewalls that separate the rating business. CARE Kalypto is a wholly owned subsidiary of CARE Ratings.

Corporate governance as a rating product

Since the ratings are published in the public domain, ratings need to be correctly evaluated and assigned.

With the ratings available in the public domain, it provides added incentive for companies to improve their performance not only in their finances but also on the governance front.

In this regard, rating agencies also provide corporate governance rating for companies. Corporate Governance Rating (CGR) is an opinion on relative standing of an entity with regard to adoption of corporate governance practices. It provides information to stakeholders about the level of corporate governance practices of the entity. It enables corporate entities to obtain an independent and credible assessment of the quality and extent of their corporate governance. The rating process also determines the relative standing of the entity vis-à-vis the best practices followed in the domestic as well as international arena. Companies can also use these ratings as reference and set benchmarks for further improvements. Investors and other stakeholders are able to differentiate companies based on degree of corporate governance.

CARE undertakes perusal of various documents like agenda papers and Minutes of Board and Board committees, Minutes of the Annual General Meeting and Extraordinary General Meeting, Annual Return and other documents filed by the company with ROC, SEBI, stock exchanges (domestic and international) and all other regulatory bodies, prospectus (if applicable) and offer documents. CARE's team interacts with the Chairman, MD/CEO and independent directors, key officials of the company, Statutory Auditors, Internal Auditors, Lenders and Institutional/major shareholders. Under the corporate governance rating exercise, seven key parameters are identified which include board composition & functioning, ownership structure, organization structure and management Information System, shareholder relationship, disclosure & transparency, financial prudence and statutory and regulatory compliance.

Good Corporate governance also helps ensuring that corporations take into consideration the interests of a wide range of constituencies, as well as of the communities within which they operate. Good corporate governance aims at value creation for its stake holders.

Evaluation of the extent of value creation and balanced distribution of wealth is undertaken by CARE under its CGV rating exercise. The exercise involves assessment of wealth creation and distribution parameters in addition to the parameters evaluated under CGR. The composite rating is called as “Corporate Governance and Value Creation Rating“. Wealth creation by a company based on sound business strategy and practices adopted by its management as also maintaining financial and operational discipline would promote enhancing stakeholder value. The quality of management and its capabilities under stress, corporate strategy & philosophy and succession planning would be examined by CARE to assess wealth management practices.

How does one rate corporate governance of CRAs?

Presently there is no way in which rating agencies are judged for right practices. The final decision is taken by the market where it decides on which ratings are acceptable and those that are not. The market is very rigorous and unforgiving and hence rating agencies have to go that extra yard to ensure that the best practices are adhered to in this business.

Conclusion

The need for rating products stems from the information asymmetry prevailing in the markets pertaining to the various services and products. Lack of information or fragmented information, regional dynamics, small size players, lack of benchmark etc. necessitate the need for an independent evaluation of the stated attributes, the strengths and weakness of the facilities on offer.

The independent evaluation of the facilities i.e. ratings and grading, done by qualified rating agencies such as CARE Ratings bring about transparency and enables all users, investors and stakeholders make informed decisions. It also promotes the adoption of best practices, increases credibility, visibility and thereby prompts overall improvement in the quality of products and services offered, resulting in improved corporate governance.