# Credit Ratings Agencies – A Perspective

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The credit rating industry began with Moody's and S&P. While they led the industry, they have also been in the news for the poor image of the industry. The reasons were relatively high number of AAA ratings that defaulted later, in the mortgaged backed securities, which some people believe as the main cause of the US financial crisis in 2008. Many of the states in the US, the Federal Government as well as a few foreign governments like Australia have filed suits against the rating agencies for misleading the investors.

The Indian journey has been relatively smooth, though industry was subject to some hiccups. The industry began with the Indian Developmental Financial Institutions sponsoring one rating each. While ICICI set up CRISIL, the IDBI set up CARE and IFCI set up ICRA. All of them have grown in the last twenty five years. CRISIL is now owned by a foreign rating agency S&P. Another foreign rating agency Moody's now controls ICRA. India Ratings a 100% subsidiary of FITCH is another foreign rating agency.

Brickwork Ratings was set up in 2008 and is based in Bangalore. Canara Bank has 10% equity stake in Brickwork. The other agency recognised by SEBI is SMERA promoted by D&B and SIDBI.

**Types of financing**

Entrepreneurs owning companies prefer own capital and internal retained earnings to finance their projects. The reasons are obvious. They need not convince any bank, mutual fund, private equity or other investors. They just need to take approval of the Board and their own shareholders in the AGM . However as the size of the projects increase, they are forced to depend on bank loans, non convertible debentures as well as public equity. In India, some companies think that the equity is the least expensive source of funding. In fact a large financial institution in its IPO prospectus stated that the cost of equity is just the dividend yield that is usually less than 3%. In reality, equity is most expensive one, and costs at least 6% more than equivalent debt. This is one of the reasons why the IPO market has not taken off, since the companies are not articulating how they will benefit the shareholders.

**IPO issuance**

The following table shows the IPO issuance form the Prime Database.

| YEAR | AMOUNT (Rs. cr) | NO. OF ISSUES |
|---|---:|---:|
| 2005-06 | 23,676 | 102 |
| 2006-07 | 24,993 | 85 |
| 2007-08 | 52,219 | 90 |
| 2008-09 | 2,034 | 21 |
| 2009-10 | 46,941 | 44 |
| 2010-11 | 46,182 | 57 |
| 2011-12 | 23,982 | 36 |
| 2012-13 | 34,313 | 44 |
| 2013-14 | 15,234 | 82 |
| 2014-15 (as on 30/6/14) | 597 | 7 |
| **Total** | **366,392** | **6,117** |

Whenever the market goes up the market sees inflow of new IPO.

It is easy for large firms to raise money since they are well known and well researched and investors' appetite is high. The problem is with mid cap and small firms which are not well known and not researched well enough by independent agencies. Quite often such IPOs come up to repay institutional loans, and reduce gearing. In such a situation, the sophisticated investor takes his money out and the retail investor enters in, and in many situations left high and dry. Credit rating agencies offer IPO grading from 1 to 5 scale based on company fundamentals. The company with great fundaments, excellent management and good future prospects should get IPO grade of 5, and those with unviable projects or floated by fly by night operators should get 1. However, it was found that some companies , which later failed badly due to mismanagement, also could get grading of 5! IPO grading is yet to attain credibility with investors. At present, SEBI has made the IPO grading voluntary. We believe that IPO grading can be one more indicator of the strength of the company if not the sole indicator.

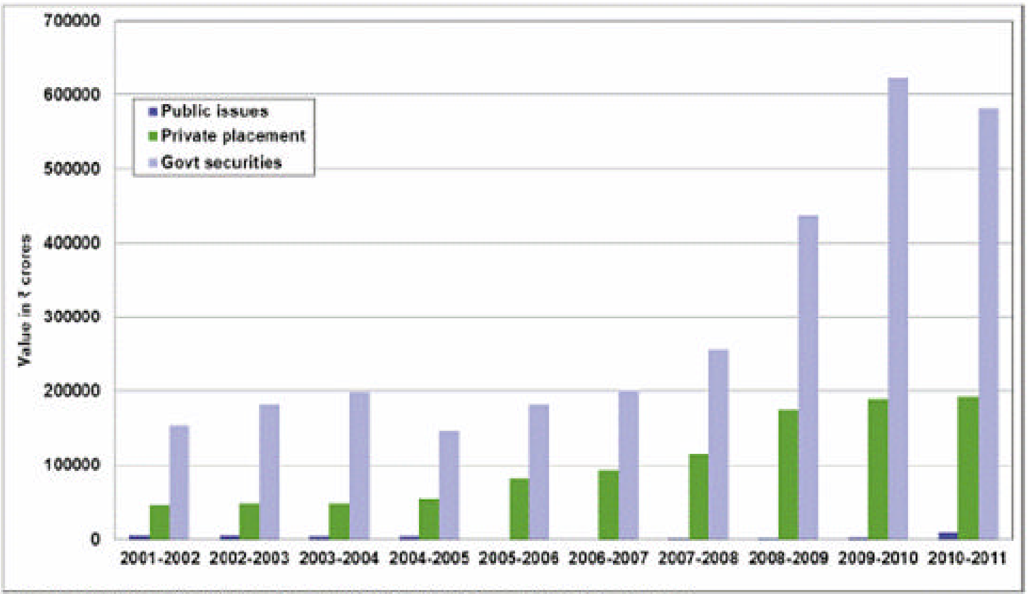
**Debt and Bank loans**

All over the world the bank loans turns out to be the most important source of financing for the companies.
The asymmetric information is least in case of bank loans where the banker is able to watch the borrower's working closely, as also see daily cash flows of the company flowing into the bank accounts. In case of NCD, the trustees get early warning signals if the payment is not made on the due date. The table below shows that, in India, the debt market is not well developed compared to other nations. In case of US, the corporate debt is very well developed and the companies have substantial alternative in NCD market and can borrow at lower interest rates.

| 2012 (%of GDP) | Govt. Bonds | Financial Bonds | Corporate Bonds | Securitized Loans | Non-securitized Loans |
|---|---|---|---|---|---|
| China | 19 | 18 | 9 | - | 132 |
| India | 26 | 5 | 3 | - | 54 |
| USA | 87 | 99 | 36 | 66 | 60 |

There are many reasons for the non development of debt market in India. One of them is that most debt is substantially sucked out by the Government of India, which always runs high deficit and takes away more than Rs 5.5 lakh crore of debt every year, which is almost equivalent to the savings in bank accounts of Indians. It is easy for the GOI to get the money because it owns most PSU banks, LIC and many other financial institutions. Thus private companies are crowded out from the financial markets. ( see table below)

**Resource Raised from Debt Market**




Source: Indian Securities Market Review (ISMR), NSE, Report from different years.

**Bank Loans**

Private firms have to depend on the bank loans for their long term and short-term requirements. Banks provide them with long-term loans and short term working capital. The cash credit limit provides an easy and versatile source of immediate financing needs. Banks in India primarily demand a lot of collateral and getting loans for firms in service sector is usually more difficult. The term loans are rated in the long term rating scale AAA to C. The working capital loans get short term scales A1 + to A4. The cash credit facility where funds are rotated and not really repaid, is rated under long term scale.

**Definition of default**

The definition of default for banks and the rating agencies is different, and this causes some confusion. Banks usually tolerate a week or fortnight delay in getting their dues, and are content with collection of penal interest. They begin follow up when the overdues reach 30 days and such accounts are typically classified as 'Irregular' or 'Special Mention Accounts'. Banks classify the accounts as NPA when the over dues reach beyond 90 days. Rating agencies recognise default even if there is a delay of one day in case of term loan payments. In case of cash credit account, continuous overdrawing of limits over 30 days constitutes a default.

**Restructuring of accounts**

When the companies' projects go adverse, they delay payments. Banks who have lent project loans have to classify such accounts as NPAs, with attendant problems such as provisioning, which can hit their bottom lines, besides high NPA percentages which are tracked by researchers. Banks are thus forced to get into salvage mode, and on many occasions, throw good money after bad projects. They classify such delinquent loans as restructured assets and the RBI guidelines come in handy to classify the loans as standard, with certain enhanced provisioning for the assets. Observers also murmur about banks using some of their foreign branches to lend to foreign subsidiaries of such companies, bring the money back to India, and prevent defaults with ever greening.

**Governments help weak banks**

The other phenomenon generally observed is that, quite often, most weak banks are helped by the government with more capital infusion. The banks with the biggest problems (read: 'highest NPA') will receive the capital infusion on priority and also get more of it. Thus while rating, the agencies will be confused to downgrade the weak banks who are most likely to receive liberal support from the government. The rating agencies have to rate based on future expectations, which are often influenced by past behaviours.

**NCD Market**

The debt market in India is small and usually the top 300 firms are able to access this market. Usually the companies with rating above 'A' can access this market. Of late the private equity and other investors, that have a game plan to acquire the firm, or merge with other companies, invest in NCD with lower ratings. The rating scale for all such issues continues to be the usual long-term scale AAA to C. The companies have to agree with a trustee for a payment structure that can vary from T-1 to T-3 and sometimes additional security in the form of debt service reserve account (DSRA) needs to be provided.

**Guarantees and support from parents**

Weak companies whose stand-alone ratings are speculative often produce extra credit enhancing mechanism in the form of explicit guarantees, comfort letters, escrow of certain cash flows etc. Such companies receive rating with suffix SO ('Structured Obligation'). It may be noted that the structured finance rating of a mortgage backed securities (MBS), and securities backed by receivables also receive the same symbol, but are evaluated differently. The latter are subject to substantial regulation from both SEBI and RBI.

**MSME Ratings**

Most small firms borrow via informal financing at exorbitant interest rates. They put their own money, borrow from the family, relatives, friends, and then money lenders. Banks come up with small percentage of financing of SMEs. Hence, in order to encourage the financing, both GOI and RBI have come up with many stipulations. The GOI scheme encourages rating of small firms and RBI makes it obligatory on the part of banks to lend money to MSME.

The NSIC has laid down a scale for ratings of MSMSE form SE 1A to SE 5C. The letters A, B and C denote financial strength, with A meaning highest financial strength. The symbol 1 stands of the best operating performance capability. The MSME scale is shown below.

**NSIC – BWR Performance and Credit Rating Scale**

| | | Performance Capability | | | | |
|---|---|---|---|---|---|---|
| | | Highest | High | Moderate | Weak | Poor |
| Financial Strength | High | SE 1A | SE 2A | SE 3A | SE 4A | SE 5A |
| | Moderate | SE 1B | SE 2B | SE 3B | SE 4B | SE 5B |
| | Low | SE 1C | SE 2C | SE 3C | SE 4C | SE 5C |

**NGO Ratings**

The Companies Act has encouraged CSR activates for the corporate sector. Companies with revenue of more than Rs 1000 cr or net worth of more than Rs 500 cr or profit of more than Rs 5 crore have to contribute for CSR activity. Often the companies are confused about such donations, since many NGO are fly by night and do not have dedicated management. Brickwork has devised PROVEN methodology for such NGO. PROVEN stands for **P**eople,**R**esources and asset quality,**O**rganization structure,**V**alue creation,**E**fficiency in operational and financial management and **N**ourishment for growth. The scale for NGO grading is given below.


**Corporate Governance Ratings**

The new Companies Act has emphasized corporate governance ratings. In India we have pubic sector banks, where the CMD is the CEO. Even though the position of Chairman and MD are not separated, the PSU banks have high levels of transparency compared to the private sector. The private sector units run by MNCs have good levels of transparency due to the multinationals who follow their international policies and processes. On the other hand, Indian private sector units run by an identifiable promoter or family has to be rated carefully. The corporate governance provisions encourage boards with independent directors and are suspicious of majority share holder directors. These provisions sometimes make one wonder if it is a crime to start a new company which will be in any case run by the independent directors. The asymmetric information problem in equity markets, the principal agent problem is usually low if the firm has one shareholder with substantial stake. If the company is owned 100% by an entrepreneur, the principal agent problem is the least. He can be expected to take most decisions in favour of the company. One needs to also look if the management is acting to the detriment of minority shareholders. The scale for corporate governance rating is given below.

| | |
|---|---|
| **BWR CG 1** | Quality of Corporate Governance is **the highest** |
| **BWR CG 2** | Quality of Corporate Governance is **very high** |
| **BWR CG 3** | Quality of Corporate Governance is **high** |
| **BWR CG 4** | Quality of Corporate Governance is **adequate** |
| **BWR CG 5** | Quality of Corporate Governance is **moderate** |
| **BWR CG 6** | Quality of Corporate Governance is **inadequate** |
| **BWR CG 7** | Quality of Corporate Governance is **low** |
| **BWR CG 8** | Quality of Corporate Governance is **the lowest** |

**Rating penetration**

In spite of so many products, the rating penetration in India is very low. For instance, India has 30 million firms. Only 0.5% are rated. As more firms are rated, the trade and commerce will flourish.

**Conclusion**

Credit ratings in India are expanding in many areas. While there are areas for them to improve, they are being guided well by two regulators SEBI and RBI. The products and methodologies are disclosed on the website. The rating penetration has to be improved in India. Apart from SEBI, RBI many other central government and state government agencies are encouraging to improve rating penetration. NSIC, IRDA, PFRDA, IREDA, tourism departments, education departments of state governments are also involving rating agencies to improve penetration.