Rebuilding Confidence in Credit Ratings

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Credit rating agencies (CRAs) have been the subject of attention particularly since last September 2018 when IL&FS and its group companies were downgraded from AAA to D within a few months. Many stakeholders believe CRAs in India would need to work harder to address the market concerns regarding the analytical rigour, the robustness of the rating processes and importantly, their governance structures.

The recent developments notwithstanding, it will be difficult to deny that the ratings industry has played an important role and has been successful in making Indian financial markets more transparent than before. Weaker credit ratings systems will be a regressive step that will take India's capital markets back by three decades. Hence it is important to rebuild confidence in the concept of credit ratings and in the agencies offering the ratings services. A robust eco-system for credit ratings is clearly a prerequisite for deepening the bond market in India, one of the key objectives for the Government.

SEBI had started to take steps to strengthen the regulatory framework for CRAs since the global financial crisis in 2008. Over the last 3 years in particular, multiple guidelines have been issued to standardize the rating processes across all the agencies and make them more transparent from the market perspective. The latest guidelines released in June 2019 propose the creation of specific default rate benchmarks for each rating category which will go a long way in improving rating standards in the industry and ensuring performance slippages by any of the CRAs are quickly identified by the market participants.

We believe that the regulators and the market participants collectively need to explore a few important ideas which can not only strengthen the regulatory steps already taken by SEBI but also enhance the comfort levels of the investors and lenders on ratings in a significant manner. They are:

- → Review of investment regulations from various regulators
- → A regulator supervised process of assigning a rating agency to an issuer, and
- → Mandatory dual ratings for large debt transactions
- → Explore rotation of CRAs

Need for review of investment regulations

Currently, the investment regulations for provident and pension funds or even insurance sector only favour sovereign, semi-sovereign, public sector debt and at the very best, highly rated private sector debt. Provident and pension fund regulations do not permit investments in private sector companies rated below AA. Over time, this has created a **"perverse"** incentive in the debt capital markets for 'high safety' or even 'highest safety' ratings. Several hundred private sector (non-govt) companies in India including non-banking financial companies (NBFCs) have either the "highest safety" or "high safety" ratings which enable them to access long term funds from these investors at highly competitive rates. Such numbers or even proportion (as a percentage of capital market ratings) are clearly elevated from the statistical perspective even if we adjust for the companies which enjoy strong support from their highly rated multinational parents. In a challenging operating environment, such high ratings are tested as has happened over the last one year and the increase in the default or transition rates in these categories are a clear testimony to the quality of such ratings.

In our opinion, there is a strong case for a revision in the extant investment regulations in India. While ensuring the interest of the retail investors and the safety of their investments, it is possible to remove the investment restrictions on lower rated papers. Some of our suggestions are given in the paragraphs below.

Provident funds are already permitted to invest up to 15% of their corpus in equity and equity linked instruments such as mutual funds which are typically high-risk assets. Similarly, a specific part of the corpus or investment portfolio can be earmarked for deployment in **lower rated i.e. A or BBB category** and higher yield papers. In order to ensure that the credit risk in the portfolio does not increase significantly, individual company exposure limits can be kept at a modest level and on an aggregate, these lower rated exposures can have a maximum ceiling of 15%-20%.

With regards to the choice of CRAs, any restrictions put due to lower experience or track record in bond ratings by fund manager or even the issuer would be unfair. As has been witnessed in the domestic credit rating landscape particularly of late, experience or track record of a CRA is no guarantee of better quality or more stable ratings. Nevertheless, dual ratings can be made mandatory for all bond issuances to ensure that biases if any of a specific CRA is taken care of. Further, the fund managers or the regulators can also decide to restrict the use of the ratings of any particular CRA if their ratings performance is consistently below the benchmarks proposed to be laid down by SEBI in terms of default rates.

In case the government or the regulator would want a

certain segment of employees to avoid exposures in lower rated debt for their PF and pension funds completely, such choices can also be provided through the creation of separate sub-funds as is the existing practice in insurance schemes. Adoption of technology and monitoring of these funds by independent agencies should make such segregation feasible where employees or investors can have access to an investment portfolio broadly based on their risk appetite.

In our opinion, several advantages will accrue to the financial markets if rating-based investment restrictions are removed. Firstly, the quality of ratings will improve significantly over the long run as any sort of "pressures" to assign high or highest safety ratings will tend to ease. The distortions in the rating distribution witnessed in the Indian debt capital markets today will thereby reduce. The issuer will still have access to long term funds with a lower rating albeit the pricing may be higher than expected. Importantly, the stability rate of such ratings would be higher and over a period of time, give higher confidence to the fund managers to invest higher amounts even in "adequate or moderate safety" papers.

Algorithm based & Regulator Supervised CRA Appointment Mechanism

Currently in the conventional rating system, the issuers pay for the rating assignment. This system is favoured by all stakeholders because this enables free dissemination of ratings information to public eliminating information asymmetry. The perceived issue of conflict of interest is addressed through, inter alia, advance payment not linked to rating outcome, and strict firewall of analytical process and people. However, the issue of conflict can be totally eliminated by using an independent system to assign a rating mandate to a rating agency for debt and money market transactions. The selection of CRAs for bond ratings can be made on a digital platform based on an algorithm using absolutely objective and transparent criteria decided by the regulator and available in public domain. This will eliminate the need for aggressive sales methods or a large sales team (as is the norm for most CRAs) to acquire new clients and totally eliminate the conflict of interest that can affect the process of choosing a rating agency. Initially, such a process can be made applicable for regular bond and also Commercial Paper (CP) issuances where the minimum market exposure exceeds say Rs. 500 Cr and over a period such a limit can be reduced progressively.

Mandatory Dual Ratings for Large Debt Exposures

Dual ratings of bonds should be made mandatory so at any point of time the investors will have access to at least two credit ratings on an outstanding bond assigned by CRAs selected through an independent and transparent process as highlighted above. While dual ratings of Commercial Paper (CP) have been made mandatory by RBI, it is limited currently only for frequent and large issuers and can be further extended for all gross annual issuances exceeding Rs. 100 Cr. While dual ratings by themselves may not ensure the quality of ratings, they are healthy for the financial markets as they provide alternative credit views to the investor community and can offset the biases, if any of a single rating agency. This will also ensure a fair opportunity to those CRAs who have good expertise and robust processes but don't have the advantage of a long track record and a large sales team.

Since RBI is shortly expected to release guidelines for the development of a secondary market for corporate loans, it will also make sense to extend the system of dual ratings for all bank loan exposures say exceeding Rs. 500 Cr.

Explore Rotation of CRAs

In the current scheme of things, very large issuers who frequently access the debt capital market manage to get their issues rated by the same 1-2 CRAs over many years, even decades. Such long-term association or relationship leaves the scope of an impression that the rating opinion after all is not unbiased and may have been subjected to influence. Often, many highly rated issuances are priced at a significant premium over the benchmark spreads in that rating category, reflecting such apprehensions. A mandatory rotation may change this perception and increase confidence in the assigned ratings.

The critics of the CRA rotation policy have argued that ratings and audit are not comparable and have highlighted many disadvantages of such a mechanism including the risk of aggressive ratings, rating shopping and lack of availability of longer-term default or ratings transition data. The aspects that may be considered in this context are:

- If the CRA is aware that another rating agency will have to provide an opinion on the debt instrument in the near future, it will be careful while assigning an aggressive rating in the first place; even the issuer will not opt for 'rating shopping' and demand a higher rating than deserved as there will be a downside risk with another CRA (particularly if not selected by them); further, the standardization of category-wise default rates proposed by SEBI will reduce any such aggressive stance by the CRAs going forward
- CRAs will actually have a motivation to ensure that the rating reflects the true credit quality of the issuer when they are being rotated out and this can significantly improve the rating standards. Since a rotation would not mean a very long-term business opportunity, the commercial considerations, if any will have minimal impact on the rating decision.
- Corporate debt market will still have adequate and reliable default or transition data if the rotation is made mandatory after 3, 4 or 5 years. The regulator and the market participants may find a 3-year transition data adequate to assess performance of rating agencies. More importantly, no assessment remains meaningful if an issuer is allowed to enjoy the ratings from the same agency for decades.

- This will also **eliminate unhealthy competition** between the CRAs. Under the current system, the bond issuer and rating agencies have an almost permanent engagement. Such a situation can trigger a mad rush among CRAs to acquire a client at any cost particularly in a scenario when the overall ratings market is growing slowly and the larger ones are listed. A rotation policy can mitigate this risk to a significant extent.

The market regulators and participants should therefore give a serious thought to the concept of CRA rotation which has already been proposed by the Parliamentary Committee and should not dismiss it away without a meaningful debate.

Conclusion

Needless to say, Indian bond markets cannot be developed or deepened further without a healthy eco-system of external credit ratings. Indian markets have already seen CRAs functioning over the last three decades with transparency and disclosures steadily improving over time. Recent events however, have tested the robustness of their processes and the quality of their ratings. The time is therefore opportune for addressing a few fundamental challenges in the existing system that constrain objectivity and independence. In our opinion, some of the steps outlined here can go a long way in restoring the credibility of the CRAs and maintaining the integrity of external credit ratings.