Rebuilding Confidence in Credit Ratings: There is really no option

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Today everybody is talking about restoring confidence in credit ratings as the string of defaults especially in the financial sector in 2018 and 2019 did dent the reputation of the rating agencies. The fact of the matter is that just like lenders grant loans to borrowers by taking risk with their capital, ratings agencies bet their reputation behind assigning a symbol anywhere from “AAA” to “D”, after understanding the plethora of data that is garnered and discussions had with the company and stakeholders. In a way the CRA is valued by its reputation. At times, the data does not come in, or in some cases is incorrect due to gaps in audit. This is the classic issue of asymmetric information espoused by Joseph Stiglitz which is very relevant to the rating business where the borrower knows more than the CRA. But the final needle of blame turns to the CRAs which take a reputation hit when there is a default. This happened in the USA when the Lehman crisis struck and in India of late though there have been past episodes of default in the NBFC sector.

CRAs must be very careful when giving ratings as defaults can lead to fines being imposed by the regulator which further tarnishes the reputation of the agency. It is interesting that whenever such a crisis happens everyone looks at the rating given by CRAs. As aggrieved investors it is understandable as money lost is a financial blow. The same umbrage is not caused when bank NPAs increase. Indian banks made provisions in FY19 and FY20 to the extent of Rs 3.2 lkh cr and Rs 2.6 lkh cr respectively and wrote off around Rs 2.4 lkh crore each in these two years. They are supposed to lend based on their internal evaluation which may or may not be at congruence with that of CRAs. But CRAs are held more responsible.

Investors like mutual funds, insurance companies, pension funds, provident funds have investment departments which are supposed to do their evaluation before taking decisions. However, when defaults happen the standard answer is that decisions were taken based on CRA ratings. Ideally these investors should be questioning the CRAs on ratings when their views are different if the financial system is to be strengthened. However, this is the reality and that is why CRAs must rebuild this confidence in the market.

The major challenge for the rating agencies is that when an initial rating is mandated, companies provide all information that is necessary. However, when the annual surveillance has to be done (which is mandatory until repayment) and the company is not doing well, there is limited response. This is where the conundrum comes in. CRAs have perforce to give a rating based on limited information available and run the risk of erring even as it comes under what is called the INC category (investor not cooperating). At times, the annual reports have fudged accounts and it is not possible to do a forensic audit. Yet, if a decision is taken based on incorrect accounting as per regulation the onus falls on CRAs. Hence from a situation where the stance of the CRA was that it was only giving a credit opinion and not advising an investment decision it is now responsible for everything that goes behind this rating.

What is the solution? The market is unforgiving, and the regulator will never condone an incorrect action and while the rules of the game have been finetuned there is still no action on companies which do not provide accurate data. Therefore, CRAs must continuously monitor the clients and ensure there is zero room for failure. Here there are two things that must be done.

The first is internal where there must be fool-proof systems in place to make the system robust. The system must be made seamless, and the process flows streamlined. Having clear responsibilities for analysts and ratings heads and ensuring a committee approach to giving the ratings is necessary. Further leveraging technology in the process chain has its merits. Conflict between business and ratings has already been addressed post Lehman by regulation. Today the top-down approach where there is direct oversight by a Board level Rating Committee ensures there is strict compliance on all grounds. By making the Chief Rating Officer answerable to this Board Committee and not the CEO, any conflict with business has been eliminated. A grievance redress mechanism through an external committee has also been put in place to ensure that issues can be resolved. The external committee now also debates in detail all cases where the ratings are not in alignment with the industry i.e. higher than those given by others. These are internal controls that have been developed by CARE Ratings which ensures there are checks and balances everywhere.

The other is external where CRAs must strengthen market intelligence. This is necessary and goes beyond the formal accounts that are examined in detail. There is need to keep in touch with the market which means talking to all stakeholders of borrowers. Let us look at some of them. A constant talk with the bankers gives an idea of where the account has any problem or not. While there are confidentiality agreements in place, a personal rapport helps a lot. Second, the supply chain is important if it is a manufacturing unit. Talking to them gives one an idea of whether the company is paying on time and hence the creditors position is known during the year. The end-of the year accounts can always be managed and the idea is to keep track of what happens during this interim period.

Third in case of a financial institution it is useful to talk to borrowers to get a feel of how loans are being given and the rates being charged. It has been a practice that the germination of any crisis takes place during boom times because human frailty assumes that it will last forever which leads to excess risk-taking while riding the wave. A casual conversation with a sample of customers helps one gauge better the pattern especially during a boom phase. Therefore, one must keep 'smelling' all developments in this business.

It is here that Akerlof's theory of detecting 'lemons' in the second-hand car market which involves signalling comes into play- but in reverse. CRAs have to pick them up through innovative means. Being part of the grapevine is always useful and, more importantly, all actions taken by the companies must be looked at carefully. There are bits of information which are put on the stock exchange sites which should be tracked as they could have implications on the future of the company. This also means having a strong grasp of the industry and this is where independent research is required to interpret the situation when doing ratings. Ideally early warning indicators need to be drawn up informally which can raise the antenna.

CRAs also must keep talking to the investors regularly in terms of knowledge sharing on the industry performance. The cumulative default rate (CDR) and rating transition matrices are regulatory compliances that must be bettered by the CRAs. Defaults in the higher rating categories can skew the results for an extended period as it is reckoned over a period of 2-3 years. Further, a handful of say 10 cases of defaults overwhelms the fact that there are 10,000 other ratings which were spot on. While the amounts involved with these cases would hit the eye as was the case in the last couple of years, the fact is that CRAs get their act right most of the times.

One must accept that in any financial sector business things will go wrong at times. This happens with banking or the NBFCs. It holds for CRAs too. The risk is higher when funds are involved and not goods and hence all crises have their genesis in the financial sector. The 'temptation to cheat' is higher when funds are transferred from the institution to the borrower. Misuse of funds is possible and even 0.1% bad apples can create a problem. Balance sheets are no longer simple to read and at times analysts may have to think like 'what if I were to misuse the funds' when evaluating a loan.

For the corporate debt market to develop the CRAs play a critical part as everything goes on the basis of the rating. Practically speaking the rating given by the CRA is held sacrosanct even by lenders on most occasions as it helps to meet their internal objectives. The pressure to perform and retain investor confidence is on the CRAs as any setback can push back the system by years. There can be, to use the cliché, no excuses.

Views are personal