Rating Industry in India: The journey so far and what lies ahead

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Credit Rating Agencies operating in India under the oversight of SEBI as the Master Regulator and with RBI playing its part in the bank loans space have contributed significantly to the development of the domestic debt and loan markets. This has been achieved by (a.) expanding the avenues for issuers/ borrowers and investors/lenders, (b.) brining to fore "new to market" entities who otherwise would have remained obscure and unknown to the larger market beyond the incumbent lenders, and (c.) playing a catalytical role in market disintermediation through dissemination of ratings. The rating industry has played an important role to help the lender / debt investor find "quality credit" who were hitherto only in the exposure list of specific banks and institutions. The advent of bank loan ratings has made it possible to transition some highly rated, "quality" borrowers of banks as issuers in the money (Commercial Paper) and debt markets (Bonds & Debentures). This has also created an unintended ripple effect. Banks are now able to redeploy the capital released from such exposures to other bona-fide borrowers who otherwise cannot approach the debt market due to their size and/or constitution.

Indeed, the rating industry has, in recent years, faced some headwinds and heightened regulatory scrutiny given a few high-profile credit events involving a couple of highly rated credits in the financial services sector. However, a lot of changes have been brought about by SEBI in the way ratings are monitored now and also publishing information about the rating performance of the agencies by themselves that augurs well for the industry and users of ratings. A few of the changes are outlined below:

(a) Increased surveillance of rated credits: A non-exhaustive list of monitorable events and avenues to search and source information have been specified for rating agencies to keep track of developments in the rated entities and the industries which they pertain to.

(b) Introduction of clauses in agreements: Issuers are now under contractual obligation to furnish certain types of information once sought by the rating agency within pre-defined and agreed timelines.

(c) Progressively reducing dependence on issuer provided information: Debenture Trustees are required to independently and directly inform the rating agency about the timely debt-servicing by issuers within one day of each and every date earmarked for debt-servicing. All rating agencies have adopted a common, industry-wide "Standard operating procedure for monitoring and recognition of defaults" and also disclosed the same on their websites. One of the clauses includes relying on the rating action of another rating agency that recognises default of an issuer as an input for another rating agency to review its outstanding rating(s) on that same issuer.

(d) Time bound dissemination of rating actions: There are pre-defined timelines to announce and disseminate rating actions depending on the rating action viz. fresh rating assigned, a rating action on an outstanding rating (other than default recognition) and default recognition.

(e) Transparent disclosure of rating performance and timeliness of actions: Rating agencies, whether listed or not, have half yearly disclosures to make to stock exchanges and depositories (NSDL and CDSL) and annual disclosures to publish on their websites in a time bound manner. There is a harmonization of the methodology and computation to be used for arriving at the annual default rates and average transition rates.

All these initiatives are expected to support the internal exercises that CRAs have taken to strengthen their internal systems and processes and ensure consistent and timely rating actions.

However, rating agencies have been witnessing a challenging trend where a significant proportion of rated borrowers refuse to co-operate with the incumbent agency by furnishing necessary data and information and paying the contracted annual fees. This is particularly true for borrowers with exposures below a certain threshold which can vary across banks. Given that an increasing number of banks do not seek ratings from borrowers whose sanctioned limits and loans are below a certain threshold, these rated borrowers have hardly any incentive to co-operate with the incumbent rating agency and provide information necessary for a rating review. As at end of June 2021, 20,529 out of 58,000 unique rated entities (accounting for over 35%) are flagged as "Issuer Not Cooperating" and do not have a live rating from any rating agency. The phenomenon of rated borrowers slipping out of rating coverage is not only a lost opportunity for the credit eco-system but also fraught with several risks and should be discouraged. Some of these risks include:

1. No independent opinion by a rating agency is available as a reference point or to benchmark the bank's internal risk rating
2. The capital allocation for the bans' exposure is not commensurate with the risks involved and therefore, there is a likelihood that banks may be inadequately capitalised on its borrower portfolio where the ratings are updated due to non-cooperation.
3. It is a lost opportunity to develop a healthy credit eco-system in India where updated and reliable credit opinion will be available across a very large number of entities be large, mid or small. It is also not a healthy development as it works against fostering and developing a disciplined credit culture. Maintaining the rating is a strong incentive for the issuer to be serious about timely debt servicing.
4. Borrowers lose an important tool in negotiation. Rating is a powerful and possibly an important tool while dealing with existing and potential lenders to secure not only the most competitive interest rates but also terms and conditions including collateral which are consistent with the rating level.
5. As an increasing number of rated borrowers exit the coverage by rating agencies, the issue of information asymmetry gets accentuated. A rating rationale which is a free report available to anyone, anywhere across the world becomes nearly meaningless once the rated entity stops cooperating with the incumbent rating agency.
6. CRAs start to lose data on a large number of credits. Such data on credit behaviour across economic cycles and across sectors is very important to develop credit models and also to validate such models.

The stage of growth that Indian economy is in and to address the challenges of unemployment currently prevalent, attracting higher quantum of capital is critical. At a macro level, availability of live and reliable credit ratings on a large number of borrowing entities provides comfort to potential investors and also convey an important characteristic and structure of the debt or loan market of the country. Availability and coverage of a large number of entities through ratings is one of the indicators of the disciplined process involved in the lending and investment decision making. The number of outstanding ratings on bank loan facilities is viewed as a precursor to the growth prospects of the debt market. External ratings on a large number of borrowing entities is also a measure of the maturity of the financial sector and also that of the borrowers/issuers and lenders/ investors. Thus, it is imperative that an entity that has entered the coverage of external ratings is not disincentivized for remaining under rating coverage.

Given the increased accountability and regulatory interventions, rating agencies are now expected to differentiate themselves through the quality of their rating process and timeliness of rating actions. At this stage, policy measures must be directed to ensure that rating agencies do not indulge in aggressive competitive behaviour in a shrinking market. Instead, if policy measures can aid the expansion of the overall, addressable market size, it will foster continuous improvement in the rating processes and facilitate use of technology and adoption of techniques to help rating agencies deliver high quality rating outcomes.