Issues Related To Credit Rating Agencies In India

This editorial is based on the article **“Singed by downgrades, NBFCs want rating agencies reined in”** which appeared in 'The Hindu Business Line' on 8th May, 2019. The article talks about problems with Credit Rating Agencies (CRAs), and how these agencies can be regulated.

What Is A Rating Agency?

Credit rating is an informed opinion of a recognised entity on the relative creditworthiness of an issuer or instrument.

In other words, it is an opinion “on the relative degree of risk associated with timely payment of interest and principal on a debt instrument”. Such recognised entity is known as Credit Rating Agencies (CRAs).

On What Basis Do CRAs Rate?

CRAs typically rate on various parameters which is different for ‘companies’ and ‘countries’.

What are the problems associated with CRAs?

Internationally

- **Ideological biases:** CRAs might favour certain political ideologies to limit negative policy and market surprises as they strive to keep ratings stable over the medium term.
    - For e.g. a panel analysis of Standard & Poor's, Moody's, and Fitch's rating actions for 23 Organisation for Economic Co-Operation and Development (OECD) countries from 1995 to 2014 shows that left executives and the electoral victory of non-incumbent left executives are associated with significantly higher probabilities of negative rating changes.
- **Conflict of interests:** CRAs are funded by the very companies they rate.
- **Lack of ability to predict:** CRAs follow the market, so the markets alert the agencies of trouble. This happens post-market and after something has happened. This is the reason for CRAs inability to predict frequent near default, default, and financial disasters.
- **Negligence & incompetence:** Methodology of CRAs has come under question. For example, even after using different methodologies, the result for sovereign debts

comes the same. It is also alleged that, CRAs can make sound judgement on rating, but they didn't make an effort to do it.

For e.g. Moody accepted that it did not have a good model on which it could have estimated a correlation between mortgages backed securities, so they made them up.

- **Politically motivated:** It has also been alleged that CRAs, through their rating mechanism forces the govt to follow the path prescribed by them.
  - For e.g. during the turmoil in Tunisia, S&P issued a report warning of "downward ratings pressures" on neighbouring governments if they tried to calm social unrest with "populist" tax cuts or spending increases.
  - Further, after Crimea annexation rating agencies downgraded the rating of Russia.
- **Policy meddling:** In 2003, to stop predatory lending, state of Georgia brought a law. Other states of USA were to follow the suit, until S&P retaliated. And it is well known that **predatory lending** is responsible for financial crisis of 2008-09. [*definition: predatory lending includes any unscrupulous actions carried out by a lender to entice, induce and assist a borrower in taking a loan that carries high fees, a high-interest rate, strips the borrower of equity*]

National Credit Rating In India

- **No uniformity among rating companies in India:** An average investor in India is not able to understand the different credit ratings prevailing in India as there is no uniformity among the credit rating agencies.
- No standardization in rating and no standardized fee structure for rating agencies in India is one of the other issues.

Why Credit Rating Agency Is Required?

From the 80s onwards, as the financial system became more deregulated, companies started borrowing more and more from the globalised debt markets, and so the opinion of the credit ratings agencies became more and more relevant.

Role of CRAs

Reduce information asymmetry

- Since CRAs get access to the management of the company, and confidential information about its working, they can give an informed opinion about the ability of an instrument to meet its obligations.
- Utility for issuers Issuer concisely communicate the quality of their issue through the rating of the CRAs which help it established its creditworthiness.

Gatekeepers for financial markets

- CRAs provide tangible benefits to financial market regulators by reducing the costs of regulation.
- Regulators such as RBI use CRAs to improve the awareness and decision-making of their regulated entities.
- For instance, credit ratings are used to determine the capital adequacy of banks, the resolution of stressed assets.

Purveyors of regulatory licenses

- Some financial regulators mandate that certain instruments must be rated mandatorily before they are issued.
- Extensive integration of CRAs into the financial system transforms their role as purveyors.

Moral Suasion

It compels developing countries to pursue more prudent and sensible monetary and fiscal policies.

Instances When Rating Agency Failed

- **World-wide**
- Enron scandal-2001
- Global Financial Crisis-2007-08
- During the global financial crisis, hundreds of billions of dollars' worth of triple-A-rated mortgage-backed securities were abruptly downgraded from triple-A to "junk" (the lowest possible rating) within two years of the issue of the original rating (2007-08).
- **India**
- The collapse of Satyam-2009
- PNB crisis
- IL&FS (Even with AAA ratings

Why CRAs Should Be Regulated?

- **Rating shopping**: It has often been seen that both issuer and investor are involved in rating shopping.
  - CRAs inflate the rating particularly for structured product market for getting more market share and profit margins. Issuers want higher ratings for their products, so they look safer and can be sold at a higher price. Higher rated securities allow investor less security, which in turn allows investor to take greater risk.

- Investors also wanted inflated ratings due to regulatory requirements and investment mandates.
- **Oligopolistic Tendencies**: Around 95% of market is controlled by only 3 CRAs VIZ. **S&P , MOODY'S and FITCH**. Further they use expansionist marketing.
  For e.g. Hannover Re lost a big chunk of market share when it didn't pay up service fee (it was initially promised a free service by CRAs).
- **Hegemonic Control:** As the big three CRAs are located in North America, America exerts a great control on the functioning of CRAs.
  - **When CRAs downgraded USA, CRAs were fined**.
  - UK was rated lower than USA, even when the fiscal deficit of UK was lower than USA. Thus, rating of countries was not done in an objective way.
- **CRAs have great control on the world economy as their ratings can result in the flight of capital from any given country**.
- **CRAs are not accountable to any country and moreover their functioning is not transparent**.

Way Forward

International

In response to the Global Financial Crisis of 2008-2009, US Congress passed the **Dodd-Frank Wall Street Reform** and Consumer Protection Act in July 2010.

- Legal liability of credit rating agencies should be increased.
- Use of credit ratings in regulations that set capital requirements and restrict asset holdings for financial institutions should be removed or replaced.
- **With the help of technology, open source models, such as Credit Risk Initiative of National University of Singapore Risk Management Institute, with fully transparent inputs and outputs should be created and promoted**.
- **It encouraged CRAs to invest in due diligence, strengthen internal controls and corporate governance, and improve their methodology**. But some of the following provision of it are still unimplemented:

National

- The Indian regulators (such as SEBI and RBI) should review their regulations and suitably modify them to ensure greater objectivity, transparency and credibility in the whole credit rating framework.
- For resolving conflict of interest disclosures being made by credit rating agencies should also include important determinants such as:
  - Extent of promoter support
  - Linkages with subsidiaries
  - Liquidity position for meeting near-term payment obligations

- **Regulators in India may consider other options as well, such as 'investor pays model' or 'regulator pays model' after weighing the relevant pros and cons**.

  Alternately, within the existing framework, the appropriate rating fee structure, payable by the issuer may be decided by SEBI, in consultation with RBI and the credit rating agencies.
- **Rotation of credit rating agencies:** Under the current framework, there is no provision for the rotation of credit rating agencies.
  - **Mandatory rotation of rating agencies should be explored**. [definition:*mandatory audit rotation imposes periodical breaks to audit engagements and is intended to avoid excessively long relationships between the auditor and the client*]
  - This would aid in avoiding negative consequences of long term associations between the issuer and the credit rating agency. This is particularly significant considering the recent instances of failure of credit rating agencies identifying trouble in their client-entities.

Drishti Input:

Despite all the problems of credit rating agencies, it remains a necessary evil. Discuss.
