



Credit Rating in India

Why in News?

- Reserve Bank of India (RBI) has pinpointed the conflict of interest in the functioning of credit rating agencies and is concerned over the role of the little known club of 'rating advisers', which are unregulated entities acting as brokers between companies and rating agencies.
- Recently the Financial Stability and Development Council (FSDC) panel has discussed ways to address challenges pertaining to the quality of credit ratings.
- Recent IL&FS defaults crisis which had AAA rating (AAA: The instrument with AAA rating is considered to have the highest degree of safety in respect of timely servicing of financial obligations) just before it started defaulting raised concerns about the credibility of Credit Rating agencies in India.

What is Credit Rating?

- A credit rating is an assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation.
- A credit rating can be assigned to any entity that seeks to borrow money — an individual, corporation, state or provincial authority, or sovereign government.

What are Credit Rating Agencies?

- A credit rating agency (CRA) is a company that assigns credit ratings, which rate a debtor's ability to pay back debt by making timely principal and interest payments and the likelihood of default.
- There are six credit rating agencies registered under SEBI namely, **CRISIL, ICRA, CARE, SMERA, Fitch India and Brickwork Ratings.**
- CRAs were set up to provide independent evidence and research-based opinion on the ability and willingness of the issuer to meet debt service obligations, quintessentially attaching a probability of default to a specific instrument.
- Evaluating the creditworthiness of an instrument comprises of both qualitative and quantitative assessments, making credit rating far from a straightforward mathematical calculation.

Importance

- **For The Money Lenders**
 - **Better Investment Decision:** With credit rating, lenders get an idea about the credit worthiness of an individual or company (who is borrowing the money) and the risk factor attached with them. By evaluating this, they can make a better investment decision.
 - **Safety Assured:** High credit rating means an assurance about the safety of the money and that it will be paid back with interest on time.
- **For Borrowers**
 - **Easy Loan Approval:** With high credit rating, banks will approve loan application of borrowers easily.
 - Credit ratings will enable independent benchmarks for pricing debt, ushered in a culture of financial discipline, helped allocate capital efficiently by pricing risk appropriately, and supported financial innovation.

Issues

- **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.
- **Distinction between equity instruments and mutual funds** is not provided which is one of the major drawback of credit ratings in India.
- **Lack of reliability of Credit rating** in India: Even credit-rated companies have failed in India and there is no remedy for this. Example CRB Capital Markets, which had a turnover of Rs.1,000 crores per year and with a credit rating of 'A', failed, and neither SEBI nor RBI could come to the rescue of investors.
- The credit rating agency in India **lacks transparency**.
- After the creation of credit rating agencies, the country has witnessed stock scam and the failure of CRB Capital Markets. This only reflects poorly on functioning credit rating agencies.
- It is the duty of credit rating agencies to forewarn the regulating authorities about the weaknesses and drawbacks, if any, of the companies they are rating and they should ensure to do so at all costs.
- There is conflict of interest with **"issuer-pays" model**, wherein the fees to the CRA is paid by issuer himself. This has to be switched to **investor-pays** model. Issue of rate-shopping, pick and choose.
- Because of **high entry barriers** for entering credit rating, there are not sufficient CRAs in India, hence there is no competition.
- There is no method to seek the accountability of CRAs - "who will rate the rating agency".

Way Forward

- CRAs should refrain from providing advisory services to the rated companies, even via subsidiaries, as this entails conflict of interest. SEBI may look into this as part of its regulatory practices for protecting investors.
- Rating Agencies should avoid arriving at ratings with limited information, even if it means foregoing that mandate.
- CRAs should operate on fixed fee structure, restricting competition to quality and not pricing, increase objectivity of rating models, thereby reducing subjectivity and cognitive bias.
- Government should build a surveillance policy, imposing stringent monitoring of an outstanding rating.
- Increase accountability of CRAs to provide better protection to consumers; this one will need intervention by Sebi by affixing some monetary or business implications. For example, restricting a particular CRA from re-rating an entity that defaulted above a threshold for a certain period of time.

After IL&FS crisis SEBI tightened guidelines for CRAs

- SEBI has asked credit rating agencies to analyse the deterioration in the liquidity conditions of the issuer and take into account any asset-liability mismatch while reviewing ratings.
- Besides, rating agencies will also have to disclose any linkage to external support for meeting near-term maturing obligations.
- SEBI also introduced a specific section on liquidity among key rating drivers to highlight parameters such as liquid investments or cash balances, access to unutilised credit lines, liquidity coverage ratio, adequacy of cash flows for servicing maturing debt obligation among others.
- While carrying out 'monitoring of repayment schedules', CRAs should analyse the deterioration in the liquidity conditions of the issuer and also take into account any asset-liability mismatch.
- If a subsidiary company gets support from the parent group or government, credit rating agencies will have to name the parent company or government that will provide support towards timely debt servicing.

Conclusion

- SEBI's directives have potential to make ratings more dynamic and align even to short-term market changes. SEBI's new guidelines could make CRAs pro-active; the ratings will hinge less on historical data and more on current and future risks or trends.
- CRAs need to introspect and strengthen their rating criteria, methodologies, processes, and oversights. Conflicts, if any, need to be addressed to reassure stakeholders on the ratings process.

PDF Refernece URL: <https://www.drishtias.com/printpdf/credit-rating-in-india>

