General Studies-3; Topic: Effects of liberalization on the economy

Credit Rating Agencies (CRA)

1) Introduction

- Credit ratings were central to the global financial crisis that began unfolding in 2008.
- Over the last few years, India has been struggling with its own credit failures.
- Corporate defaults, such as IL&FS (Infrastructure Leasing & Financial Services), require us to take a critical look at the financial system and learn from these failures.

2) Credit Rating Agencies in India

- A credit rating agency (CRA) is a company that rates debtors on the basis of their ability to pay back their interests and loan amount on time and the probability of them defaulting.
- Credit rating agencies in India came into existence in the second half of the 1980s.
- Some of the credit rating agencies registered under SEBI are: CRISIL, ICRA, CARE, SMERA, Fitch India and Brickwork Ratings.

3) SEBI's Directions

- The Securities and Exchange Board of India (Sebi) tightened disclosure standards for credit rating agencies while assigning ratings to companies and their debt instruments.
- The regulator directed that rating agencies must now disclose the liquidity position of a company being rated.
- If the rating is assigned on the assumption of cash inflow, the agencies would need to disclose the source of the funding.
- Rating agencies must disclose their rating history and how the ratings have transitioned across categories.
- Credit rating firms will also have to analyse the deterioration of liquidity and also check for asset-liability mismatch.

4) Why this move by SEBI

- Experts say rating agencies in India often failed to consider cash flows and ground conditions before assigning a rating.
- Rating agencies came under the spotlight following the crisis at IL&FS and its group entities.
- The agencies faced criticism that they had failed to see the financial troubles in the group and adjust its rating of IL&FS when its debt jumped by 44% at the end of March 2015.
- IL&FS was rated AAA (the highest rating) right up until it defaulted on its huge debt.
- With IL&FS being too big to fail -- it accounts for 16 percent of the banking sector's exposure.
- This prompted the regulator to review the rating standards.

5) Impact

- Disclosures of a company’s financial situation and cash flows will help certain investors and funds in making an informed decision and prevent over-reliance on ratings.
- A rating rationale will increase accountability as ratings assigned would need to be backed by strong reasons.
- Disclosure of ratings track record will help investors decide on the quality and trustworthiness of the rating.

6) **Concerns / Challenges**

- Too many disclosures for the rating can put additional onus on the rating agency, prompting them to assign a conservative rating which may not be good for investor sentiment.
- SEBI has failed to touch upon an important issue -- the issuer-pays model for rating agencies.
- In India, as in many countries, the company looking to raise debt, picks the rating agency that will rate their debt. This may lead to 'rating shopping'.
- As long as the company has a right to choose and pay a rating agency, there will always be the threat of conflicts of interest and oversight.
- Another important issue that is who will ‘rate the rating agency’ is not looked into. The accountability is lacking.
- The credit rating market in India has high barriers to entry, which prevent competition that is vital to protecting the interests of investors.
- Without a sufficient number of alternative credit rating providers, quality standards in ratings will not improve.

7) **Way Forward**

- India’s rating agencies have to be more responsible and careful while assigning fresh ratings, especially before assigning any AAA rating.
- This would ensure that ratings remain stable and does not require overnight correction.
- It is also time to rate rating agencies themselves.
- A form of an ‘investor pays’ model can be considered by Sebi, where the rating fee is borne by all investors who subscribe to a debt issuance, in proportion to the size of their bids.
- The RBI should also insist that bank borrowers obtain multiple ratings with the regulator picking the agency.
- Competition combined with reward for good performance will enhance the quality of ratings.
- Structural reforms are needed to bring accountability to the credit rating industry.
- Structural reform should aim to solve another severe problem plaguing the industry, which has to do with rating shopping and the loyalty of credit rating agencies in general.
- Rating agencies will have to come up with lucrative business models that put the interests of investors above those of borrowers.
- Such a change requires a policy framework that allows easier entry and innovation in the credit rating industry.