Recent Issues on Credit Rating Agencies[1]

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While a fair share of the blame for the current global financial crisis has been apportioned to credit rating agencies (CRAs), Indian stands as an exception. A committee, authorized by the High Level Coordination Committee on Financial Markets (HLCCFM) to revisit comprehensively the legal and policy framework regarding the CRAs, recently concluded: *"Prima facie, there is no immediate concern about the operations and activities of CRAs in India even in the context of the recent financial crisis. However, there is a need to strengthen the existing regulations by learning the appropriate lessons from the current crisis."* Further, while the world is revisiting the regulatory framework for CRAs, based on the lessons from the recent global financial crisis, India has already comprehensively overhauled the regulatory framework with a view to improving the quality of services rendered by the CRAs.

Unlike the experience elsewhere wherein the CRAs performed badly in the rating of structured products, defaults in structured products in India had been negligible. India has been witnessing a very healthy growth of the market for rating the various instruments. The financial year 2004-05 witnessed rating of corporate debts valued at $ 48 billion. This increased to $ 176 billion in financial year 2008-09, a four-fold increase in four years. Interestingly, the financial year 2008-09, which was indeed a very bad year at least for the debt market, witnessed such huge volume of ratings. During the first half of the current financial year, the CRAs have rated corporate debt securities valued at $ 140 billion. Besides corporate debt, the CRAs also rate structured products, brokers, corporate governance, etc.; they grade initial public offers (IPOs) and do many other activities. These activities are increasing in direct proportion to the growth of the securities market, which has been spectacular in the last decade. Further, all forecasts indicate that India will experience strong growth of financial markets over the next decade due to buoyant domestic demand and huge infrastructure investments. This will translate into increasing business opportunities for CRAs in India, provided they conduct themselves responsibly.

Accountability

Mr. Thomas Friedman commented in 1996: *"There are two super powers in the world today in my opinion. There is the United States and there is Moody's Bond Rating Service. The United States can destroy you by dropping bombs, and Moody's can destroy you by downgrading your bonds. And believe me it is not clear sometimes who is more powerful."* This was true in 1996 which may not be so in the aftermath of the 2008 global financial crisis. Be that as it may, this raises the issue: Do we have an institutional mechanism to ensure that the CRAs exercise the power with responsibility and accountability? What are the powers of the CRAs? By their ratings, they influence the behavior of investors and issuers and affect

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resource allocation, cost structure and competition. Are they legally accountable for their ratings? No, they do not have any legal liability for inaccurate ratings. On the top of it, ratings sometimes have unintended consequences. For example, ratings drive out poor issues by discouraging promoters with poor record from accessing the markets. If there were no rating, there would have been a market for all grades of instruments. The first issue, therefore, is how to hold the CRAs accountable for their ratings? The ways to do are many: promote competition, improve public awareness about the use of rating, disclose incomes received by the CRAs from related parties / activities, disclose policy, methodology and procedure relating to ratings, etc. Generally, there are a few ways to ensure accountability. One is disclosure. Disclose, for example, the default history or performances of the ratings over time. This will affect the volume of business they can get. Another is the maintenance of records. For example, mandate a CRA to record the factors underlying a rating and sensitivity of such rating to changes in these factors. Similarly, if a quantitative model is a substantial component of credit rating process, the CRA should record the rationale for any material difference between the credit rating implied by the model and the rating actually assigned. These records should be available to auditors and regulators for scrutiny. One extreme measure being suggested now-a-days to enforce accountability is: put rating fees in an escrow account and release the same to the CRA only after the ratings have performed as expected.

Wither the CRAs?

The next issue is the raison d'être of the CRAs. Do we really need the CRAs? Are they relevant today when the world follows disclosure based regulations? One extreme view is that they are not in a better position, in comparison to the market, to decipher the default risk present in an instrument. Empirical evidence from some countries suggests that markets do this information processing in a better manner than the CRAs. Some academics argue that by analyzing the market price, it is possible to infer the effective credit rating of each instrument. Since market prices are available at near zero cost, there would appear to be no role for the CRAs. After all, the CRAs are supposed to bridge the information asymmetry between the issuers and the investors. Do they have access to better / more information than that is available publicly to all investors? Probably, 'No'. Further, the quality of the rating is as good as the quality of the financial statements. This, in turn, depends on the quality of the audit and the governance standards of issuing companies. Generally, the lower / middle managers of the issuers suppress the bad news. Senior managers are under pressure to show better financial results quarter-after-quarter and suppress some more bad news. Auditors, thus, get filtered information and, hence, come to know less adverse information than the management of the companies. Further, the efficiency of the auditors may not be the best everywhere, when creative accounting hides more than it reveals and there are balance sheets where nothing is left on the left side and nothing is right on its right. Therefore, the exclusive dependence on the audited financial statements may not be in the interest of the quality of ratings. The CRAs need to supplement and cross-verify the financial statements with information from formal and informal sources and their own in-house research.

Another extreme view is that though the CRAs are supposed to reduce information asymmetry, they at times contribute to information asymmetry. They do it in many ways. First, the strength of the CRAs is that they have

financial information and they are able to condense the same into a few letters. Each of them has condensed information into a series of incomparable alpha-numerals with different connotations, not easily intelligible to the investors. Another view is that they abet the creation of products with intricate structures with high credit ratings beyond the comprehension of ordinary investors. They abet the creation of all kinds of structured products. Sometimes they abet the creation of even funny products. For example, in India, we have a product called ELD. The principal as well as the return on this instrument is linked to the value of some equity share or an equity index. There is no guarantee of return of even the principal amount, yet it is called a debenture. The CRAs were supposed to make life simpler, but they have made life more difficult by complicated product structures and a plethora of alphabet soups.

And yet another view is that the reliance on the ratings accentuated the current global financial crisis. Accordingly, there is a call on the authorities to reduce the reliance on the credit ratings. The Financial Stability Board (FSB), in particular, has called upon the standard setters and authorities to: (i) reduce the reliance on the CRA ratings in standards, laws and regulations; (ii) encourage banks, market participants and institutional investors to have the capacity to make their own credit assessment; and (iii) educate users of the fact that the CRA ratings are not a substitute for the due diligence, including an assessment of the credit and other risks. Fortunately, the FSB has proposed that ratings could be used during the transition period when the participants develop their own credit risk assessment capacity. I believe, the FSB is providing a window of opportunity when the CRAs can reestablish their credibility.

Competition

The next issue is competition in the CRA space. It is axiomatic that we want competition. But, do we promote competition and how do we do it. Historically, the authorities and the CRAs promoted oligopoly, if not monopoly. The NRSRO (Nationally Recognised Statistical Rating Organisations) model of the US Securities and Exchange Commission (SEC) perpetuated the dominance of the established players. Under this regime, a rating agency cannot become NRSRO unless its ratings are nationally recognized, yet they cannot be nationally recognized unless recognized by SEC as NRSRO – a classic 'chicken and egg' problem. This insurmountable barrier to entry limited the number of CRAs to three in the US. India has five CRAs while the business in India is a fraction of that in the United States. However, the Credit Rating Agencies Reform Act of 2006 established a registration and oversight regime for CRAs. This has subsequently increased the number of NRSROs to ten.

Another barrier to competition is the first mover advantage. The first comers come up with some rating symbols. These symbols get themselves registered in the minds of the issuers and the investors. They fail to take notice of any new symbols coming subsequently. This is the reason why larger and better firms prefer for rating their products the CRAs with established symbols. This perpetuates oligopoly. To add salt to the injury, there is too much of product differentiation by the CRAs. For example, there is no standard definition of default; practices vary from one CRA to another CRA. Some consider even a single day's delay as a default. Others consider the grace

period, in case the debt covenants provide for it. Some do not consider delay in payment of coupon in the case of long term instruments as default. When financial literacy is at a nascent stage almost everywhere, which will remain so always in all countries, thanks to the fertile brains of financial engineers, multiple practices and symbols keep confusing the investing community. In the interest of competition, there is a need for a framework agreed upon by all the CRAs and the regulators to have a standardized and operational definition of default and the disclosure of the defaults to be made accordingly. Similarly, various symbols need to be organized in a comparable format and the multiple ratings to be disseminated in a comparable table. These symbols also need to be comparable across jurisdictions to enable the investors to participate in the global issues, which would promote global competition.

Another way to promote competition is to allow unsolicited rating, i.e., a CRA can issue a rating even if it has not been assigned by the issuer to do so. It has the danger that if a CRA does not get a job from issuer, it may issue a less-than- warranted rating which would undermine the issue. In the interest of transparency, the CRA should disclose the extent of participation by the issuer and its management, bankers and auditors in the credit rating process and the information used and the sources relied upon in arriving at and reviewing the credit rating. In the interests of the investors, a CRA should monitor and disclose credit rating during the entire life of the rated securities, as if it were a solicited rating. To avoid the possible conflicts of interests, the CRA should disclose all the unsolicited ratings carried out by it in the last few years and of them, the names of the issuers who were given solicited ratings in the recent years.

Regulation

The issue is: should the CRAs be regulated? Till recently the CRAs generally argued that their reputation was at stake and the users would approach them for rating only if their opinions carry credibility with the investors. This thought process postponed the regulation of the CRAs in the West. The US and the European markets have seen CRA regulations coming up only in the latter half of this decade. Since the source of the conventional wisdom was the West, the CRAs in Asia also clamoured for no regulation. There was tremendous pressure on the regulators in India not to bring the CRAs within the ambit of regulation because they were not regulated in the West. India was among the first countries in the world to have formally adopted a regulatory framework for CRAs way back in 1999. India also proactively brings about amendments to these regulations in line with the evolving market dynamics, the most recent one being in May, 2010. The Regulations cover all aspects of a CRA's functioning with respect to ownership, code of conduct, operations, conflicts of interests, etc. and have served the market well over the last decade.

The financial crisis has settled the issue that the CRAs need to be regulated. What is not yet settled is the extent of regulation. Should regulations standardize rating methodology or ratings? Should regulations standardise the methodology or make the CRAs disclose their rating methodologies? I think, regulation should promote transparency and governance, and quality and fairness of rating, rather than managing the rating itself. Regulations

should not stifle innovation and competition while protecting the interests of investors.

Who should regulate CRAs?

Generally, two aspects of rating are regulated. One is the regulation of rating as such and the other is the regulation of the use of the rating. While the rating is regulated by one regulator, many regulators prescribe the use of rating for various purposes. For example, in India, the CRAs are regulated by SEBI, as the primary users of rating are the investors in securities. However, the central bank, the insurance regulator and the pension funds regulator have prescribed that their regulated entities can invest only in investment-grade instruments or can accept investment-grade instruments as collaterals, or prescribed different hair-cuts for different grades of instruments for margin purposes. Since the users have a stake in the rating, the regulators of the users are claiming to regulate the CRAs also. The use, therefore, brings a CRA under the jurisdiction of many regulators. The issue is: Should a CRA be regulated by one regulator or many regulators simultaneously? This kind of issue is generally resolved by adopting a primary or lead regulator model. The CRA should be registered and regulated by the regulator for securities market. They may acquire further accreditation with other regulators, if felt necessary, for rating products that come in their regulatory domain or that are used by their regulated entities. The respective regulators may independently frame guidelines in respect of activities coming under their purview. If a CRA is to be inspected, it should be carried out by only one team which has representation from all the concerned regulators to oversee the areas of activities governed by such regulations.

The related issue is what can a CRA rate? Only securities? All financial instruments? All matters in the financial markets? Or beyond? The CRAs do not limit themselves to the rating of credit only. They rate securities and many other financial instruments such as bank loans, grade IPOs, etc. There are rating agencies, which are not CRAs, yet they provide rating services such as SME rating, individual credit assessment, rating of builders, etc. In order to clearly signal which ratings are regulated, no entity shall bear a name having the words 'credit rating' unless it is registered as a CRA with the securities regulator, and to be eligible for registration as a CRA, it must incorporate the words 'credit rating' in its name.

Who Should Pay?

Conflicts of interests arise from two sources, one is who pays and the other is who receives. Who should pay for the rating? In the aftermath of the current global financial crisis, the whole world has been debating on this. There are generally three models: the issuer pays model, the investor pays model and the public agency pays model. Generally, there are four criteria based on which these models are assessed. The criteria are: conflicts of interests, wide availability, continuous surveillance, and competition. It is generally believed that the issuer pays model has an inherent bias in favour of higher-than-warranted ratings to the issues that are rated. Some discount this belief on the logic that the ratings are uniformly distributed across the entire rating scale. If the ratings were influenced by the issuers, most of the issues would have carried high ratings. Further, ratings are widely available under this model

and, therefore, it reduces information asymmetry. This model provides access to the CRAs to company management on a regular basis ensuring continuous surveillance on the rated credits. Under the user pays model, source of conflicts shifts from the issuer to the user. It is believed that the user pays model has inherent bias in favour of lower-than-warranted rating to provide higher return to the user. It also believed that the downgrades are not prompt as investors try to avoid marking-to-market their assets. These beliefs are not tested in the absence of data. Further, only big users get it and small investors do not have access and, therefore, the ratings are not widely available. Issuers may not provide complete information to the CRAs. As a result the quality of the ratings as well as the surveillance suffers. The public agency pays model leads to control over rating agencies. The rating is perceived to be carrying a government endorsement. Government being an issuer through PSUs, the conflicts of interests embedded in the issuer pays model also surface. This model may not ensure continuous interaction with the issuers and, hence, surveillance becomes a casualty. This brings complacency among the CRAs leading to inefficiency and no incentive to do a better job. Besides, there are practical problems in the sense that which agency will rate which issuer. Thus, there are some problems with all the models whether the payer is the issuer, the user, or the public agency. India debated extensively and decided to continue with the investor pays model and found the other two models either not desirable or not feasible. It also decided to manage the conflicts of interests associated with it through greater transparency and disclosure and better governance practices.

Conflicts of Interests

There are a large number of sources contributing to conflicts of interests. First is that most of the CRAs are for-profit organizations. In their endeavour to maximize the profits, they may relax their standards to get more business. The issue is: will a not-for-profit model solve this problem? Yes. But it would raise another set of problems. Can there be CRAs who are neither for-profit nor not-for-profit organisatons? Can they be just profit making, and not profit maximizing? This is a matter of debate.

The second conflict arises from the fact that CRAs have parents and siblings and off-springs. There may be directors common to the CRA and its associates and the rated companies and their associates. The employees of the CRAs and their dependants may have stake in the companies being rated. CRAs may be in the business of consulting and advisory services, either directly or through sister organizations. If a subsidiary has advised credit enhancement of a particular structured instrument, the CRA would find it extremely difficult later to downgrade the rating. These conflicts are generally handled by several prescriptions in the Regulations. Generally, the regulations mandate that a CRA shall not offer any fee-based service to the rated entities beyond the ratings. It also mandates an arms-length relationship between the CRA activity and other activities. India has gone a step further. It has recently specified that:

1. A CRA shall formulate the policies and internal codes for dealing with the conflicts of interests. It shall ensure that its analysts do not participate in any kind of marketing and business development, including negotiation of fees with the issuer whose securities are being rated. It shall also ensure that the employees

involved in the credit rating process and their dependants do not have ownership of the shares of the issuer.

2. Similarly, a CRA shall disclose the general nature of its compensation arrangements with the issuers. It shall disclose, in case of accepted ratings, its conflicts of interests, if any, including the details of relationship – commercial or otherwise – between the issuer whose securities are being rated / any associate of such issuer and the CRA or its subsidiaries.

3. A CRA shall disclose annually

   a. its total receipt from rating services and non-rating services;

   b. issuer-wise percentage share of non-rating income of the CRA and its subsidiary from that issuer to the total revenue of the CRA and its subsidiary; and

   c. names of the rated issuers who along with their associates contribute 10% or more of the total revenue of the CRA and its subsidiaries.

Public Awareness

We have prescribed various disclosure by the CRAs. For example, a CRA is required to disclose its policies, methodology and procedures in detail regarding solicited and unsolicited credit ratings. Further, a CRA shall disclose not only the history of the credit ratings of all outstanding securities, but also the average one-year and three-year cumulative default rates for the last 5 years. Do the investors understand such disclosures? Quite often I have heard investors arguing that how can price of a AAA-rated bond go down or how can it be illiquid. In fact, many investors do not have the basic understanding that rating is not a recommendation to buy, hold or sell certain instruments. They do not know that it is specific to an instrument and not the issuer of the instrument. The CRAs need to educate investors that the rating is just one of the inputs to decision making. Credit related information is dynamic and subject to changes. Higher rating of a security does not mean that it has all the desirable qualities of a security. It is in the interest of the CRAs that they deemphasize the rating, otherwise they themselves would attract disrepute.

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