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TRENDS IN CREDIT RATING AND THE ROAD AHEAD

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"Ratings are important owing to the existence of imperfect markets and existence of asymmetric information between lender and borrower."

In a dynamic and complex financial world, credit rating plays a crucial role in providing individual and institutional investors with information that assists them in determining whether issuers of debt obligations will be able to meet their commitments. A credit rating is an opinion on relative degree of risk associated with timely payment of interest and principal. The analysis for the same is based on past trends and future prospects. Rating agencies thus play a critical role in assessing the credit worthiness of any corporation or country. Ratings are important owing to the existence of imperfect markets and existence of asymmetric information between lender and borrower.

Historically, companies and other borrowers have been taking loans from the banks, wherein the banks have their own mechanisms to verify the credit worthiness of the borrower. This was the reason behind intermediation where the bank takes money from the public in the form of deposits and deploys the same to borrowers by evaluating the loan proposals hence addressing the issue of credit risk. However with the opening up of the market and increased financial requirements of the companies, various other sources of funding are now available. One fall out was the process of disintermediation where the ultimate lender and borrower met directly thus saving intermediation costs. This resulted in a boom in both the equity market (IPOs) as well as debt issuances such as bonds, debentures and commercial papers. But, opening up of the financial markets also resulted in little information available to the investors about the risk associated. While the balance sheet provides information in a standardized format, interpretation of the same is not easy for the lay investor. This is where a credit rating agency made a difference by evaluating the debt servicing ability of the borrower and providing a rating denoted by a letter of the English Alphabet (AAA, AA, A, B, C and D). SEBI had since then made it mandatory of the companies to acquire credit rating for any amount of debt raised from the public.

> "Credit rating assesses risk in the financial system. The main purpose of a credit rating is to bridge the information asymmetry between the issuer and investor of any financial instrument. While the issuer might know that it may or may not be able to service the instrument, the investor may not be in a position to take an informed decision."

Why do we require credit rating?

Credit rating assesses risk in the financial system. The main purpose of a credit rating is to bridge the information asymmetry between the issuer and investor of any financial instrument. While the issuer might know that it may or may not be able to service the instrument, the investor may not be in a position to take an informed decision. This is where the CRA provides an unbiased view on the state of the entity and its ability to meet its commitment on time. While some large firms may have in-house expertise to do so, most investors would need this opinion from a neutral party.

Credit rating is a necessity in today's world as there is no alternative signal available to the market about the worthiness of a financial instrument. Such signals are used by multitude players for taking decisions. Several investment houses like provident and pension funds make their investment solely on the basis of this rating as their by-laws do not allow them to take on high risk investments. Even large investment houses with in-house expertise would like to have an additional credible and independent opinion before taking investment decisions. At the retail level, credit rating does perform a very useful task of bridging this information asymmetry. However, a rating is only an opinion and not a recommendation to invest in any instrument. Interestingly, institutions such as pension funds and

Insurance companies have internal investment policies where their fund deployment is linked with the credit rating given by the CRAs.

The USP of a rating for the investor is that once a rating is accepted, the company has to perforce have a surveillance conducted by the CRA until the debt is repaid fully. This way there is complete tracking of the performance of the company and its servicing record.

As a regulatory requirement by SEBI, any amount of debt raised by companies from public has to be rated by a credit rating agency. Although only public issues are mandatory to be rated, it has been observed that private placements are also seeking rating, proving that CRAs indeed add value and provide unbiased opinion. This has helped in the growth of the corporate debt market in the primary stage and the rating industry had performed well as is evidenced by the cumulative default ratios which are comparable to those in other countries.

The year 2007-08 was a turning point for the credit rating industry when the banking sector too was assimilated in the system. The RBI, which had been working along with the BIS in introducing the framework in stages, had implemented the concept of credit rating by an external rating agency for calculating the risk weighted portfolio of banks which would finally be used for reckoning capital. The BASEL II guidelines, as they are called, require banks to provide capital on the credit exposure as per credit ratings assigned by approved credit rating agencies. Thus, banks need to get their portfolio rated under bank loan ratings for loans of above Rs 10 crore. However, very often banks had asked their clients with even less than Rs 10 crore exposure to get rated by the CRAs. This helped banks in fixing capital requirement as well as the client who would get the advantage of a lower interest rate.

The other significant development in the rating space has been the involvement of the government in encouraging the SME segment to get ratings from CRAs. Here a subsidy scheme is provided by Govt. of India through NSIC (National Small Industries Corporation) to SMEs which get them rated. This rating also helps them procure a loan from banks on more advantageous terms.

CARE and Ratings

CARE Ratings commenced its operations in April 1993 and over the two decades has established itself as the second largest credit rating agency based on rating income. CARE Ratings has been committed towards offering a range of high-quality services to all stakeholders in the capital market with its experience and expertise. Having rated a large volume of debt of around Rs. 54,701 billion (as onDecember 31, 2013) since inception, CARE Ratings has played a critical role in eliminating information asymmetries and building investor confidence in the Indian capital market through the expression of unbiased, independent, fair and transparent credit opinions based on in-depth research and rigorous analysis. CARE had around 7500 clients as of December 2013 and in FY13, completed around 7500 assignments with total volume of around Rs 7.8 lkh crore of debt rated.

The primary focus for CARE has been to provide credit rating services in India. CARE has long years of experience in rating debt instruments and related obligations, and has covered a wide range of sectors, such as manufacturing, services, banks and infrastructure. With regards to conventional debt-ratings, CARE rates short, medium and long-term instruments, such as commercial paper, bonds (including perpetual bonds), debentures, preference shares, structured debt instruments etc. Also, rating of bank loans and facilities are an important component of CARE's rating portfolio.

With the systems becoming complex, rating services can be extended to other products such as Edu-grade (an assessment of the effectiveness of inputs and processes provided by an educational institution in achieving the objectives of the course), project star rating (an assessment of the ability of the developer to construct the real estate project with the agreed quality standards), MFI grading (onetime assessment of a Micro Finance Institutions (MFI) operational and financial capability to undertake and sustain the target level of operations) etc. Intuitively, it may be seen that there are several opportunities for grading quantities that needed to be sifted by the ultimate users based on professional opinion.

The road ahead

Given the $1 trillion estimated investment in infrastructure sectors in the 12th plan, the demand for investment will increase substantially necessitating the parallel growth of the debt market as the private sector will have an important role to play here. Also, the increased penetration by the pension funds and insurance companies will provide boost to the bond market.

Bank loan ratings have been a major pillar for the rating business ever since the introduction of Basel II ratings. The progressive growth in bank credit, which should be typically in the region of 18-20% once the economy recovers and is on the 8% plus growth path, will mean that this canvas will widen further. Quite clearly, the CRAs will have a progressively more important role to play especially so as business cycles will be more frequent in the country and quality of health of the issuers of debt would be a variable to be tracked relentlessly.

D. R. Dogra is Managing Director & CEO of CARE Ratings, which is the second largest credit rating agency in India in terms of rating income. He has over 35 years of experience in the financial sector in the areas of banking and credit rating. Under his leadership, CARE has acquired Kalypto Risk Technologies, opened its first global office in the Republic of Maldives, forged ties with other global rating agencies to create of a global rating agency, ARC Ratings and has been listed on the bourses.

He is Board Member and Non-Executive Chairman of ARC Ratings, S.A.He holds the position of Director, Chairman of Membership Committee and Member of Training Committee at Association of Credit Rating Agencies in Asia (ACRAA), Manila, Philippines. He is a public interest Director (approved by SEBI) on MCX-SX, Member - FICCI Maharashtra State Council and member of WR Economic Affairs Sub-Committee of Confederation of Indian Industry (CII).

He is also an Expert Member of the Academic Advisory Committee in Finance Area, Birla Institute of Management Technology and on Board of Governance of Universal Business School, Mumbai.

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