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Sifting the Facts From Fiction in Credit Ratings

Guest Column

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There is need to address several issues that have pervaded the mindset relating to credit rating where facts have been distorted based on convenience or perception rather than practice.

The first issue is that the rating agency gets higher fees if the client gets a higher rating. The truth is that the fee is paid in advance along with the mandate. So there is no question of charging a fee depending on the rating.

Second, it has been argued that to avoid conflicts, the fee should be paid by the investor and not the client. This will be quite cumbersome as a single instrument might have many investors. In case of capital market instruments which are traded, the paper passes hands over time and it is not possible to track the same.

The major issue in the 'investor pays' model will be how to force issuers to give information for review of ratings if there is no contract between the issuers and the CRA. This is why the model has not succeeded anywhere in the world. Besides, if the 'issuer pays' model has conflict, the 'investor pays' model will also inherently have a bias towards lower ratings. At another level, 'investors pay' model will be advantageous to CRAs as there will be multiple fee flows for a single company.

Third, it is often felt that in this industry, there can be rating shopping. But we should remember that the ultimate user of the rating is the investor and not the client. The investor will not accept the rating of a CRA which does not have credibility. Interestingly in the US market while there are 10 recognised CRAs, only two to three are popular with investors.

Fourth, rating companies have a perverse incentive to give higher ratings to get market share. While there is a conflict of interest between business and ratings, CARE Ratings has resolved this by having a multi-layered rating process.

The first stage of the internal rating committee comprises members who do not have any business target and perform the analytical function. Next, there is an external rating committee which assigns all ratings that are investment grade at the time of initial rating and all surveillance cases where the rating band changes.

> **A credit rating adds a very important dimension to information dissemination**

Here, the majority members (four out of five) have no relation with the management, shareholders or board of directors at all, and are truly independent. While talking about addressing conflict of interest, other CRAs which have discontinued the 'External Rating Committee', can effectively emulate this structure.

The fifth issue is that if ratings are suspended, there is something amiss and the CRA wants to hide something. A rating is suspended when information required for the rating exercise, which goes beyond what is in the public domain, is not supplied by the client. As there is a regulatory responsibility for the agency to apprise the investors of the situation, the only option is to suspend the same. Publicly available information has its own shortcomings and in-depth information including business plans, interaction with the management etc is required to assess future debt servicing ability.

Sixth, it has been reported that there has been a spate of downgrades in the market with a lot of media attention making it seem a bit exaggerated. In general, most of the downgrades happen in the sub-investment category.

Seventh, it has also been argued that rating outlooks provide value and have to be present to add a direction to ratings. However, it is seen from publicly available data that close to around two-thirds the ratings of a CRA which have been downgraded have been from 'stable' outlooks. Just about 20% of these downgrades actually occurred from cases with specified 'negative' outlooks (balance were on credit watch or did not have an outlook). If this is the case, we really have to ask ourselves whether outlooks serve the intended purpose or have misled investors, and are more of a disservice than service.

The last issue relates to correlation of market pricing with the rating. Market pricing is more often than not asymmetric, and is a function of demand and supply of paper. It may not always truly reflect the fundamentals of an issuer. It also varies with time, duration, size of investment as well as the sector in which the issuer company operates and not just the rating.

Hence, a credit rating adds a very important dimension to information dissemination, which bridges the information asymmetry in the financial system. CRAs have to perforce adhere to the industry best practices as the market, which is the ultimate judge, is unforgiving.

(Views are personal)