RATINGS AGENCIES: IMPORTANCE, IMPACT AND OUTLOOK

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Background

Credit rating plays a crucial role in providing both individuals and institutional investors with vital information that helps them in determining whether or not issuers of debt obligations will be able to meet their obligations on a timely basis. It is hence an opinion on relative degree of risk associated with timely payment of interest and principal. The analysis of the same is based on past trends and future prospects and is hence quite all-encompassing. At a more macro level, they also assess the credit worthiness of a country. The concept of ratings has grown in importance owing to the existence of imperfect markets which has resulted in the prevalence of asymmetric information in financial markets.

Traditionally under the system of financial intermediation borrowers have been taking loans from the banking system where the banks have used their own mechanisms to verify the credit worthiness of the borrower. This is the value added service performed by them where they channeled deposit money into loans. However with the opening up of the market and increased financial requirements of companies, various other sources of funding are now available through the disintermediation route. This resulted in a boom in IPO market as well as debt issuances such as bonds, debentures and commercial paper. However, this also resulted in little information being available to the investors about the risk associated with such debt. While regulation ensured that there were detailed reports available for these issues, interpreting the same was a challenge for most investors.

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Purpose of credit rating

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 may know that it may or may not be able to service the instrument, the investor would not be in a position to assess the same. This is where the Credit Rating Agency (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 an unbiased party.

A credit rating is an opinion on the creditworthiness or the relative degree of risk of timely payment of interest and principal on a debt instrument. It is a commentary on the relative likelihood of default in comparison to other rated instruments and therefore provides a benchmark for measuring and pricing credit risk. It compresses an enormous amount of diverse information into a single alphanumeric symbol, such as AAA or A1, which is used to convey a credit rating. Currently rating agencies have standardized rating nomenclature for long term ratings, short term instruments, medium term ratings, fixed deposits, corporate/issuer credit rating, long and short term debt fund portfolios, IPO grading etc. However, it must be reiterated that it is only an opinion and that investors have to use their own judgment as a rating is not a recommendation to buy.

Credit rating is a necessity in today's world as there are no alternative signals available in the market about the credit worthiness of a financial instrument. These signals are used by multitude players for taking decisions like investment houses, provident and pension funds, insurance companies etc. which make their investment solely on the basis of this rating as their by-laws do not allow them to take on high risk

investments. At the retail level too, credit rating does perform a very useful task of bridging this information asymmetry.

Value provided by credit rating

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. It is hence possible for any investor to track the quality of the debt invested in over time.

The value of these ratings can be gauged not just by the growth in the corporate debt market where companies also take multiple ratings from different CRAs even for private placements where it is not mandatory. Further, in 2007-08 the RBI implemented the standardized approach to reckoning capital under BASEL II banking norms whereby all banks had to get their loan portfolio rated by external credit rating agencies (based on value of exposure) for calculating their capital requirements. This was considered superior to having banks do their own ratings as there would be a tendency to overstate the quality of their portfolio to save on capital. The bank loan business has added a major layer to the credit rating business and has in a way compensated for the low level of bond market activity in the last couple of years when infrastructure growth in particular slowed down due to low growth.

Future outlook

The outlook for credit ratings appears to be very positive given the structure of our financial system and the huge sums of money required for sustaining growth of 8-9% in GDP over the next decade or so. There are 4 areas that would see accelerated pace of credit rating.

1. The corporate bond market in the country remains under developed. The regulator has shown serious intent to deepen the corporate debt market, through announcements with regard to increasing investor participation in the corporate bond market by enhancement in the FII limit in G-Sec and corporate bonds, inclusion of short-term money market instruments for repo, introduction of Credit Default Swaps (CDS) for corporate bonds, and measures to enhance the role of standalone primary dealers in the corporate bond market. The increased penetration by the pension funds and insurance companies will provide boost to the bond market.

The corporate bond market acts as alternative source of funding in times when banks' balance sheets are weak and when they are rationing credit given alternative avenues for deployment. Besides, given the asset liability mismatches it is not possible to finance on a standalone basis long term projects. With banks' asset quality already under severe stress, and as they being very cautious in taking any further risk by lending to risky projects or sectors, corporates would have to resort to the either domestic bond market or overseas market for their funding requirements. Banks too would be raising capital for shoring up for Basel III and would necessarily have to be in this market as a seeker of ratings.

2. Secondly, the bank loan ratings market is still under penetrated. Bank loan ratings have been a major pillar for the rating business ever since the introduction of Basel II ratings. A part of the bank loans have yet not been rated. Further, the progressive growth in bank credit will mean that this canvas will widen further. New banking licenses will also result in increased business.

3. Thirdly, SME segment would continue to be the main focus of CRAs since scope of growth is high as out of the 1.5 million ratable functional SME units only around 10% have been rated. This sector still remains untapped. MSME segment is an integral part of the economy. MSME sector consists of around 26 million units and produces more than 6,000 products, providing employment to around 70 million people. 45% of the manufacturing produce comes from this sector. Performance & Credit Rating Scheme for MSEs implemented by NSIC is expected to drive ratings. Good rating would enhance the acceptability of the rated unit in the market and also enables it to access cheaper credit. It has been established that a rating for the SME helps in obtaining credit on more advantageous terms from banks and therefore this segment offers plethora of opportunity to CRAs.

4. Fourthly, owing to the presence of asymmetric information in various areas and to expand their rating portfolio into other related areas that go beyond conventional debt or bank loans. Fields like real estate, education, equity etc. have several players some of which are well established while others are relatively unknown. This is where credit rating agencies can make a difference by grading these entities based on the relevant parameters which provide a snapshot to the users of these products/services. CARE for instance has launched products such as Edu-grade, Equi-grade and Real Estate Star Ratings etc. and this perimeter can be extended to other fields too.

It is therefore clear that we do need a credit rating as there is no other signaling mechanism that exists today which is available to all investors. CRAs do play an important role in assessing risk and its allocation in an unbiased manner and also help to allocate capital efficiently across all sectors of the economy by pricing risk appropriately.

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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).

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