



CIO Dialogue

With Credit Rating Agencies

in partnership with





CIO Dialogue with Credit Rating Agencies

Background

Credit rating agencies are the first to come under fire when there are debt defaults – especially those that default from high rating categories. The role of rating agencies and the quality of ratings has been questioned, especially in the wake of the IL&FS default that crippled the economy. The concerns over ratings quality no longer remained an issue with investors – it became a national debate with Parliament seeking a review of rating agencies, including raising concerns over the inherent conflict of interest in the business model. The other enforcement bodies too were brought in and SEBI, as the dominant regulator of credit rating agencies (RBI regulates credit rating agencies for their ratings on bank loans), became prescriptive in its regulations. From its earlier laissez faire attitude, SEBI began articulating some parts of the process credit rating agencies would follow, including what inputs they would use in their assessment process.

Yet, rating agencies continued to defend their position, citing at times that investors' expectations were unreal. There is some merit in that argument. Ratings are expected to be an independent input into credit decisions, but for some investors, these have become substitutes – putting the entire system at risk for the failure of the rating agency. World over rating agencies have failed – they are not infallible – but what rating agencies have learnt from their failures and how they have strengthened their systems and processes to prevent a recurrence of such failure is important. While domestic rating agencies have indeed taken steps over the past 24 months to strengthen their analytical processes, including using more technology to capture market information as well as control work processes, these are not getting communicated enough to investors – this is an area that needs more focus.

National Stock Exchange (NSE) and Institutional Investor Advisory Services (IiAS) collaborated to host a roundtable, on 24 February 2020, between rating agencies and some institutional investors to discuss these issues and the ramifications of these for them both.

Demanding more from credit rating agencies

Credit rating agencies hold the mantle and consequently are first in the line of fire when it comes to sudden defaults by issuers, and sometimes rightfully so. Investors can create an ecosystem that strengthens overall ratings quality by demanding more from credit rating agencies and becoming selective in their choice of the credit rating agency. Independent of this, credit rating agencies need better self-regulation, else regulation will likely become suffocative.



Credit rating agencies become central to any sudden defaults by companies they rate – investors begin to complain about the quality of credit ratings, regulators become increasingly prescriptive, and civil society continuously raises concerns over the inherent conflict of interest of their business model. Regulation today is more prescriptive than in the past and borders on micro-management.

Credit rating agencies bear the cross as far as rating cliffs¹ are concerned. rating cliffs – where issuers default on debt despite being highly rated – tend to rile the market because of the sudden fall. This isn't to say that no rated credit should default – these just should not come as a surprise. Credit rating agencies are expected to monitor the

¹ Cliff credit rating is where a multiple-notch downgrade occurs, and issuers may even default. We have used the term 'default' to refer to this phenomenon.



outstanding credit ratings and ensure that these continuously depict a current reflection of credit quality.

For domestic funds and investors this problem is exacerbated in terms of their mandate, they tend to invest primarily in national 'AAA' and 'AA' rated paper. Any drop leads to a sudden scramble to exit, pushing prices lower.

Rating cliffs may occur for external reasons too – like the Supreme Court's decision to cancel coal block allocations. But investors are more understanding of such event-based debt defaults. Leaving aside these idiosyncratic risks, investors have a two-fold complaint: either the market knows of the credit deteriorating (and prices of the debt instrument accordingly reflect the credit deterioration) well before the credit rating changes, and that the credit rating agency completely missed material issues affecting the credit. Credit rating agencies' argument that the number of credit rating cliffs are insignificant in comparison to the over Rs. 200 trillion of rated debt (outstanding) no longer holds water. The IL&FS default crippled the economy, while the outstanding credit ratings continued to keep sending out the message that the credit was safe.



Despite the concerns, credit rating agencies should not be criticized with a broad brush. To assume that every credit rating agency is equally competent (or incompetent, for that matter) is a fallacy. Before looking at the credit rating symbol, investors would be well placed in first evaluating which credit rating agency has assigned the rating. Beyond that, understanding what credit ratings are – and more importantly, what they are not.

Understanding credit ratings and outlooks

Note: For the purpose of this report, we are commenting on plain vanilla credit ratings and not including the credit ratings on structured obligations as part of the discussion.

Credit ratings are defined as the ability of an issuer to service financial obligations (interest and principal) on time. But this is not a yes-or-no decision, credit ratings indicate a probability of default and not a guarantee against default. Therefore, it is not that issuers will not default on a debt instrument, just how likely is that default. This is why credit ratings are assigned across a scale – for long-term debt (over one year), the scale begins from AAA (highest safety) going all the way down to D (default). Simply put, a AA (pronounced double A) credit rating is safer than a single A, which is safer than a BBB (pronounced triple B) credit rating. Each credit rating category carries a '+' or '-' to show relative positioning of the credit quality within the category. Based on market conventions, credit ratings in the BBB category and above are considered investment

grade credit ratings (scaling the degree of safety), and those below are considered speculative grade credit ratings (scaling the degree of risk).

For the credit ratings quality to be good, the probability to default at a portfolio level should have ordinality across the scale. The probability of debt instruments defaulting should be lower for a AA credit rating category than for a BBB category, and so on. To this extent credit ratings are a relative rank ordering of the quality of credit.

Once credit ratings are assigned on the long-term scale, these are mapped onto the short-term scale for debt instruments with a maturity of less than one year (like commercial papers, or short-term loans). In addition to the mapping of the long-term scale to the short-term scale, an assessment of immediate liquidity is also factored into assigning the short-term credit rating. Short-term credit ratings are assigned on the scale of A1 to A4, and D if there is a default on the short-term debt. On the short-term scale, the relative positioning of credit quality within the credit rating category is decided using the '+' symbol – short-term credit ratings do not have a '-' symbol.



Credit rating outlooks are often attached to long term credit ratings – these are either stable, positive, or negative and depict the directionality of the credit rating over the next 18 months. However, this does not definitely signal a credit rating action – a positive outlook will not always result in a credit rating upgrade. Credit rating agencies in India began to publish credit rating outlooks in the early 2000s, although global credit rating agencies have been publishing credit rating outlooks for much longer.

Above all, stakeholders will do well to remember that credit ratings are not price calls on debt instruments, neither do they reflect any aspect of an equity investments. These are strictly related to financial obligations and not commercial obligations.

Credit ratings are not audits. Yes, credit rating agencies are required to ask a set of questions to sense check the financial statements, but if the financial statements are fudged, holding credit rating agencies responsible is perhaps too harsh. Credit rating agencies, like all other market participants, rely on auditors for the accuracy of financial statements.

For more on credit rating symbols and their definitions, please refer to SEBI's January 2011 circular, available here: <https://bit.ly/3joZmdI>



The complexity behind the simplicity of the credit rating symbol

The credit rating symbol simplifies the understanding of credit quality and simplifies comparing apples with oranges. While this helps lenders benchmark the risk, the process is far more complex than the simplicity of the symbol.

Credit ratings have to be futuristic, because these are assigned for debt that is being issued now, but will be repaid over the next few years – much like banks where the NPAs of today are a function of lending decisions taken a few years ago.

There are two parts to the analysis – the ability and the willingness to repay debt.

The ability to repay debt is established through an estimation of the issuer's future cash flow in relative context to its debt. This is mainly driven by the issuer's business and financial risk.

Even if companies generate sufficient cash flows, the debt repayment is hinged upon whether there is intent to repay or not. While credit rating agencies read this as management risk, there is a larger governance risk at play – an area that credit rating agencies would do well to focus on, given that this is a common thread across several credit rating cliffs.

After these factors have been addressed, additional issues such as debt subordination, possible support from the controlling shareholder (like the Government of India) or shareholder group (like the Tata group), or support to be extended to the group (as Vedanta Limited has done for its parent) are factored in.

Distilling all the issues into a single symbol is as much a science as it is a skill – and having the experience of seeing several credit ratings, through cycles, is essential to make the right call, since credit ratings are a relative positioning. Most credit rating agencies use a committee process in deciding the final credit rating.

In doing all of this, credit rating agencies have several challenges. While they are given access to unpublished price sensitive information, cooperation from the issuers is often wanting. Some issuers provide limited information and access to management, while others stop co-operating completely if there is a possible downgrade on the cards. Despite this, credit rating agencies are required to keep the credit ratings alive till the debt is repaid. If the issuer is listed, there is still reasonable amount of information for credit rating agencies to monitor the credit rating – but in case of unlisted issuers, it is a shot in the dark.

As bank loans began to get rated under the Basle II guidelines (earlier credit ratings were used only for capital market instruments), bankers influenced the credit rating process – by either encouraging credit rating shopping or getting their customers to not accept 'poor' or low credit ratings or downgrades because the risk weight for unrated debt was lower than the risk weight for speculative grade credit ratings. This usually translates into a higher borrowing cost. The rise in non-cooperating issuers reached a point where [SEBI came up with guidelines](#) on how credit rating agencies need to treat these credit ratings, and the terms and conditions of withdrawing the outstanding credit rating, even if the debt has not been fully repaid.





Investors' and lenders can create an ecosystem that rewards credit ratings' quality

All credit rating agencies are not equal. Although the degree of reliance on credit ratings differ it is important for both lenders and asset managers to take a proactive stance by demanding better credit ratings quality. They can do so by rewarding the 'better' credit rating agencies by purposefully choosing to invest in papers rated only by a selected set of credit rating agencies. If, based on credit rating quality, market forces drive the market share for credit rating agencies, there will be an imperative to improve credit rating quality all around. This is likely to be a more enduring solution for credit rating agencies, rather than increased regulation.

On the other hand, by not being discerning on the choice of credit rating agency, it could be argued that both lenders and investors are tacitly supporting credit rating shopping, thus compelling price, rather than quality, to determine market share of credit rating agencies.

We list out some indicators that allow both issuers and investors to differentiate between credit rating agencies:

1. **Credit rating transition and default studies, and probability of default:**
Although not a regulatory requirement, some credit rating agencies publish credit rating transitions and default studies annually – this is a best practice and is followed by credit rating agencies globally. The credit rating transition and

default studies help investors in terms of pricing debt, maintaining portfolio-level thresholds for credit quality (especially for debt funds), and defines the efficacy of the credit rating scale.

Credit rating transition studies show how credit ratings have changed over a defined period. This data must be looked at comparative to the credit rating category and across credit rating agencies. Credit ratings will change, but the relative speed at which these do reflects analytical strength – steadier the credit ratings, stronger the analytical quality. Higher credit ratings should typically show greater stability – credit ratings at the lower end of the credit rating scale tend to be volatile, because of the inherent vulnerability of the credit profiles in those credit rating categories.

One of the troubling reasons why credit ratings transition faster is that the credit rating agency assigns a higher credit rating to get the credit rating accepted by the issuer – once that is done, over time, the agency corrects the credit rating. With pressures to increase market share, some credit rating agencies have followed this practice at different points in time.

Credit rating default studies show transitions of credit ratings to debt default over a defined period. Regulations require credit rating agencies to publish cumulative default rates. Default from higher credit rating categories reflect poorly on the credit rating quality. Credit rating agencies try to manage this data by first downgrading the credit rating from an investment grade to a speculative grade credit rating, and then letting the credit rating move to default stage. Even so, past history of credit ratings defaulting speaks volumes the overall analytical quality.

Credit rating agencies have been [mandated to disclose the probability of default \(PD\) of each long-term credit rating category](#) against standardized and uniform PD benchmarks that SEBI has set. The objective of this disclosures is “to enable investors to discern the performance of a credit credit rating agency vis-à-vis a



standardized PD benchmark scale”. However, it is debatable whether the PD for a credit rating category can be standardized. The defaults across credit rating categories can change depending upon the economic cycle and will change year-on-year. Therefore, instead of comparing the PD against a uniform measure, investors will be better placed in comparing these across credit rating agencies, to establish relative analytical strength.

2. Tracking debt covenants

The debt markets have become far more sophisticated over the past decade, and credit rating agencies that keep pace will maintain their relevance. Although credit ratings are assigned for a specific debt instrument, credit rating agencies assess debt repayment capacity against aggregate debt. Therefore, unless the debt is subordinated, or carries specific characteristics (like credit enhancement structures, guarantees, or has some shades of equity), all bank loans, bonds, and other debt carry the same credit rating. While this worked for the market earlier, debt markets have evolved, and the debt covenants attached to each instrument can be different. Triggers for accelerated payments (on credit rating downgrades, or on exceeding pre-agreed debt levels) will have a cascading impact on a company’s liquidity, which may in turn impact the overall credit rating. Credit rating agencies, to this extent, must have a mechanism to track the debt after it has been rated and an ability to monitor instrument-wise covenants.



3. Investment in the credit ratings business

Although credit ratings use non-quantifiable information as an input, assigning credit ratings is a technical skill. To this extent, the degree of investments that the credit rating agency has made in terms of developing criteria for assessments, periodically training its analytical teams, having processes in place to assess the strength of its processes, review mechanisms to periodically review its own credit ratings quality are some of the questions both investors and issuers must ask credit rating agencies to disclose.

With the regulator becoming prescriptive, asking credit rating agencies to evaluate bank statements of issuers, monitor their entire portfolio of rated debt regularly, and maintain data and documents supporting the credit rating analysis, credit rating agencies need to implement technology tools that help them govern the operations and improve the quality of their analysis. Some of the credit rating agencies have created workflows on technology platforms, and web crawlers to capture news, data, and updates, while others have begun experimenting with automated data extraction and natural language generation. The technology-intensity of operations is perhaps reflective of the degree of control over processes and analysis held by the credit rating agency.



Because credit ratings must be forward-looking (assessing future credit quality), the judgement of the analytical team and the credit rating committee is critical. To this extent, credit rating agencies must be asked to publish the average experience (in credit risk assessments) of their credit rating committee members.

4. Addressing credit rating failures

Credit ratings have failed in a spate of instances. While never failing is an impossible task, credit rating agencies need to have processes to look back on the failures objectively and strengthen their systems. In the aftermath of the 2009 meltdown, global credit rating agencies were hauled over coal, and in response they articulated a series of measures they undertook to strengthen processes, systems, and overall analytical quality. This is where credit rating agencies in India need to communicate more. In the aftermath of the IL&FS crisis, credit rating agencies have been busy publicly defending their credit ratings rather than accepting the failure and learning from it, and reassuring the market that they have improved their standards. Credit rating agencies not embroiled in these credit rating collapses too need to articulate what they have done to continuously improve standards and minimize the risk of potential failures: saying they are better than the rest will not suffice.



Better self-regulation will reduce regulatory risks for credit rating agencies

With the increasing number of credit rating failures, regulators have stepped in – not only in conducting investigations of the failures, but in becoming far too prescriptive in the credit rating process. This is a change from the regulator’s earlier stance, which used disclosure as a form of enforcement. Regulators are asking credit rating agencies to of large corporates like RIL or L&T), talk to audit committee members, talk to [auditors](#)², check if bond spreads mirror the credit rating category, and have independent external members for committees where credit rating changes are appealed by issuers, among many other things. evaluate bank accounts of issuers (not sure what one can glean from the bank accounts.

Credit rating agencies are also expected to create board-level sub-committees to which the Chief Analytical Officer will report. But how many of the board members of credit rating agencies understand credit risk and credit ratings? Having public sector bankers is not sufficient – especially considering the asset quality of public sector banks. Credit rating agencies need domain expertise on their board. Unlike AMFI or GIPSA, credit rating agencies in India do not have a self-regulatory body – although four of the seven are members of the [Association of Credit Rating Agencies in Asia](#) (ACRAA). A self-regulatory body will help the industry set a set of self-regulatory standards, that may help arrest the slew of prescriptive regulation and compliance costs.

Credit rating agencies, world over, have been central to credit debacles. China recently banned two local credit rating agencies from credit rating new issuances and asked one credit rating agency to pay 10% of the debt that had defaulted. This is a dangerous precedent but one that both regulators and civil society would want to see implemented. If credit rating agencies in India don’t self-regulate, they could face similar regulatory action.

It is time credit rating agencies fight to get back their reputation if they are to remain a credible lighthouse for the credit markets.

² The [ICAI has taken a position](#) that under the provisions of Chartered Accountants Act, 1949, it is not permissible to members to share client information with the credit credit rating agencies, except if permitted by the Auditee client.

ANNEXURE

A. Default rates and credit rating transition studies

CRISIL	:	https://www.crisil.com/en/home/our-analysis/publications/default-study.html
ICRA	:	https://www.icra.in/Home/ViewTransitionalStudy
India ratings	:	https://www.India ratings.co.in/Uploads/TransitionandDefaultStudy.pdf
CARE	:	https://www.carecredit ratings.com/pdf/credit rating-resources/01022021060237 Default and Transition Study FY20.pdf
Brickworks	:	https://www.brickworkcredit ratings.com/Credit ratingsPublications.aspx ;
Acuite	:	One year credit rating transition: https://bit.ly/2MBfXPA Average default rates: https://www.acuite.in/for-the-period-ended-31-March-2020.htm
Infomerics	:	Credit rating Transition; https://infomerics.com/db-include/uploads/Transition Matrx1 2016 2020.pdf Defaults rates: https://www.infomerics.com/disclosures-as-per-sebi's-circular-sebi_ho_mirsd_dos3_cir_p_2019_70.php

Note: These are the most recent, and updated from those at the time of the CIO Dialogue

B. Regulatory disclosures

Between SEBI and RBI, rating agencies are required to make a series of disclosures on their website regarding ratings processes and statistics around the quality of ratings. These include (among others):

- Credit rating history and defaults
- New credit ratings assigned during the previous year and six months
- Upgrades and downgrades of credit ratings
- Movement of investment grade credit ratings to sub-investment grade credit ratings
- Disclosure of non-credit ratings income from issuers
- Standard operating procedures for monitoring and recognition of default
- Standardized and uniform probability of default benchmarks for long-term credit ratings
- List of rated companies that have sought moratorium on debt facilities
- Average one year transition rates for long-term credit ratings for the last 5 financial years

CRISIL	:	https://www.crisil.com/en/home/our-businesses/credit ratings/regulatory-disclosures.html
ICRA	:	https://www.icra.in/RegulatoryDisclosure/Index
India ratings	:	https://www.India ratings.co.in/regulatory-disclosures
CARE	:	https://www.carecredit ratings.com/credit rating-stastitics-regulatory-disclosure.aspx
Brickworks	:	https://www.brickworkcredit ratings.com/Credit ratingsServices.aspx
Acuite	:	https://www.acuite.in/regulatory-disclosures.htm
Infomerics	:	https://www.infomerics.com/regulatory-disclosures.php

C. Board of directors

CRISIL	:	https://www.crisil.com/en/home/our-businesses/credit-ratings/our-people/board-of-directors.html
ICRA	:	https://www.icra.in/Home/BoardOfDirector
India ratings	:	https://www.India ratings.co.in/about-us/BoardofDirectors
CARE	:	https://www.carecredit ratings.com/board-of-directors.aspx
Brickworks	:	https://www.brickworkcredit ratings.com/BoardDirectors.aspx
Acuite	:	https://www.acuite.in/directors.htm
Infomerics	:	https://www.infomerics.com/board-of-directors.php

D. Composition of the credit ratings sub-committee

CRISIL	:	https://www.crisil.com/en/home/our-businesses/credit-ratings/our-people/board-committees-and-policies.html
ICRA	:	https://bit.ly/2YyJ08Y
India ratings	:	https://www.India ratings.co.in/about-us/BoardofDirectors
CARE	:	https://bit.ly/3cxFoMq
Brickworks	:	https://www.brickworkcredit ratings.com/BoardDirectors.aspx
Acuite	:	https://www.acuite.in/credit ratings-sub-committee.htm
Infomerics	:	Not available

For the list of participants at the roundtable, please write to solutions@iias.in

About NSE

The National Stock Exchange of India Ltd. (NSE) is the leading stock exchange in India and the second largest in the world by nos. of trades in equity shares from January to June 2018, according to World Federation of Exchanges (WFE) report.

NSE has a fully integrated business model comprising our exchange listings, trading services, clearing and settlement services, indices, market data feeds, technology solutions and financial education offerings. NSE also oversees compliance by trading and clearing members and listed companies with the rules and regulations of the exchange.

About IiAS Foundation

The IiAS Foundation has been established by IiAS to serve as a platform for market participants i.e. business leaders, board members, academics, investors, issuers and intermediaries to interact on the practice of corporate governance and there to approach to ESG. It aims and to foster debate around regulations, corporate and investor behaviour and capital markets

About IiAS

Institutional Investor Advisory Services India Limited (IiAS) is an advisory firm, dedicated to providing participants in the Indian market with independent opinions, research and data on corporate governance and ESG issues as well as voting recommendations on shareholder resolutions for ~ 800 companies that account for over 95% of market capitalization. IiAS is a SEBI registered research entity (proxy advisor registration number: INH000000024).

IiAS has equity participation by Aditya Birla Sunlife AMC Limited, Axis Bank Limited, Fitch Group Inc., HDFC Investment Corporation Limited, ICICI Prudential Life Insurance, Kotak Mahindra Bank Limited, RBL Bank Limited, Tata Investment Corporation Limited, UTI Asset Management Company Limited and Yes Bank Limited



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