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Shriya Bubna won the PoleStar Award for 2009 for her article, 'The risk in ratings', which appeared in The Week.

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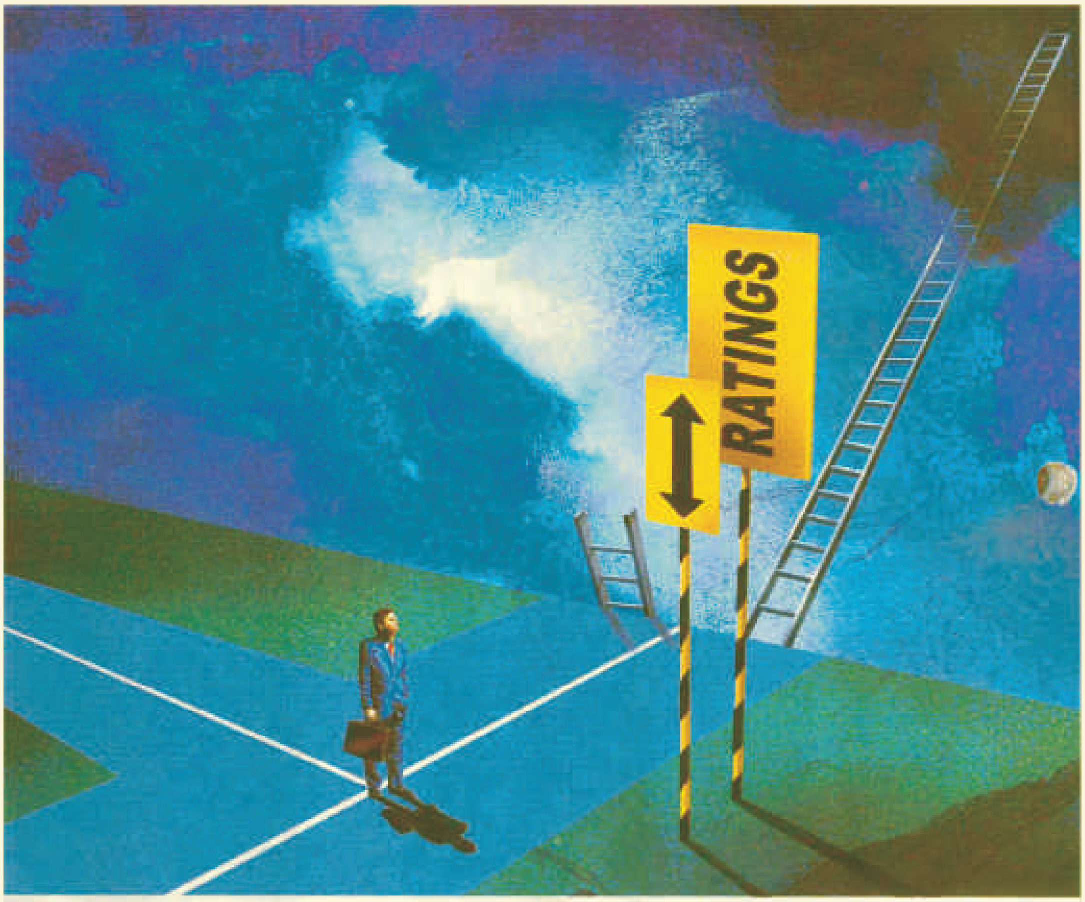

The risk in ratings

The Satyam scandal has thrown the spotlight on a little known segment of the Indian corporate landscape—rating agencies

By Shriya Bubna

The Satyam incident has brought in the insurance regulator in the picture too. Two insurance companies, LIC and ICICI Prudential, had taken exposures of around 4 per cent in Satyam in the recent past. As per rules, insurers can invest only in double A rated companies. Now the insurance regulator IRDA is asking how the rating agencies Crisil and ICRA gave Satyam an AAA rating in the face of recent revelations about the company's dodgy accounting practices.

The last few months have seen more rating downgrades than upgrades. Crisil says not only has the number of downgrades gone up, it is also seeing defaults for the first time in three years. CARE has seen about 11 downgrades against seven upgrades during April-November. Rating agencies are now conducting more frequent surveillance on companies in specific sectors like auto and auto ancillaries, textiles, hospitality and real estate that have been hit particularly hard by the present crisis.

Among the institutions and practices facing flak in the wake of the recent US sub-prime crisis is a little known part of the finance industry—the five-billion dollar ratings agency business. Inevitably, the outcry in the US and Europe for its formal regulation, rather than the earlier voluntary arrangement, found an echo in India, too, now getting louder in the wake of the Satyam accounting scam.

Though Indian rating agencies, which together generate yearly business of around Rs 200 crore, have been spared the kind of criticism faced by their American counterparts, the SEBI nevertheless in August asked credit rating agencies (CRAs) to provide details of all products rated by them and a list of all their activities, including research and advisory services provided by them and their associate or group companies. The government, too, has set up a committee to look into the functioning and regulation of rating agencies.

The SEBI, on its part, is looking at ways to fill the regulatory gaps that would bring in CRAs, too, under the overall regulatory umbrella. Particularly, issues like conflict of interest, one of the key concerns analysts have raised.

Just three players—Standard & Poor's, Moody's and Fitch—dominate the 150-year-old US ratings industry. The Indian version, which took form in 1987, has four agencies recognised by the SEBI and RBI—Crisil, Icra, CARE and Fitch. A new Bangalore-based agency, Brickworks Ratings, acquired a rating licence from SEBI early this year, but has not yet been accepted by RBI.

"The market in India is comparable to the US in a sense and not comparable also," said Naresh Takkar, managing director of ICRA, a Moody's associate. The Indian debt market is not as complex as in the US, but the ratings principles used in India are largely similar. As of now, the structured finance market in India is limited to issue of securities against auto loan receivables, residential mortgages, in addition to a few equity-linked structures. But rating of all commercial papers and initial public offerings has been made compulsory.

Accountability of rating agencies needs to be looked at. I see credit rating agencies as a regulator. I cannot comment on how to regulate them.

ADI GODREJ
Chairman, Godrej Group

"India already has a very strict code of conduct. Indian regulators are also looking at developing the IOSCO (International Organisation of Securities Commission) code for rating agencies," said Takkar. In fact, SEBI laid down norms governing CRAs as far back as 1999, mandating them to carry out periodic reviews of ratings and provide a rationale of ratings with an analysis of risk and favourable factors and disclosures on methodology and information quality and history. The mutual fund industry, too, has asked the SEBI for more disclosures on ratings.

In the wake of the Satyam scandal, Indian rating agencies have decided to strengthen their methodology and verification processes. Given that so much depends on the ratings, rating agencies now face their own challenges to maintain credibility. "The Satyam fraud has certainly made us more cautious, we will now take a closer look at the balance sheet, though the rating methodology, which goes beyond the balance sheet and looks at a host of other issues like comparison with peers in the industry, does not need a change," said D.R. Dogra, executive director of CARE.

The lack of any regulation of the rating agencies was felt rather painfully after the sub-prime crisis during which many AAA-rated mortgage-backed securities, collaterised debt obligations and credit default swaps turned worthless. The failure of American rating agencies to adequately assess the risks of complex securities led to massive losses for investors. Both the US Securities Exchange Commission (SEC) and European Commission have only now begun regulatory oversight of rating firms.

"More norms are needed on disclosures in India," said Dogra. "Every CRA should publish cumulative default rates and ratings transition for each instrument. The rationale behind a ratings decision should be available in detail to the public." Especially, added Takkar, when the rating takes into account qualitative aspects such as "management quality, risk appetite of management, succession planning and future prospects."

The need to explain how such factors have influenced the rating is obvious. Simply put, a rating of a financial product, like bonds, mutual fund or other commercial paper, is merely an opinion of the agency that does the rating, on the likelihood of default by the issuer of the instrument. It is by no means any kind of guarantee against default. A high rating merely means that the probability of default, as assessed by a handful of error-capable humans of the rating agency, is low. But the risk of default is always there.

That ultimately is the crux of the problem. Financial instruments need to be rated. Rating agencies need to be trusted to do that job honestly. People place their investments based on that trust in the rating given. The problem arises, as it has at present, when that trust is thought to have been abused in some way.

Companies as a policy do not speak on ratings. At a recent CII event, Adi Godrej, chairman, Godrej Group, admitted that "accountability of rating agencies needs to be looked at," but refused to be drawn into the kind of regulation needed for CRAs, saying, "I see credit rating agencies as a regulator. I cannot comment on how to regulate them."

The possibility of abuse, or at least undue influence, is always there, given some of the practices of the rating agencies, like providing advisory services on how to structure the product they are hired to rate. Also, the competition for getting business could result in a dilution of standards and a cutting of corners. Then there is the possibility of ratings shopping, where rating agencies "assign higher ratings to get more business and do ridiculous pricing which would force them to cut corners in other ways," Takkar pointed out. The standard fee for rating an issue is 0.1 per cent of the size of the issue.

The obvious conflict of interest inherent in such practices is now being addressed. Some safeguards do exist, like not allowing CRAs to rate their promoters, but there is clearly need for more. The European Commission, for instance, has proposed that credit rating agencies be barred from providing advisory services and mandatory disclosure if more than 10 per cent of their total fees comes from one client.

Domestic rating agencies say they have created a firewall between analysts and those negotiating with clients. Crisil, whose majority shareholder is S&P's, has separated the research, advisory and ratings business operationally but not into standalone companies. CARE, which was earlier in the advisory business, has stopped offering these services. Fitch does not offer these services in India. Icra has spun off its consultancy arm into a separate entity.

Yet, industry officials are sceptical about this "wall between consulting and advisory services". The RBI has suggested that rating firms should implement the revised IOSCO code to avoid any conflict of interest in rating structured (also known as asset-backed) securities, which were at the root of the financial crisis, and to improve their ratings process. The RBI wants to separate ratings on structured credit products, from those on bonds. Currently, the same scale is used to rate both, though structured products are marked with an SO symbol.

One obvious regulatory option is to make entry norms for recognition of rating agencies stricter. Currently, financial institutions, Indian or foreign banks, international credit rating agencies and companies having a net worth of at least Rs 100 crore over the last five years, can promote CRAs. "Only firms with international experience or background in ratings business should be allowed to enter," said an industry official. But cautioned Dogra: "The rating process should not be reduced to a check list."

Indian regulators are thus expected to act in a way that promotes regulatory consistency across the globe but without interfering in the credit rating process, leaving CRAs with sufficient flexibility to adapt to changing market situations. This is necessary given that the Indian ratings industry is in its growth phase, especially with the implementation of new Basel II capital norms that encourage companies to get rated.

About 40 per cent of new business is now coming from ratings required by Basel II. By October 2007, Indian credit rating agencies had ratings outstanding of 2,000 companies. Under the first phase of Basel II, which applies to companies taking a loan of Rs 50 crore, a potential to rate 15,000 companies has emerged. By March 2009, the new norms would apply to companies with a minimum loan limit of Rs 10 crore increasing the business potential for rating agencies even more. ■

WHO RATES WHAT?

Ratings are a must for short-term commercial papers (up to a year) like bonds, issued by a company, bank or other institutional investor. For instance, commercial paper issued by Godrej Industries would likely be assigned A1+ rating indicating the lowest credit risk. While, an issue by a relatively unknown company would get a rating of A4 which denotes high credit risk.

SEBI has made it mandatory for mutual funds to get capital protection schemes rated by a CRA.

Long-term ratings on instruments of more than a year can be assigned AAA, AA, A, BBB, BB and below, in decreasing order of credit quality. CARE's short-term rating scale ranges from PR1, PR2, PR3, PR4 to PR5, while Crisil denotes these as P1, P2, P3 and lower. The + or - signs are added to indicate relatively stronger or poorer quality within the band covered by the rating symbol.

The initial rating issued is reviewed every year over the life of the instrument. However, a change in industry scenario can lead to a review of rating.

A high rating means banks need to set aside lower amounts as a safety margin and hence can charge lower rates of interest.

A rating that misfired: *The probe is on into Satyam's ratings*