E - RESOURCES FOR AUDIT AND CORPORATE GOVERNANCE

- Topic: Credit Rating Agencies
- Section : H and I
- Year: 3 rd, 6th semester

- Prepared by:

Anu Malhotra

- This study material is in relation of my class room lecture for the topic “ Credit Rating Agencies”
- The study material is for one week module for the subject Audit and Corporate Governance
- The study material is specifically for my students of SRCC, 3 year , 6th semester (section H and section I)

CREDIT RATING

TOPICS INCLUDED

- Meaning
- Features
- Uses of CRAs
- CRAs in India
- Rating symbols
- SEBI newly issued guidelines for CRAs
- Dubious role of CRAs
- Lacunas in the Functioning of Credit Rating Agencies in India
- Measures taken by SEBI for their better functioning

MEANING

- A **credit rating** is an evaluation of the credit risk of a prospective debtor (an individual, a business, company or a government), predicting their ability to pay back the debt, and an implicit forecast of the likelihood of the debtor defaulting. The credit rating represents an evaluation of a credit rating agency of the qualitative and quantitative information for the prospective debtor, including information provided by the prospective debtor and other non-public information obtained by the credit rating agency's analysts.
- Credit reporting (or credit score) – is a subset of credit rating – it is a numeric evaluation of an *individual's* credit worthiness, which is done by a credit bureau or consumer credit reporting agency

- Credit rating agencies rate the worthiness or financial strength of individual companies to determine their capacity to repay obligations.
- The debt instruments rated by CRAs include government bonds, corporate bonds, CDs, municipal bonds, preferred stock, and collateralized securities, such as mortgage-backed securities and collateralized debt obligations.

- These agencies focus primarily on the repayment ability and financial condition of companies:
- Liquidity
- Leverage
- Cash flows
- Earnings
- Market shares and competition
- Litigation and contingencies

FEATURES

- Rating agencies do diligent credit analysis which involve qualitative review, including an examination of the nature and quality of the firm's management and internal controls.
- Rating analysis techniques vary by agency and may be solely on analysis of publicly available information or supplemented by management discussion and the review of non public information

- Since access to public capital markets almost depends on a credit rating and since issuers pay for such ratings, the rating agencies have indirect control over can access capital market
- Various agencies have begun to review the quality of governance processes within the company

USES OF CREDIT RATING AGENCIES

- Credit ratings establish link between risk and return
- Investor uses the ratings to assess the risk level and compares the offered rate of return with his expected rate of return to optimize risk return trade off inbuilt in any instrument
- Credit ratings are issued by different parties looking for dimensions of relative credit risk for investors, issuers, investment banks, brokers dealers and government

- Credit rating is likely to enhance quality consciousness in the market and establish over a period of time, a more meaningful relationship between the quality of debt and the yield from it
- Ratings are considered to be an objective of evaluation of the profitability that a borrower will default on a given security issue, by the investors.
- Credit ratings helps regulators like RBI and SEBI to use credit rating to determine eligibility criteria for some instruments

- Credit rating lowers costs for both borrowers and lenders. This in turn, increases the total supply of risk capital in the economy leading to better growth.
- Ratings are extremely crucial to Assets backed Securities, like Mortgage backed Securities, who’s financial engineering make them “harder to understand and price than individual loans”

CREDIT RATING AGENCIES IN INDIA

- CRISIL(Credit Rating Information Services of India Ltd)
- ICRA(Information and Credit Rating Services ltd)
- CARE (Credit Analysis and Research Ltd)

CRISIL(CREDIT RATING AND INFORMATION SERVICES OF INDIA LTD.)

- The first rating agency ‘Credit Rating Information Services of India Ltd. , CRISIL, was promoted jointly in 1987 by the ICICI and the UTI.
- It pioneered the concept of credit rating in the country and since then has introduced new concepts in credit rating services and has diversified into related areas of information and advisory activities.

ROLE OF CRISIL

- Offers a reliable and independent view of the corporate governance practices
- Takes into account the perspectives of all stakeholders (shareholders, debt holders, employees, customers, suppliers, and the society at large)
- Quantifies the value created on account of good governance practice
- Recognizes crucial role of stakeholders in value creation for shareholders
- Provides an appropriate balance of quantitative and qualitative factors

ICRA

- Information and Credit Rating Services (ICRA) has been promoted by IFCI Ltd as the main promoter and started operations in 1991.
- The main objectives of ICRA are to assist investors both individual and institutional in making well informed decisions
- To assist issuers in raising funds from a wider investor base.
- To enable banks, investment bankers, Brokers in placing debt with investors.
- To provide regulators with market driven systems to encourage the healthy growth of capital markets.
- It provides rating services, information services and advisory services.

CARE

- Credit Analysis and Research Ltd or CARE is promoted by IDBI jointly with Financial Institutions, Public/Private Sector Banks and Private Finance Companies.
- It commenced its credit rating operations in October, 1993 .
- It offers services like :

1. Credit rating of debt instruments

2. Advisory services like securitization transactions, structuring financial instruments, financing infrastructure projects and municipal finances.

3. Information services like providing information to companies, industry and businesses.

4. Equity research

RATING SYMBOLS

- The rating agency reduces complex risk factors into simplistic outcomes by assigning symbols like A,B or C
- The symbols used to convey safety grade to investors
- Some agencies use alphabets, some use numbers and mainly use combination of two for ranking risk of default
- sometimes the suffix such as “+” , “-” are used to indicate comparative position of the instrument within same group i.e. if the position is better than most of the companies instrument in the same group
- suffix (P) is also used to indicate money raised will be put into a new project

ENHANCED GOVERNANCE NORMS FOR CRAS ISSUED BY SEBI

MD/CEO of a CRA shall not be a member of rating committees of the CRA

Rating committees of a CRA shall report to a Chief Ratings Officer (CRO).

One third of the board of a CRA shall comprise of independent directors, if the board is chaired by a non-executive director. In case the board of the CRA is chaired by an executive director, half of the board shall comprise of independent directors.

The board of a CRA shall constitute the following committees:

- Ratings Sub-Committee
- Nomination and Remuneration Committee

- The Chief Ratings Officer (CRO) shall directly report to the Ratings Sub- Committee of the board of the CRA.

- The Nomination and Remuneration Committee shall be chaired by an independent director.
- During the rating process, CRAs shall record minutes of the meeting with issuer management and incorporate it in the rating committee note.
- CRAs shall meet the audit committee of the rated entity, at least once in a year, to discuss issues including related party transactions, internal financial control and other material disclosures made by the management, which have a bearing on rating of the listed NCDs.

DUBIOUS ROLE OF CRA

High ratings influence the buyer’s decisions and on the other hand allowed the issuer to get a good price for their security and poor ratings sharply lowered the prices

It becomes critical for any potential buyer of any debt paper to get an impartial “ true and fair” independent assessment of the entity’s capacity to service the debt
thus came into the picture the concept of independent credit rating agencies

- Rating system originated in the US in 70’s
- Because of high level of defaults which occurred after the Great depression in US capital market. The default of 82$million of commercial paper by Penn central in 1970 lead to massive crisis. This promoted capital issuers to get commercial paper programs rated by independent CRAs
- Rating agencies have acquire enormous power as watchdogs of the capital markets such that they fail to do their jobs well, investors would surely suffer

- The role of auditors and independent auditors examined closely — even though there is a long way to go still in this measure. But credit rating has been, in a relative sense, the one that got away.
- Securities and Exchange Board of India , the stock market regulator, fining rating agencies and CARE Ratings `25 lakh each for failing to exercise proper care, skill and due diligence for the scandal-hit Infrastructure Leasing & Financial Services (IL&FS).

- For credit rating, we could consider a partial ‘postpaid’ rating regime in which after a base fee is paid for by the borrower or issuer or paper into an escrow account, the lenders may be charged a small fee to be paid later to the rater after the duration of a loan or paper for which a rating is being assigned.
- The novel approach can be accompanied by terms and conditions including rules for disclosures, and the time-frame during which the rating agencies are required to be proactively monitoring the financial health of the borrowers. These, of course, must be buttressed by hefty fines for serious irregularities.

- The CRA performing incidental and ancillary services. A credit rater could also have structured the bonds like in the case of collateral debt obligations or the process of securitization of receivables that proved to be the bane of the US mortgage loans in 2007-8. Having had a hand in the role of structuring the bonds, it is difficult for the same rater to talk about it except in superlative terms -- AAA rating! The Sarbanes Oxley Act put paid to this potentially corrupting and compromising practice by banning a CRA from performing any incidental or ancillary services. There is an Indian parallel also – an internal auditor cannot be the statutory i.e. financial auditor as well

LACUNAS IN THE FUNCTIONING OF CREDIT RATING AGENCIES IN INDIA

- **Conflict of Interest** – Under Issuer Pay model, which is adopted in India, the entity that issues the instrument also pays the ratings agency for its services. This often leads to a situation of conflict of interest, with tremendous potential for rating biases.

- **Entry Barrier**: the credit rating market in India has high barriers to entry, which prevent competition that is vital to protecting the interests of investors.

- **Rating shopping**: It is the practice of an issuer choosing the rating agency that will either assign the highest rating or that has the most lax criteria for achieving a desired rating.

- **Poor Rating Quality**: Often ratings are provided on limited information. For e.g. If the issuer decides not to answer some determinant questions, the rating may be principally based on public information. Many rating agencies don’t have enough manpower which often leads to poor quality. There have been a record **163 downgrades** (negative change in credit worth) of debt instruments this year, according to data released by Prime Database this week.

- **Independence of the ratings committee**: Over the years, the membership of the ratings committee has shifted from external experts to employees of the ratings agency which has raised concerns about their independence.

MEASURES TAKEN BY SEBI FOR THEIR BETTER FUNCTIONING

- SEBI has been working hard to improve transparency and credibility among rating agencies.
- According to the new norms, credit rating agencies will have to inform investors about the liquidity situation of the companies they rate through parameters such as their cash balance, liquidity coverage ratio, access to emergency credit lines, asset-liability mismatch, etc.
- Rating agencies will have to disclose their own historical rating track record by informing clients about how often their rating of an entity has changed over a period of time.
- The agencies will have to publish information on how their performance in the rating of debt instruments compares with a benchmark created in consultation with SEBI.
- The Securities and Exchange Board of India has asked credit rating agencies in the country to, among other things, clearly state the "probability of default" of the instruments they rate for the benefit of investors.
- SEBI laid down a new standard framework for **financial disclosure** by credit rating agencies that it believes will enhance the quality of information made available by these agencies to investors.
- The suggestion to revise the method of computing default rates and the precise definition of terms that raters should use in describing a client's liquidity position — strong, adequate, stretched and poor — are aimed at sharpening disclosure and leaving little room for raters to be ambiguous.

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