ISSN 2278-3091

International Journal of Advanced Trends in Computer Science and Engineering, Vol.2 , No.6, Pages : 237-242 (2013)
Special Issue of ICETEM 2013 - Held on 29-30 November, 2013 in Sree Visvesvaraya Institute of Technology and Science, Mahabubnagar – 204, AP, India

A STUDY ON CONUNDRUMS IN FINANCIAL SERVICES - CREDIT RATING AGENCIES AND ITS PARADIGMS

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ABSTRACT

A credit rating is technically an 'opinion' on the relative degree of risk associated with timely payment of interest and principal on a debt instrument. It is 'informed' indication of the likelihood of default of an issuer on a debt instrument, relative to the respective likelihood of default of other issuers in market. It is therefore an independent, easy-to-use measure of relative credit risk. Given the universal reliance on rating, and hence the power of the opinion, credit rating is expected to increase the efficiency of the market by reducing information asymmetry and lowering costs for both borrowers and lenders. A simple alphanumeric symbol is normally used to convey a credit rating. Ordinarily the company which issues the debt instruments is not rated. It is the instrument which is rated by the rating agency. But the issuer company which has the debt instrument gets strength and credibility with the grade of rating awarded to the credit instrument it intends to issue to the public for raising funds. Though the purpose of rating is to rate instruments, a general perception may be gathered that the organization issues a highly rated instrument is also sound and a highly rated entity. Thus, credit rating is a mechanism whereby an independent third party makes an assessment, based on different sources of information on the credit quality of the assessed.

INTRODUCTION

The institution of credit rating as a mechanism for addressing the considerable degree of information asymmetry in the financial markets has traveled along way form the times of the US rail road companies in the mid- 19^{th} century. The need for an independent rating agency capable of assessing creditworthiness of borrowers was felt when corporates started mobilizing resources directly from savers instead of accessing it through banks which hitherto assumed the credit risk in such cases. The history of systematic credit rating , however, is a century old beginning with rating of US railroad bonds by john Moody in 1909. During this one century of growth and adaption, CRAs progressed from rating simple debt products to rating complex derivatives to national economies and altered their business models to cover a range of activities/products. There are three major credit rating agencies operating internationally Fitch, standard and Poor's, Mood's Investor Services: between them they share the bulk of the $5 billion rating business globally relegating other 60 plus local/regional players into just competitive fringes.

In India, credit rating started with the setting up of The Credit Rating Information services of India (now CRISIL Limted) in 1987. CRISIL was promoted by premier financial institutions like ICICI, HDFC, UTI, SBI, LIC and Asian Development Bank. Now CRISIL is an S&P company

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with a majority shareholding. Apart from CRISIL four more rating agencies have been registered by SEBI in India. These are ICRA, promoted by IFCI and now controlled by Moody's,CARE promoted by IDBI, Fitch India a 100% subsidiary of Fitch, and a new born Brickworks. In India, CRAs that rate capital market instruments are governed by Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999. The regulation provides detailed requirements that a rating agency needs to fulfill to be registered with sebi.

Investors

CRAs typically open on the credit risk of issuers of securities and their financial obligations. Given the vast amount of information available to investors today some of it valuable, some of it not CRAs can play a useful role in helping investors and others shift through this information, and analyze the credit risks they face when lending to a particular borrower or when purchasing an issuer's debt and debt like securities. CRAs also provide investors with rating reports, giving detailed information and analytical judgements on the issuer's business and financial risk profile.This assists investors in taking more informed investment decisions, calibrated to their own risk-return preferences.

Securitised instruments are among the most complex instruments in the debt market. Securitised instruments backed by retail assets are classified as ‗Highly Complex' by some Indian rating agencies. Given the inherent complexity in these instruments, an independent assessment of the risks involved in the instruments by a credit rating agency acts as an important input to an investor's decision-making. Unlike most corporate bonds, where an investor can independently assess a borrower's creditworthiness, in a securitisation transaction there will normally be little or no information in the public domain for an investor to carry out such an assessment. Understanding the nuances of different pools and analysis of the past behaviour of asset classes are areas where CRAs can play an important role. Tracking the performance of the transaction and the corresponding impact on the riskiness of the instruments is a feature where CRAs play an important *monitoring* role. These aspects have also been recognised by Indian regulators. As required by Basel capital accord risk weights are assigned to all rated rated and unrated bank exposures.

Issuers

Issuers rely on credit ratings as an important tool to access investors and also to reach a wider investor base than they otherwise could. In most cases, successful placement of a significant bond issuance needs at least one rating from a recognised CRA; without a rating, the issue may be undersubscribed or the price offered by investors may not be appropriate. Further, they enable issuers to price their issues competitively. In financial markets, the price of debt is determined primarily by the rating of the debt issue.

Banks/ Bank loan rating

Although credit rating is not mandatory under Basel II, banks are likely to save capital if they get their loan rated. If a bank chooses to keep some of its loans unrated, it may have to provide, as per extant RBI instructions, a risk weight of 100 per cent for credit risk on such loans. As provided under Basel II, supervisors may increase the standard risk weight for unrated claims where a higher risk weight is warranted by the overall default experience in their jurisdiction. Further, as part of the supervisory review process, the supervisor may also consider whether the credit quality of corporate claims held by individual banks

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should warrant a standard risk weight higher than 100%.

In terms of RBI instructions on the 'New Capital Adequacy Framework (Basel II)' issued in April 2007, banks were required to initially assign a risk weight of 100 per cent in respect of unrated claims on corporates with the caveat that such claims would be assigned higher risk weights over time.

To begin with, for the financial year 2008-09, all fresh sanctions or renewals in respect of unrated claims on corporates in excess of Rs.50 crore were to attract a risk weight of 150 per cent, and with effect from April 1, 2009, all fresh sanctions or renewals in respect of unrated claims on corporates in excess of Rs. 10 crore were to attract a risk weight of 150 per cent. This higher risk weight of 150 per cent for unrated corporate claims was equivalent to the risk weight to be assigned to exposures rated ‗BB and below'.

However, in November 2008, as a counter cyclical measure, RBI relaxed the regulatory prescription of 150 percent risk weight for unrated claims. Accordingly, all unrated claims on corporates, irrespective of the amount currently attract a uniform risk weight of 100 percent. This relaxation is temporary and will be reviewed at an appropriate time.

A large number of Indian companies, hitherto unrated by rating agencies, have now come forward to get their bank facilities rated. Basel-II norms hold significant potential for further development of the domestic debt markets, by introducing into the public domain easily accessible credit information about a large pool of mid-sized companies. This will not only allow these companies to explore alternative sources of funds, but, through greater visibility, also facilitate healthy competition among fund providers. For banks and other investors, it creates an information base that can be used for efficient portfolio selection.

The acceptance of credit ratings by the investor community has led to investors showing increasing interest in the bank loan rating portfolio. Investors have also begun to consider offering a suite of market-linked borrowing products (including non-convertible debentures, commercial paper, and MIBOR-linked short-term debt instruments) to rated mid-sized companies.

Regulators

Regulators—typically banking regulators and capital market regulators—use credit ratings, or permit ratings to be used, for regulatory purposes. For example, under the Basel II capital framework of the Basel Committee on Banking Supervision, banking regulators can accredit credit rating agencies based on specified criteria. The ratings assigned by these accredited External Credit Assessment Institutions or ECAIs are used to assign risk weights to various bank exposures in calculating capital charge for credit risk. Further, some regulators (such as IRDA and PFRDA) have incorporated ratings into the investment guidelines for the entities they regulate. Rating thus provides an additional layer of comfort to the regulators in their assessment of product risks and overall systemic risks.

Table 3.1 : CRAs registered with SEBI.

Name of the CRA	**Year of commencement of Operations**
CRISIL	1988
ICRA	1991
CARE	1993

CRISIL RATING SYMBOLS

SYMBOL	INDICATION
AAA	HIGHEST SECURITY
AA	HIGH SAFETY
A	ADEQUATE SAFETY
BBB	MODERATE SAFETY
BB	INADEQUATE

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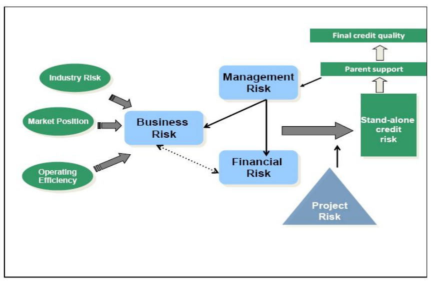
	SAFETY
B	HIGH RISK
C	SUBSTANTIAL RISK
D	DEFAULT

Rating related products and activities

A sample ratings analytical framework is shown in the chart below:

Chart 4.1: Analytics behind credit rating



CRAs in India rate a large number of financial products:

1. Bonds/ debentures- [the main product
2. Commercial paper
3. Structured finance products
4. Bank loans
5. Fixed deposits and bank certificate of deposits
6. Mutual fund debt schemes
7. Initial Public Offers (IPOs)

CRAs also undertake customised credit research of a number of borrowers in a credit portfolio, for the use of the lender. CRAs use their understanding of companies‘ business and operations and their expertise in building frameworks for relative evaluation, which are then applied to arrive at performance grading. For example developer gradings are carried out to assess the ability of the developers to execute projects on a timely basis and promised quality while maritime institute gradings are carried out to assess quality of education imparted to the students vis a vis DGS (Directorate General of Shipping) objectives.

NON-RATING RELATED ACTIVITIES

CRAs often undertake a variety of non rating related activities. These include the following:

1. **Economy and Company Research**: Some Indian CRAs have set up research arms to complement their rating activities. These arms carry out research on the economy, industries and specific companies, and make the same available to external subscribers for a fee. In addition, they disseminate opinions on the performance of the economy or specific industries, available through releases to the media. The research would also be used internally by the rating agencies for arriving at their rating opinions. SEBI permits CRAs to carry out this activity subject to relevant firewalls.

2. **Risk consulting**: With the application of Basel II regulations for
banks, there is considerable demand for tools and products that will allow banks to compute their capital adequacy ratios under the revised guidelines. The risk consulting groups of credit rating agencies would leverage the agencies‘ understanding of credit risk to develop and provide the tools and data that banks would require. The products in this area include tools for internal ratings, operational risk evaluation, and overall capital calculation.

3. **Funds research**: Some CRAs have diversified from mutual fund ratings into mutual fund research. The services that are available under this head include fund rankings, performance attribution tools (to help users understand the reasons for funds‘ performance), desktop tools, and fixed income research.

4. **Advisory services**: CRAs offer various kinds of advisory services, usually through dedicated advisory arms. Most of this is in the nature of developing policy frameworks, bid process management, public private partnership consulting, and creating an

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enabling environment for business in India and globally.

5. **Knowledge Process Outsourcing**: Some Indian CRAs (CRISIL and ICRA) have KPO arms that leverage their analytical skills and other process and manpower capabilities. These arms provide services to the CRAs' affiliates in developed markets, and also to other clients outside India.

THE RATING PROCESS

Rating is a multilayered decision making process**.** The process of rating starts with a rating request from the issuer, and the signing of a rating agreement. The rating agreement has important clauses

like confidentiality, agreement by the issuer to share information with the CRA for the purpose of assigning the rating and thereafter on an ongoing basis when the rating is under surveillance. The rating agency undertakes discussion with the management of the issuing entity. Discussions during a management meeting are wide-ranging, covering competitive position, strategy, financial policy, historical performance, and near- and long-term financial and business outlook. Discussions with company managements help rating analysts evaluate management capability and risk appetite, which is an important aspect of the evaluation. After discussion with the issuer's management, a report is prepared detailing the analyst team's assessment of the business risk, financial risk, and management risk associated with the issuer. The report is then presented to the rating committee. This is the only aspect of the process in which the issuer does not directly participate. Drawing on the knowledge and expertise of the participants, the rating committee determines the rating. The process is an attempt to ensure objectivity of the rating, since the decision results from the collective thinking of a group of experts analysing the risks pertaining to the issuer vis-a-vis its competitors in the industry and markets in which they operate. On finalisation of a rating at the rating committee meeting, the rating decision is communicated to the issuer. As the decision to get an initial rating is at the issuer's discretion (except, in India, for public issues of debt), the global best practice is to allow the issuer to decide whether to accept the rating. If the issuer disagrees with the rating, it can also appeal for a fresh look at the rating assigned. The rating committee then discusses the information submitted; it may or may not decide to modify the rating, depending on the facts of the case. If the rating is not changed and the issuer continues to disagree with the rating, it can choose not to accept the rating, which then does not get published.

LIMITATIONS OF CREDIT RATINGS

Specifically, a credit rating, in the words of the CRAs, is:

- **Not** a recommendation to buy, hold or sell any shares, bonds, debentures or other instruments issued by the rated entity, or derivatives thereof. A rating is one of the many inputs that is used by investors to make an investment decision.
- **Not** Intended to measure many other factors that debt investors must consider in relation to risk - such as yield offered, liquidity risk, pre-payment risk, interest rate risk, taxation aspects, risk of secondary market loss, exchange loss risk, etc.
- **Not** a general-purpose credit or performance evaluation of the rated entity, unless otherwise specified. The rating is usually specific to the instrument and is not the rating of the issuer.
- **Not** an opinion on associate, affiliate or group companies of the rated entity, or on promoters, directors or officers of the rated entity.

- **Not** a statutory or non-statutory audit of the rated entity

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- **Not** a guarantee against default of the rated instrument. Even the highest-rated instrument faces some risk of default, although the risks associated with this are lower than lower-rated instruments.

Credit Ratings are typically ordinal in nature – for example we know that a rating of BB has a higher likelihood of default than BBB, but we do not know how much higher. It is not until each rating is assigned a probability of default that we can say how much more risky a BB rated instrument is thus making the system cardinal. Cardinality is more useful for pricing an instrument. Translation of credit ratings to default probabilities is, however, not a straight forward task.

Some of the serious limitations of credit rating are its backward looking nature (depends on past data) which in a dynamic market framework can have serious consequences including accentuating a systemic crisis like the current global crisis, and its failure and unwillingness to capture/cover market risks. Estimating market risk can potentially make the rating exercise forward looking, could avoid sudden, multiple downgrades and reduce the pro-cyclicality of rating.. If rating is to straddle the high ground it aspires to hold rating exercise has to achieve this dynamism to really help measure all the risks of the market, rather than sticking to a partial methodology of expressing an opinion on a few aspects of the product they rate. No product can be usefully rated in a vacuum, isolated from the caprices of the market as a whole.

RECOMMENDATIONS

The recommendations are based on India‘s own experience with the CRAs till now. India has been proactive in introducing effective and comprehensive regulations for CRAs as early as 1999. In contrast, the US market saw substantial regulations only recently in 2007, and the European Union is still in the process of framing its regulations. SEBI‘s CRA regulations have been used as a model by other regulators in emerging economies. SEBI‘s code of conduct for CRAs addresses some of the basic issues relating to conflicts of interest. The Code of Conduct is designed to ensure transparent and independent functioning of CRAs.

Since answers to the questions raised in Para 7.1 are ‗no‘ or ‗uncertain‘ as well as the CRA assertion that rating is only an opinion mandatory rating may need to be relooked at. Regulators also need to enhance their due diligence and investors need to strengthen their own information processing systems. Moreover, market participants need some time for such a migration to the world of no mandatory rating, particularly because of the low levels of financial literacy. Accordingly all regulators felt that rating is an essential tool in the current context. The Committee therefore recommends a number of steps for enhancing the transparency of the functioning of the CRAs through greater disclosure requirements, reducing the conflict of interest in their business models and in improving their rating methodology and process. These recommendations will also provide another window of opportunity, both to the CRAs to show their capability to assimilate and absorb their fiduciary role as well as for the policy makers to see how these work which will help charting the future policy trajectory itself. The recommendations below are designed to strengthen provisions related to conflicts of interest, and improve transparency, disclosures and accountability.

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