Don’t Malign CRAs Based Just on Some Instances

(This editorial is based on the article “Don’t Malign CRAs Based Just on Some Instances” which appears in Livemint.)

The recent downgrade of Infrastructure Leasing & Financial Services Ltd (IL&FS) has led to criticism of the role of credit rating agencies (CRAs), specifically, the conflicts in their **“issuer-pay” revenue model*** and their non-ratings businesses.

In India, Crisil Ltd and ICRA Ltd have substantial non-rating revenues and the performance of their ratings reveals that they show the lowest default rates in the industry and yields on instruments they rated are closest to benchmarks. They also had the least number of cases going to the National Company Law Tribunal (NCLT) that had “investment grade” a year prior to default.

The issuer pays revenue model: is a compensation structure in which the entity issuing the debt pays CRAs for the initial rating and ongoing ratings of a security instrument.

- CRAs provide quality ratings to all paying companies at the lowest cost.
- This is the model followed across the world.
- “Issuer pays” affords CRAs access to company management, which improves the quality of ratings.
- It helps provide ratings and updates to all stakeholders—investors, regulators, intermediaries, and media—at zero cost and gives access to all clients.

What is Credit Rating?

- **A credit rating is an assessment of the creditworthiness of a borrower in general terms or with respect to a particular debt or financial obligation.**
- A credit rating can be assigned to any entity that seeks to borrow money — an individual, corporation, state or provincial authority, or sovereign government.

- Credit agencies, also known as credit rating agencies, help potential lenders and creditors determine whether to lend or extend credit to an individual or business, by predicting the likelihood that the borrower will repay the debt in a timely manner.
- The information provided to credit agencies includes how much credit is available to that borrower, how much of the available credit they have used, and what their repayment activity looks like.

Current Arguments & Criticisms

- **The first argument is that CRAs should not be in any business other than ratings because revenue from common clients can influence their judgment and** rating **calls.**
- Some also question the "issuer pays" model followed by CRAs—where the entity issuing debt pays for the rating—saying it evokes conflicts and compromises on analysis. **They contend "investor pays" and "government/regulator/stock exchange pays" are viable alternatives.**

Importance of CRAs

- **CRAs have played a critical role in the development of the domestic debt market, spawning efficiencies and stability by providing comparable, transparent and forward-looking metrics for decision-making.**
- They have enabled independent benchmarks for pricing debt, ushered in a culture of financial discipline, helped allocate capital efficiently by pricing risk appropriately, and supported financial innovation.
- CRAs have also brought in the international standard of **"one day, one rupee default" [a delay of one day even of one rupee (of principal or interest) from the scheduled payment date is to be construed as a default.] a**nd helped remove information asymmetry by ensuring that over 35,000 ratings and their analyses are available publicly for free.

Flaws in CRAs

- Though rotating CRAs (i.e mandating one CRA to rate a company only for a limited amount of time before another CRA takes over) can be done just like it's done in auditing—saying that would reduce conflicts, that's incorrect because **auditing looks at the past and rating, the future.**
- Asking a CRA to look at the future and then absolving it of responsibility in three to five years by asking another CRA to take over would evoke conflict because the former would tend to give higher-than-warranted rating knowing it won't have to defend that for long. **This will increase rating shopping.**
- The "government/regulator/stock exchange pays" model potentially obviates the perceived fee conflict and can make public all ratings for free, but it raises the question of moral hazard because ratings may seem sovereign-backed.

Way Forward

- **For CRAs:** CRAs need to introspect and strengthen their rating criteria, methodologies, processes, and oversights. Conflicts, if any, need to be addressed to reassure stakeholders on the ratings process.
- **For regulators: I**ndia has had proactive CRA regulations since 1999 and these have served the market well. The raft of changes introduced over the past two years has ensured greater transparency, accountability, and oversight than ever before. Today, we need more enforcement, not more regulations. That would mean vigorously questioning ill-managed conflicts, and analyzing if any CRA is regularly showing steep changes in ratings.
- **For investors:** Investors have to look beyond the rating symbol and scrutinize the CRA behind it. The temptation to shop for a higher rating, but factoring in the risk in the pricing, need to be avoided because it is faux (i.e fake) comfort. Investors need to distinguish between CRAs using yardsticks such as default rates and transition rates, the intensity of rating changes, the ability to flag distressed assets, etc. For, not all ratings are equal.
- **The "issuer-pays" model needs to change to an "investor-pays" model**, with fees being standardized by the market regulator. However, at the governmental level, fiscal decisions should be marked by a push towards developing an economy with full employment and innovation,

instead of seeking to chase down rating quarter by quarter.

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