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FULL DISCLOSURE: ON SEBI NORM FOR FINANCIAL DISCLOSURE

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Capital Market & SEBI

Amidst the rising number of defaults by companies, the chief markets regulator is taking the fight to what it thinks is the enemy: ratings agencies. 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. There have been a record 163 downgrades of debt instruments this year, according to data released by Prime Database this week. This is more than double the number of defaults over the whole of last year. Debt instruments issued by prominent companies including Yes Bank, Essel and Jet Airways have been downgraded this year. This spate of defaults, which may well be a sign of the turning of the credit cycle in the broader economy, may have forced SEBI to crack the whip on credit rating agencies. In a circular released on Thursday, 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. Notably, 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 regulator believes this will help investors to better gauge the performance of credit rating agencies.

SEBI’s aggressive regulatory approach seems to suggest a certain disappointment with credit rating agencies, which may not be unfounded. They have been caught napping on several occasions, including during the recent default by Infrastructure Leasing & Financial Services on its debt commitments. They are also seen by many as being more loyal to companies whose instruments they rate rather than to investors who provide precious capital. These concerns need to be addressed. SEBI’s attempt seems to be to align ratings methodologies with global best practices. 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. What is not clear, though, is how the new framework will effectively resolve the conflict of interest issue that plagues the rating industry. The issuer-pays model where the ratings agency is paid by the issuer of the instrument that it rates is not a healthy one. But the problem is that a viable alternative is yet to be proposed. The bottomline is that the poor track record of credit rating agencies is known to most investors and is appropriately discounted by market participants.

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