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# OF CREDIT RATING AGENCIES AND CREDIBILITY

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The IL&FS saga has brought the spotlight back on credit ratings agencies for all wrong reasons. The last time such a situation arose was in late 2015, when auto ancillary company Amtek Auto defaulted on the repayment of its bonds.

The aftermath of the Amtek episode witnessed a series of measures from SEBI aimed at strengthening the ratings process and enhancing the standards of credit ratings agencies. While this has helped in standardising the processes across the agencies and plugging some obvious loopholes like suspension of ratings (to avoid a downgrade) and lack of timely updates, the IL&FS episode reminds us that there are issues that still need to be addressed before reliance on credit ratings can increase further.

Among other things, there are two elements that warrant a close examination, given their susceptibility to impact the quality of a rating. These are (a) the extent of independence of the ratings committee and (b) quality of the analysis.

**Membership**

Over the years, the membership of the ratings committee has shifted from external experts to employees of the ratings agency. While there is no evidence to suggest that this has resulted in dilution of rating standards, it is nonetheless pertinent to note that the ‘independence’ of the members of the rating committee could always come under question. After all, as they say, Caesar’s wife should be above suspicion.

Given the large number of ratings issued, which should be in hundreds at any given ratings committee meeting (one ratings agency has issued more than 120 rating releases on October 31), there has to be a mechanism to ensure that the large systemically important issues are addressed through a separate mechanism.

Therefore, it may be useful to have an element of ‘independence’ in the ratings committee — at least in cases that involve systemically important entities.

The second element of the ‘quality of analysis’ is a more subjective and difficult issue to handle. To quote S. Raman, former whole-time member of SEBI, “Credit rating firms have sadly been rarely ahead of the curve.” There appears to be an element of truth in this statement given what we are witnessing.

It appears that the ratings agencies are cautious when credit quality is improving and probably do not want to be ahead of the curve when things are getting better, but the lag continues when there is trouble ahead.

While it is easy to say that ratings agencies need to be ahead of the curve (akin to saying sell high and buy low in the stock market!), in reality, it is certainly difficult. However, there are a few factors that could be addressed in order to ensure better quality of analysis and rating actions.

The sheer increase in the number of ratings issued after the commencement of Bank Loan Ratings in 2007 has put significant work pressure on the ratings agencies. While the processes and standards can be defined and outlined, the output in terms of quality of analysis can’t be regulated or legislated. There will always be pressure from clients to complete the ratings

exercise as quickly as possible, which means that the agencies will have to be staffed adequately or even in excess of the requirements, given that bunching of work is very likely. A cursory look at some of the rating rationales published by the rating agencies reveals the shallow nature of the analysis.

For instance, in the case of IL&FS Financial Services, the comment on liquidity profile is identical in the rating rationales published by an agency in March 2018 and August 2018 and in both cases, the liquidity position is mentioned as a key strength! Over time, relevant information contained in the rating rationale is almost down to a trickle and one cannot make any independent assessment based on the information provided. It will be helpful if the requirements of a rating rationale are laid down to ensure the provision of meaningful information.

**Earnings pressure**

The ratings agencies seem to be in the race to maximise earnings, thanks to three of them being listed, which probably has an impact on the quality of the output. It can be seen that the operating margins are consistently at over 40%, with one company even posting a 65% operating margin. Obviously, such high margins are a result of low employee expenses, which is the main head of expenditure for a knowledge organisation.

This calls for some mechanism to ensure that the rigour of analysis is not lost in the race for better financial performance. It is also pertinent to note that the credit rating industry, unlike the decade of the 90s and 2000s, does not attract the cream of talent. If recruitment on Day 0 and Day 1 at the premier IIMs or the CA institute are any indicators, the credit ratings agencies do not appear to have a seat at the high table as far are placements are concerned.

It may also be useful to clearly delineate the bond rating and bank loan rating businesses, as the users of these two products are different. The investor who uses the bond rating product does not have any window into the issuer’s business, whereas the banker who uses the bank loan rating has a more detailed view of the borrower’s business — in most cases a view which is better and deeper that the ratings agencies themselves.

Credit ratings is a business where the better you perform professionally, it is more likely that your client (read the entity that is rated) may not be too happy! It is therefore essential to incentivise rigorous analysis so that the pressure of improved financial performance does not force them to cut corners.

This may be done by standardising the fee structure at least in the case of bond ratings.

Having external experts on the ratings committee for large issues and bringing in safeguards to ensure that the analytical rigour is not diluted are some steps that could help rating agencies regain their credibility.

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