New Guidelines for credit rating agencies

Why in news?

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SEBI has come out with new guidelines to improve the quality of disclosures made by credit rating agencies recently.

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What does the guidelines say?

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- The regulator issued a circular tightening disclosure norms for rating agencies when they rate companies and their debt.
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- Experts say rating agencies in India often failed to consider cash flows and ground conditions before assigning a rating.
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- Hence rating agencies must now disclose the liquidity position of a company.
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- They have to inform investors about a company through parameters such as their cash balance, liquidity coverage ratio, access to emergency credit lines, asset-liability mismatch, etc.
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- If the rating is assigned on the assumption of cash inflow to the company they rate, the agencies would need to disclose the source of the funding.
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- Thus they would now be required to furnish information on whether the rating is factoring in support from a parent company, its group companies or from the government.
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- They are also required to name of such entities, along with rationale for such expectation.
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- Rating agencies must also disclose their rating history and how the ratings have transitioned across categories.
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- This is to inform clients about how often their rating of an entity has changed

over a period of time.
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- Also, when subsidiaries or group companies are consolidated to arrive at a rating, list of all such companies, along with the extent (e.g. full, proportionate or moderate) and rationale of consolidation, will have to be provided.
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- All rating agencies would require furnish data on its rating actions in investment grade rating category, to stock exchanges and depositories for disclosure on website on half-yearly basis, within 15 days from the end of the half-year.
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Why are the norms revised?

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- SEBI has been working hard to improve transparency and credibility among rating agencies for some time now.
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- It has already issued a circular in November 2016 calling for enhanced standards for rating agencies.
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- But the latest disclosure norms seem to be a response to the IL&FS defaults and the ensuing crisis.
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- Rating agencies came under the spotlight following the crisis at Infrastructure Leasing & Financial Services Ltd (IL&FS) and its group entities.
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- Many mutual fund houses, invested in it, were caught unaware as major credit rating agencies started to cut ratings from high investment grade to default or junk.
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- The agencies faced criticism that they had failed to see the financial troubles in the group and adjust its rating of IL&FS only when its debt jumped by 44% at the end of March 2015.
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- This prompted the regulator to review the rating standards and whether there is a need for increased accountability, and insist on more disclosures.
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- Thus the recent measure mandating the formal disclosure of these facts is

welcome.
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- The ready availability of information can help investors make better decisions.
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What are the concerns?

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- However, the latest regulations can only help to a certain extent as a lot of the problems with the credit rating industry have to do with structural issues rather than the lack of formal rules.
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- The primary one is the flawed "issuer-pays" model, where a bond's issuer pays the rating agencies for the initial rating of a security, as well as ongoing ratings.
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- The public (and investors) can then access these ratings free of charge.
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- This often leads to a situation of conflict of interest wherein the entity which issues the bond/debt instrument also pays the ratings agency for its services, with tremendous potential for rating biases.
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- Second, the credit rating market in India has high barriers to entry, which prevent competition that is vital to protecting the interests of investors.
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- This is not very different from the case in many developed economies where rating agencies enjoy the benefits of an oligopoly.
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- Better disclosures can increase the amount of information available to investors, but without a sufficient number of alternative credit rating providers, quality standards in ratings will not improve.
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- It is thus no surprise that even after repeated ratings failures in their long history, credit rating agencies continue to remain and flourish in business.
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- Structural reform should aim to solve another severe problem plaguing the industry, which has to do with rating shopping and the loyalty of credit rating agencies in general.
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- Rating agencies will have to come up with lucrative business models that put the interests of investors above those of borrowers.

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- Such a change requires a policy framework that allows easier entry and innovation in the credit rating industry.

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Source: The Hindu

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