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Credit rating agencies

Published On: 23-12-2023

Why is in news? Rating agencies too subjective, loaded against India, need reform: CEA

Calling for urgent reforms and transparency in the process of sovereign credit rating, the office of the Chief Economic Advisor in the Union Ministry of Finance, has said that methodologies used by agencies Fitch, Moody's and S&P, are **heavily loaded against developing countries** like India due to an "over-reliance" on non-transparent and subjective qualitative factors.

The rating of India during the last 15 years **remained static at BBB-** during the last 15 years, despite it climbing the ladders from the 12th largest economy in the world in 2008 to the 5th largest in 2023, with the second-highest growth rate recorded during the period among all the comparator economies.

Credit Rating:

A credit rating is an **evaluation of a borrower's creditworthiness**, either generally or in relation to a specific debt or financial obligation.

Any organisation looking to borrow money, whether it be a **person, business, state or local authority, or sovereign nation**, can be given a credit rating.

Credit rating companies assign ratings to entities **after evaluating their financial and business risk**. After considering additional variables like the ability to repay the loan, the firms compile a thorough report.

Credit Rating Agencies:

Credit Rating Agencies are institutions that evaluate and assess an individual's or a company's creditworthiness. These agencies assess the financial strength of companies and other government entities.

Credit Rating Agencies in India **help investors to identify the company's ability to pay debts and its level of risk**. Poor credit rating indicates that the entity is at a high risk of defaulting.

The **SEBI (Credit Rating Agencies) Regulations, 1999** of the Securities and Exchange Board of India Act, 1992 govern all credit rating agencies in India.

Some of the registered and authorized **Credit Rating Agencies in India** are as follows:

CRISIL (Credit Rating Information Services of India Limited)

ICRA (Investment Information and Credit Rating Agency)

India Ratings and Research Pvt Ltd, etc.

Sovereign credit ratings **predate the Bretton Woods institutions**, i.e., the World Bank and the International Monetary Fund. There are **three main globally recognised credit rating agencies**: Moody's, Standard & Poor's and Fitch.

Moody's is the oldest; it was established in 1900 and issued its first sovereign ratings just before World War I. In the 1920s, Poor's Publishing and Standard Statistics, the predecessor of S&P, started rating government bonds.

Benefits of Credit Rating Agencies:

It provides an **independent assessment of creditworthiness**. This helps investors and lenders make informed decisions.

It provides **standardized credit ratings** for companies and securities. This **improves transparency and efficiency** in **financial markets**.

Ratings given by credit rating agencies are used as **benchmarks for financial market regulations**.

Lowers the cost of borrowing for companies by reducing information asymmetry and increasing investor confidence.

Encourages companies to **maintain good financial health and transparency** to avoid negative credit ratings.

A good credit rating **helps countries attract high-value investors** and foreign direct investments.

Issues with respect to credit rating agencies:

No uniformity among rating companies in India: An average investor in India is not able to understand the different credit ratings prevailing in India as there is no uniformity among the credit rating agencies.

No standardization in rating and no standardized **fee structure** for rating agencies in India is one of the other issues.

Lack of reliability of Credit rating in India: Even credit-rated companies have failed in India and there is no remedy for this. Example CRB Capital Markets, which had a turnover of Rs.1,000 crores per year and with a credit rating of 'A', failed, and neither SEBI nor RBI could come to the rescue of investors.

They are **opaque and appear to disadvantage developing economies** in certain ways.

The credit rating agency in India **lacks transparency**.

After the creation of credit rating agencies, the country has **witnessed stock scam and the failure of CRB Capital Markets**. This only reflects poorly on functioning credit rating agencies.

It is the duty of credit rating agencies to **forewarn the regulating authorities about the weaknesses and drawbacks**, if any, of the companies they are rating and they should ensure to do so at all costs.

There is **conflict of interest with "issuer-pays" model**, wherein the fees to the CRA is paid by issuer himself. This has to be switched to investor-pays model. Issue of rate-shopping, pick and choose.

Because of high entry barriers for entering credit rating, there are **not sufficient CRAs in India**, hence there is no competition.

There is **no method to seek the accountability of CRAs –** "who will rate the rating agency".

The rating agencies **do not convey clearly the assigned weights** for each parameter considered. While Fitch does lay out some numerical weights for each parameter, they do go on to state that the weights are for illustrative purposes only.

Conclusion:

The credit rating system in India plays a crucial role in the financial market by providing investors with information on the creditworthiness of debt securities. It helps in determining the risk associated with investing in a particular security and aids in making informed investment decisions.

Overall, the credit rating industry in India has shown steady growth and improvement in recent years, with increased regulation and transparency. However, challenges such as conflicts of interest and limited coverage of certain segments of the market remain to be addressed.