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# RATING DIVERGENCE ACROSS RATING AGENCIES COULD SOON BE A THING OF PAST

All rating agencies have now been asked by SEBI to do PD benchmarking for AAA, AA and A the rating categories, subject to any unexpected legal events impacting such with certain permitted tolerance levels. For example, AAA rated companies is expected to deliver a benchmark default rate of zero over a two year horizon with a tolerance of 1% is permissible when default is measured over a three year period. Though SEBI has directed zero tolerance level for one year default for AAA, AA without tolerance and for A with 3% tolerance level, we observe divergence in PD itself across Rating Agencies. For example, in AAA category though the PD is zero in CRISIL and ICRA, it is 0.51% and 0.80% in CARE and India Rating respectively. Similarly, stability rate indicates the proportion of rating that remain unchanged over a period. It is observed that CRISIL has stability rate of 98.84% in AAA whereas CARE and India Rating have 97.07% and 95% respectively. For, AA rated borrower also while CRISIL's stability rate is 95.68% for CARE and India Rating the same is 93.70% and 93.20% respectively.

What would the new SEBI directives do? Firstly, **the SEBI approach would certainly bring in tighter credit assessment,** comparability of ratings across issuers and of course, combined with detailed appraisal and assessments to look at credit quality of each and every loan proposal . **Secondly, new guidelines would moderate ratings and our country would have lesser number of AAAs and AAs**. Additionally, it should also raise the requirement of bank capital requirements.

**Thirdly, one consequence of such lesser number of AAA rated borrowers** is **that it will result in diversification of ratings across categories**. For example, most of the corporate issuance in India is currently of top credit quality, with AAA till AA– papers accounting for about 80% of all issuance while BBB or worse accounted for only 14%. This shows that the corporate bond market is largely accessible to the top rated borrowers. Thus MSME have no recourse to corporate bond markets in India and have to rely on banks for credit. Hopefully, a better diversification of ratings could help MSMEs to tap markets**. Such a diversification could result in better trading in Corporate Bond Market**. As we see now, Corporate Bond market annual Bond (trade) market is only around Rs.15 to Rs.18 lakh crore, meaning thereby on an average only Rs.1.5 lakh crore worth of bonds are being traded monthly, with the outstanding corporate bonds of more than Rs.30 lakh crore, as on March'19.

**Fourthly, over a longer time horizon**, banks should experience lower impairments and better stress test outcomes, with beneficial impact on baseline stress test related capital requirements. **Fifthly, investor confidence will increase which leads to a better and robust secondary market with increased participation from the retail investors too.**

## SEBI NORMS ON RATINGS COULD RESULT IN STRUCTURAL CHANGES

- With rising instances of defaults and investors concerns around the role of rating agencies in timely evaluation of the possible risks, sudden transition of rating, deteriorating credit profiles of firms etc., Securities and Exchange Board of India (SEBI) on 13th June 2019 came out with a set of wider disclosure norms for External Credit Rating Agencies / ECRA.
- Under the new framework, ECRAs will be required to disclose a matrix on the probability of default (PD) for various rated instruments for one-year, two-year and three-year cumulative default rates, both for short-run and long-run and to comply with uniform Standard Operating Procedure (SOP) in respect of tracking and timely recognition of default.
- All rating agencies have also been asked by the markets regulator to disclose the standardised and uniform PD benchmarks on the website for ratings of long-term and short-term instruments on a consolidated basis for all financial instruments rated by an agency by December 31, 2019. Further, ECRAs to give two ratings (with and without group support).
- Among others, SEBI has now directed PD benchmarking for AAA, AA and A the rating categories, subject to any unexpected legal impacting such with certain permitted tolerance levels.
- **Though SEBI has directed zero tolerance level for one year default for AAA, AA without tolerance and for A with 3% tolerance level, we observe significant divergence in PD itself across ECRA. For example, in AAA category though the PD is zero in CRISIL and ICRA it is 0.51% and 0.80% in CARE and India Rating respectively.** Similarly, in A category also the PD rate varies from 0.07% to 3% across rating agencies (See Table).
- **In AA category, where regulator has directed zero default, the existing PD ranges from 0.07% to 0.82%, it will be interesting to see how these AA rating will feature on compliance of the direction**. Combined one year PD in all the three-rating category put together i.e. AAA, A and A, also varies across ECRAs from 0.14% to 3%. There is further a greater divergence in three year CDR also, i.e. in A rating the PD ranges from 0.44% to 6.27% (see table).

**Benchmarking PD**

| Rating | | AAA | AA | A |
|---|---|---|---|---|
| Tolerance Level | | Zero for 1-year and 2-year default rate | Zero for 1-year default rate | Zero for 1-year default rate with a tolerance level of 3%. |
| | | Zero for 3-year default rate, with a tolerance level of 1%. | Zero for 2-year default rate with a tolerance level of 2%. | - |

Source: SEBI; SBI Research

**ECRA wise one year Default Rate**

| Rating | CRISIL | ICRA | CARE | India Rating | Brickwork | Acuite |
|---|---|---|---|---|---|---|
| AAA | 0.00% | 0.00% | 0.51% | 0.80% | 0.00% | NA |
| AA | 0.07% | 0.20% | 0.09% | 0.28% | 0.82% | 0.00% |
| A | 0.07% | 0.22% | 0.49% | 1.25% | 1.11% | 3.00% |
| AAA,AA and A | **0.14%** | **0.42%** | **1.09%** | **2.33%** | **1.93%** | **3.00%** |
| BBB | 0.58% | 1.04% | 1.77% | 2.23% | 1.84% | 1.50% |
| BB | 2.23% | 7.08% | 4.33% | 3.61% | 3.23% | 4.40% |
| B | 5.21% | 2.74% | 7.76% | 4.46% | 4.39% | 7.00% |
| C | 13.86% | 8.00% | 29.15% | 34.09% | 24.75% | 100.00% |

Source: ECRA; SBI Research; average default rates for the last 5-financial year period (FY15 to FY19)

**3-year Cumulative Default Rate (CDR)**

| Rating | CRISIL | ICRA | CARE | India Rating | BRICKWORK | Acuite |
|---|---|---|---|---|---|---|
| AAA | 0.00% | 0.00% | 0.90% | 0.68% | 0.00% | NA |
| AA | 0.24% | 0.40% | 0.67% | 0.42% | 1.29% | 0.00% |
| A | 1.43% | 0.44% | 2.39% | 5.41% | 6.27% | 0.00% |
| AAA,AA and A | **1.67%** | **0.84%** | **3.96%** | **6.51%** | **7.56%** | **0.00%** |
| BBB | 1.74% | 1.69% | 6.44% | 6.88% | 7.62% | 1.50% |
| BB | 5.59% | 8.02% | 10.48% | 8.10% | 9.71% | 4.50% |
| B | 11.25% | 16.44% | 13.86% | 9.44% | 13.73% | 2.80% |
| C | 27.67% | 12.00% | 40.88% | 17.54% | 37.50% | 20.00% |

Source: ECRA; SBI Research; average default rates for the last 5-financial year period (FY15 to FY19)

- On the positive side, the SEBI approach would certainly bring in tighter credit assessment, comparability of ratings across issuers, to an extent, even across countries and, of course, more scrutiny and accountability in light of disclosure requirements put in place.
- However, as a logical corollary, rating agencies may go conservative to comply with the directions, in assigning rating which may lead to higher risk weights and so as the capital requirements for the banks.
- One view is that the new guidelines would moderate ratings and our country would have lesser number of AAAs and AAs. Additionally, it should also raise the requirement of bank capital requirements.
- But the question is whether and how long to continue with the existing ECRA for capital measurement or should banks move on to advance approaches and depend on their own rating and PD, combined with detailed appraisal and assessments to look at credit quality of each and every loan proposal .
- Over a longer time horizon, banks should experience lower impairments and better stress test outcomes, with beneficial impact on baseline stress test related capital requirements.
- One consequence of such lesser number of AAA rated borrowers is **that it will result in diversification of ratings across categories**. For example, most of the corporate issuance in India is currently of top credit quality, with AAA till AA– papers accounting for about 80% of all issuance while BBB or worse accounted for only 14%. This shows that the corporate bond market is largely accessible to the top rated borrowers. Thus MSME have no recourse to corporate bond markets in India and have to rely on banks for credit. Hopefully, a better diversification of ratings could help MSMEs to tap markets.
- Such a diversification could result in better trading in Corporate Bond Market. As we see now, Corporate Bond market annual Bond (trade) market is only around Rs.15 to Rs.18 lakh crore, meaning thereby on an average only Rs.1.5 lakh crore worth of bonds are being traded monthly, with the outstanding corporate bonds of more than Rs.30 lakh crore, as on March'19.

**Average one year stability rate for the last five financial year (FY15-FY19)**

| Rating | CRISIL | CARE | India Rating |
|---|---|---|---|
| AAA | 98.84 | 97.07 | 95.00 |
| AA | 95.68 | 93.70 | 93.20 |
| A | 91.98 | 90.11 | 87.60 |
| BBB | 90.78 | 88.73 | 86.70 |

Source: ECRA; SBI Research; for CRISIL period is for ten years (2008-18)

- Bond market in India currently lacks depth mainly because of structural impediments in the markets, including dominance of issuances by financial sector entities, prevalence of private placements, very limited market liquidity, and restrictions on institutional-investor allocations to non-investment-grade bonds, it also lacks confidence on the rating front too, specially from the retail investors.
- With revised SEBI norms and better stability ratio coupled with transparent and structured disclosures, investor confidence will increase which leads to a better and robust secondary market with increased participation from the retail investors too.

**DIVEREGENCE IN STAIBILITY RATES ACROS RATING AGENCIES**

- Stability rate indicates the proportion of rating that remain unchanged over a period. It is observed that CRISIL has stability rate of 98.84% in AAA whereas CARE and India Rating have 97.07% and 95% respectively. For, AA rated borrower also while CRISIL's stability rate is 95.68% for CARE and India Rating the same is 93.70% and 93.20% respectively. Higher stability rate indicates lower volatility. ECRA should aspire for a better stability rate across investment grade and which could also be a parameter to rate the performance of rating agency.

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