Regulating Credit Rating Agencies

What is the issue?

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- SEBI has released a consultation paper on review of regulatory framework of credit rating agencies (CRA).
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- Though it is expected to improve market efficiency, there are other issues like competition that have to be addressed.
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What is CRA?

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- It is a company that assigns credit ratings, which rate a debtor's ability to pay back debt by making timely interest payments and the likelihood of default.
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- CRAs rate the creditworthiness of issuers of debt obligations, of debt instruments and of the servicers of the underlying debt but not of individual consumers.
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What are the highlights of the paper?

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- As per the new norms, no CRA should directly or indirectly, hold more than 10% of **shareholding** and/ or voting rights in another CRA.
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- Also, a CRA shall not have **representation** on the board of the other CRA.
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- SEBI's prior approval would be needed for **acquisition** of shares or voting rights in a CRA that results in change in control.

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- The minimum **net worth threshold** for the rating agencies has been proposed to be raised to Rs 50 crore from the current level of Rs 5 crore.
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- The rating agencies should come out with an **annual rating summary sheet** presenting a record of rating action carried out during the year.
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- It has suggested that certain class of promoters of credit rating agencies should have at least five years' **experience**.
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What are the possible benefits?

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- The proposed norms are likely to have an impact on global rating agencies like S&P, Moody's and Fitch which have significant holdings in domestic agencies besides their direct presence.
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- The changes are primarily aimed at improving the **market efficiency** by reducing the information asymmetry in the market.
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- It is also aimed at enhancing the **governance, accountability** and functioning of CRAs.
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- It is expected to make rating activities more efficient and professional, thereby, yielding timely and accurate ratings.
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- The move to restrict cross-shareholding will enhance **credibility** in ratings, and enhance **transparency** in key management decisions.
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- Also, biased rating because of the presence of a common controlling shareholder and conflict of interest can now be checked.
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- The obligation of an increased net worth requirement can ensure that CRAs have adequate **financial capabilities**.
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- This can possibly increase investment in building intellectual capital, developing efficient systems and infrastructure, and adopting better technology.
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What are the concerns?

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- The proposal to increase the net worth requirement from Rs5 crore to Rs50 crore may not be very practical.
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- The increased requirement may affect the competition in the market, and discourage new entrants.
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- Also, the same net worth requirement for a CRA and an entity which manages huge sums of public money like a mutual fund asset manager seems to be contentious.
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- The business model of rating agencies allows for issuers of securities to shop for a favourable rating or avoid negative ratings.
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- How far will the new norms address this problem of “rating shopping” in the business of credit rating is uncertain.
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What is the way forward?

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- The new rules are less likely to make any substantial impact on the quality of credit rating in India.
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- There is a need for prescribing a more realistic net worth criteria.
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- Importantly, the issue of ensuring fair competition in the rating space should be considered before the rules come into force.
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- The way forward lies in making it easier for new players to enter the credit rating space and compete against incumbents.
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- This will go a long way in making credit rating agencies actually serve creditors rather than borrowers.
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Source: The Hindu, Business Standard

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