Regulating Credit Rating Agencies

What is the issue?

\n\n

\n

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

\n\n

What is CRA?

\n\n

\n

- 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.
\n
- 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.
\n

\n\n

What are the highlights of the paper?

\n\n

\n

- As per the new norms, no CRA should directly or indirectly, hold more than 10% of **shareholding** and/ or voting rights in another CRA.
\n
- Also, a CRA shall not have **representation** on the board of the other CRA.

\n

- SEBI's prior approval would be needed for **acquisition** of shares or voting rights in a CRA that results in change in control.
\n
- 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.
\n
- The rating agencies should come out with an **annual rating summary sheet** presenting a record of rating action carried out during the year.
\n
- It has suggested that certain class of promoters of credit rating agencies should have at least five years' **experience**.
\n

\n\n

What are the possible benefits?

\n\n

\n

- 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.
\n
- The changes are primarily aimed at improving the **market efficiency** by reducing the information asymmetry in the market.
\n
- It is also aimed at enhancing the **governance, accountability** and functioning of CRAs.
\n
- It is expected to make rating activities more efficient and professional, thereby, yielding timely and accurate ratings.
\n
- The move to restrict cross-shareholding will enhance **credibility** in ratings, and enhance **transparency** in key management decisions.
\n
- Also, biased rating because of the presence of a common controlling shareholder and conflict of interest can now be checked.
\n
- The obligation of an increased net worth requirement can ensure that CRAs have adequate **financial capabilities**.
\n
- This can possibly increase investment in building intellectual capital, developing efficient systems and infrastructure, and adopting better technology.

\n

\n\n

What are the concerns?

\n\n

\n

- The proposal to increase the net worth requirement from Rs5 crore to Rs50 crore may not be very practical.
\n
- The increased requirement may affect the competition in the market, and discourage new entrants.
\n
- 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.
\n
- The business model of rating agencies allows for issuers of securities to shop for a favourable rating or avoid negative ratings.
\n
- How far will the new norms address this problem of "rating shopping" in the business of credit rating is uncertain.
\n

\n\n

What is the way forward?

\n\n

\n

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

\n\n

\n\n

Source: The Hindu, Business Standard

\n