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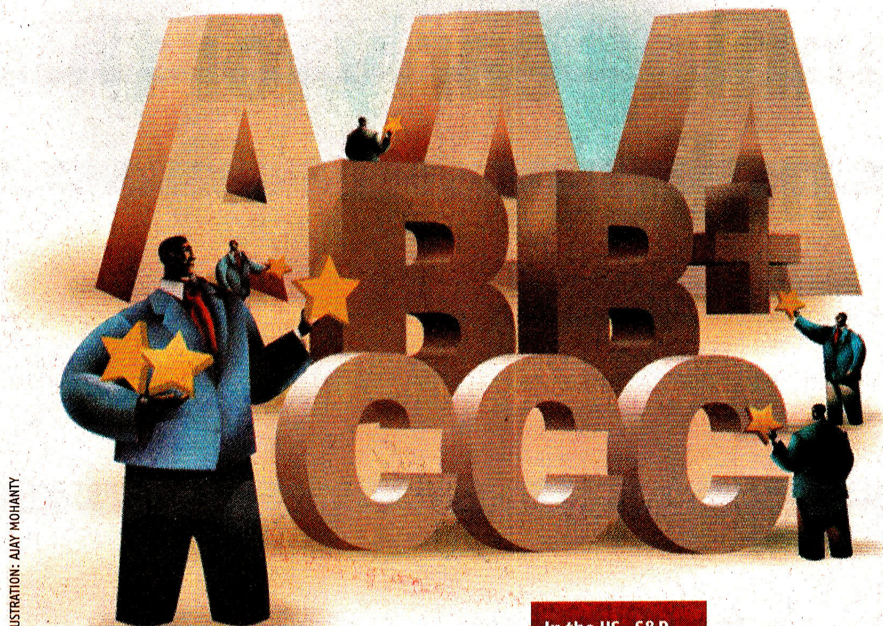
RAGHU MOHAN & SUDIPTO DEY

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so"
— **Mark Twain** (quoted in the Oscar-winning 2015 film *The Big Short*)

It's particularly true of credit rating agencies (CRA). The blowout at Infrastructure Leasing and Financial Services (IL&FS) is the latest to hit the headlines — going to junk status from being triple-A rated in a matter of weeks. Back in 2017, Reliance Communications' debt was downgraded to default status, two months after failing to service its non-convertible debentures; and still earlier, you had the case of Amtek Auto. But it took an IL&FS to jolt the system from its slumber given the contagion in its aftermath.

A fortnight ago, the Standing Committee on Finance on 'Strengthening the credit rating framework in the country', headed by M Veerappa Moily, called for a shift to the 'investor-pays model' or 'regulator-pays model', mandatory rotation of CRAs akin to statutory auditors, and a bidding process to appoint the agency to rate large issuances of paper. It's too early to say if we are on track to the Indian equivalent of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, or the European Securities and Markets Authority in 2011, to protect investors and increase CRA's liability. In the US, both S&P and Moody's had to pay $1.37 billion and $864 million, respectively, as settlements with federal and state authorities in January 2017.



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Paying the price

It's no more a whisper that issuers "shop around" for ratings for a fee; that the methodology is curated — though, all of this denied by the industry, the perception still holds. Will the 'investor-pays model' work?

Shreya Prakash, research-fellow at Vidhi Centre for Legal Policy, says: "For securities, apart from the impracticality of having this implemented, an investor-pays model may result in higher costs of rating, and a bias against smaller issuers and borrowers (in the case of loans)". In the case of securities, an exchange-pays model could be adopted, she adds.

Prakash is of the view that exchanges (as market institutions) may be able to choose CRAs and pay for them in an efficient manner. "The financial burden on the exchange could be shared by the issuers in the form of higher trading fees," she adds.

The Committee had opined the 'issuer-pays model' may lead to a "conflict of interest" and result in compromising the quality of analysis, or the objectivity of the ratings assigned. But the cure suggested rings in other headaches.

H Jayesh, founding-partner at Juris Corp, points out: "When taken to its logical conclusion, then all intermediaries must be paid by the investor. Not only that, each one of them should get appointed by investors. How do you do that when you have multiple investors, especially non-sophisticated or retail investors? By having the arranger appoint other intermediaries as well? Isn't that what is being largely even now? And who appoints the arranger?"

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He adds for good measure: "A repeat issuer and an arranger are the rainmakers for all other intermediaries. They are both the payer and the pied piper!"

On a merry-go-round

As for CRAs being rotated, it is to do away long associations with the issuer given the instances of a failure to sense "simmering trouble in their client-entities". But the Department of Economic Affairs (DEA) informed the Committee that this may result in each CRA taking a short-term view on the credit-worthiness of the issuer, instead of a longer-term perspective spanning the entire tenure of an instrument. While there are stringent conditions for the withdrawal of rating from a CRA at present, mandatory rotation may pose the problem of "rating-shopping" as the issuer on rotation may approach a CRA promising a higher rating. In effect, we may be running in the same spot.

Still rotation as an idea is worth exploring. Leena Chacko, partner at Cyril Amarchand Mangaldas, says: "Companies should be required to obtain a rating from different agencies when making a second issue of the same nature". And in the event a company chooses to continue with the same rating agency, a detailed rationale for such choice should be required of the company and the same should be made available to the regulator and the agencies. "However, for now, it may be advisable to get two credit ratings for issues of a certain size and complexity," she feels.

An apparently unrelated issue is the lack of a deep bond market — it puts pressure to get a good rating to the extent large investors including insurers and pension funds, have mandates to invest only in highly-rated paper. This is of import given that it is mandatory that corporates with long-term borrowings of ₹100 crore tap the bond-mart for 25 per cent of their incremental needs from April 1.