SPEECH

VALEDICTORY ADDRESS*

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1. I am indeed very thankful to the organisers for asking me to deliver the valedictory address at this International Conference on Credit Rating. I must congratulate ICRA for taking the initiative to organise this Conference at a time when credit rating has begun to assume importance in the Indian context. I am sure that you have, during the last two days, discussed in detail the various technical aspects of rating. The sharing of international experience must have considerably enriched the discussions. It was indeed a good idea to have brought together at this Conference the corporate issuers, market intermediaries and investors along with the rating specialists.

A. The Role and Significance of Credit Rating

2. Throughout the world, financial markets are changing rapidly. The most distinctive feature *has been the deepening and broadening of the* capital market. Complex linkages have developed among the different segments of the financial system and consequently the risk elements, viz., default, liquidity, price and business risks are increasing. Growing institutionalization of savings has been associated with a number of important trends, such as increased trading activity in financial markets, rapid growth in the use of financial derivatives and increased cross-border equity holdings. Behind these developments have been a variety of causes, including greater inflation and interest rate volatility, improvements in information and communications technologies, the end of capital controls and the advent of flexible exchange rate systems.

3. Different constituents of the financial system therefore are continually trying to find innovative ways to cope with the growing uncertainties of the market. Risk is an integral element of the business of finance. While there can rarely be zero risk situation, there can however be several ways in which risk minimisation or even risk neutralisation strategies can be put in place. It is here that credit rating comes to play an important role as a signal.

4. Ratings are used primarily by investors to assess the risk-level and hence to optimise risk-return trade off. In many countries, regulatory authorities insist on compulsory rating of a debt instrument in both capital and money markets. Credit rating performs the function of credit risk evaluation reflecting borrowers' expected capability to repay. As credit rating is primarily assigned to identify risks which may be worth avoiding, the equity instruments which are influenced by the risks worth taking, are not assigned any rating.

5. A credit rating agency acts as an assessor. Rating of a financial instrument of a company is based on fundamental analysis taking into account various risk elements. It provides guidance to the investors in determining the credit risk associated with debt instruments, thus helping the investors to take a decision about their investments. Continuous monitoring of the rating assigned by the agency is inevitable. The rating may be upgraded, downgraded or continue unchanged depending upon new information or developments and their resultant effect on the debt instrument being rated.

6. Rating helps to establish a link between risk and return. In a developing debt market, yields on different debt instruments would need to be progressively calibrated to the different levels of risks. This has not taken place significantly in many countries including India. We need to gradually move to a situation, where the

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investors would expect different rates of returns at different levels of risks.

7. Rating is, however, neither a general purpose evaluation of a corporate entity nor an overall assessment of the credit risk likely to be involved in all the debts contracted or to be contracted by such entity. Credit rating is merely an indicator of the current opinion of the relative capacity of a corporate entity to service its debt obligations within a specified time period and with particular reference to the debt instrument being rated.

B. Transformation of the Indian financial system and the significance of credit rating

8. As you are aware, the Indian financial system is in the process of rapid transformation and financial sector reform is an integral part of India's agenda of economic reform. The reform objective in our country is largely to promote a diversified, efficient and competitive financial system. It aims at raising the allocative efficiency of available savings, increasing the return on investments and promoting the accelerated growth and development of the real sector. The reforms are aimed at having an impact over a wide cross-section of the economy. With improvements and greater efficiency in mobilising and allocating resources the basis will become stronger for promoting economic growth and development. The reforms aim at increasing efficiency of the financial sector and the range of financial services available within the economy. The introduction of bank capital adequacy and accounting standards, together with improvement in the regulation and supervision of financial institutions and capital markets aim at instilling greater public confidence, ensuring safety and soundness of the financial system, bringing about greater transparency and accountability in operations and encouraging, overall, increased resources mobilisation within the economy.

9. In the years to come, there is no doubt that the Indian financial system will grow in size and complexity. Different segments of the market will become closely linked and it will become difficult to influence or act on only one segment without affecting the others. The major link connecting the various segments will be the interest rate as is the case in many of the industrially advanced countries now. There will be increasing specialisation; simultaneously, there can emerge financial conglomerates dealing in different financial products and services. The existence of healthy and sound financial institutions should be able to put pressure on investors and other borrowers, to use resources in an efficient and productive manner in order to repay the existing obligations and qualify for new finances. The trends that have shaped commercial banking worldwide will probably come into play in India as well.

10. During the Eighties, the Indian financial system has already seen the introduction of several new products. Convertible bonds have become popular in capital markets. Commercial Paper and Certificates of Deposits have started circulating in money markets. These are however standard products. Many of the products which are currently in vogue in the developed markets may take time to make their appearance in the Indian financial market. We have to achieve a higher degree of interest rate deregulation and freer international capital mobility before such products make their appearance. There are innovations such as Note Issuance Facility and Securitisation of assets, which may assume importance even over the immediate term. However, as and when such instruments are introduced, banks and other institutions will have to acquire the necessary expertise for risk assessment, control and management.

11. The capital market in India is also bound to grow in size. With the induction of private participation, public sector companies will also come to the capital market to access funds. The growth of the corporate sector will also be in tune with the growth of the economy. Equity cult which gained immense popularity during the last half decade is becoming a permanent aspect of

the Indian market. Mutual funds, foreign institutional investors and overseas country funds are new entrants to the market. Thus, both on the supply and demand sides, the market is bound to expand.

12. In this emerging scenario the credit rating activity will help in developing the market in a proper manner. Investors could draw up the credit risk profile and assess the adequacy or otherwise of the risk premium offered by the market. Issuers of debt instruments will have a wider access to capital along with better pricing and timing of issues. It will be a tool in the hands of financial intermediaries, like banks, for taking decisions relating to lending and investment activities. Finally, it will also help market regulatory bodies, in prescribing the requisite eligibility criteria for existing as well as new debt instruments, monitoring financial soundness of organisations and promoting efficiency in the securities market.

C. Credit Rating Agencies in India

13. India was first among the developing world to set up a credit rating agency in 1988. The need for rating was more or less visualised with the beginning of growth of the Indian capital market and a need for unbiased and independent professional opinion was increasingly felt. The credit rating function was further institutionalised, when RBI and SEBI made 'credit rating' mandatory for the issue of Commercial Paper and certain categories of debentures and debt instruments.

14. Special mention must be made of Commercial Paper. In order to help highly rated corporate borrowers to diversify their sources of short term borrowings as also to provide an additional financial instrument to investors, Reserve Bank of India introduced Commercial Paper in 1990. The eligibility criteria, for issuance of Commercial Paper, inter alia, included obtaining a specified minimum credit rating from an agency approved by the Reserve Bank of India from time to time. The various parameters considered by Reserve Bank of India, while granting recognition to the three credit rating agencies for their ratings awarded to Commercial Paper have been: a) status of promoters; (b) professional assistance available; (c) infrastructure facilities at the disposal of the agency; (d) norms for rating various debt instruments,and (e) performance of the agency judged by ratings awarded to debt instruments in the past.

15. Reserve Bank of India has so far approved three credit rating agencies, viz., Credit Rating Information Services of India Ltd. (CRISIL), Investment Information and Credit Rating Agency of India Ltd. (ICRA) and Credit Analysis and Research Ltd. (CARE). The minimum credit rating stipulated for issuance of Commercial Paper is P-2 by CRISIL, A-2 by ICRA and PR-2 by CARE. Further, at the time of issuance of Commercial Paper the rating must be current and not more than two months old. All the three rating agencies have been promoted by all-India financial institutions. RBI had impressed upon these agencies at the time of granting recognition of their ratings for issuance of Commercial Paper, that they should ensure total objectivity and integrity of the rating process, and that the rating of a debt instrument is insulated from the promoters so that there is no conflict of interests.

D. Credit Rating: Some issues

16. An important issue relates to the credibility of the rating agencies. Credibility arises primarily from the objectivity which results from the rater being independent of the issuer's business. The investor is willing to accept the credit rater's judgement only where such credibility exists. When enough investors are willing to accept the judgement of a particular rater, that rating agency gains recognition and credibility. The critical issues for credibility of rating agencies thus include their independence, professionalism, research capability, consistency and confidentiality.

17. Owing to the peculiar situation in India, the credit rating agencies have so far been promoted largely by the all-India term lending institutions. Most of the corporate borrowers are also clients of these financial institutions for raising term loans for their large projects. Apart from these borrowers seeking to raise funds through a variety of short-term and long-term debt instruments, these financial institutions themselves are approaching the capital market to raise resources on an increasing scale and their debt instruments would need to obtain the requisite rating. Hence, it would be desirable that the rating agencies must have an arm's length relationship from their promoters and also maintain the highest standards of independent evaluation.

18. In this respect a question arises whether a company should go to more than one agency for rating purpose. There have been instances where companies that are unhappy with ratings given by one agency have gone to another. This is possible if it is not mandatory for companies to publish all the ratings. Concern arises from instances of companies wishing to borrow through Commercial Paper after having been rated differently by two different agencies. Although perception and rating could differ at times, in no case should there be a dilution of norms which might threaten the confidence of the investors. For this purpose, the methodology adopted for rating should be technically sound with minimum subjectivity. Transparency in the operations of the rating agencies should send a clear message to all the players in the market that rating is immune to the influence of any vested interest and is completely unbiased. Commercial interest of the rating agencies should be kept above board and companies should disclose all the necessary and relevant information to the credit agencies to enable them to reach at correct assessment. Rating agencies, of course, must ensure confidentiality of such information.

19. Another issue which requires discussion is that whether credit rating should be mandatory. Rating of debentures and CPs is a must in Korea, Japan and France. In Japan, the rating agencies even determine the amount to be raised, rate of interest, the period over which to raise the money, etc. In fact, the term 'junk bonds' originated in the US when the Securities and Exchange Commission prohibited banks from maintaining a portfolio of instruments rated below A3/P3. In India, debentures (excepting those which are convertible within 18 months or maturing within 18 months) and Commercial Papers have to mandatorily get ratings. RBI has also stipulated credit rating for non-banking financial companies in June 1994. Credit rating at the moment is optional for PSU bonds and privately placed non-convertible debentures upto Rs.5 crore. Fixed deposits of manufacturing companies also come under the purview of optional credit rating.

20. Credit rating is an important requirement for any company or institution wishing to enter the capital market. As and when the secondary market for debt instruments deepens and the number of investors widens, the importance of the rating agencies will be increasingly be felt. The PSU bonds which have been granted waiver temporarily from rating stipulation have to necessarily get ratings in near future. New instruments such as floating rates have been making use of the ratings. Securitisation of debt which is yet to develop in India, would also necessarily require credit rating.

21. Credit rating demands a high level expertise and keeping in view the vast expansion in fund raising through debt instruments in the future, it is perhaps right time for us to bestow special attention on recruitment of appropriate personnel and indepth training facilities for the existing personnel handling credit rating.

22. We must also understand that rating is ultimately an opinion. The opinion, of course, is based on adequate information, detailed analysis and intensive research. The process involves not only subjective and objective assessments, but also considerable amount of forecasting and

prediction of future scenario. The risk perceptions of different rating agencies may differ, sometime resulting in difference in rating by a notch or two. There is nothing wrong in it and the market takes such difference into consideration for determining the rates of return. For this purpose it is an usual practice in the developed countries to obtain at least two ratings for all the major issues of debt instruments. So far, we have not insisted on more than one rating considering the cost involved. It may be worth considering at this stage that whether the debt issue programmes, above a particular amount, require to be rated by at least two rating agencies. Alternatively, one may consider making it compulsory to publicise all the ratings, if an issuer has approached more than one agency. This would help the debt market to mature in the context of progressive deregulation of interest rates. With increase in the volume and complexities in the Indian capital and money markets, it may be necessary to bring all debt instruments under compulsory rating to ensure healthy growth. One may, therefore, visualise a larger number of rating agencies also to take care of the needs of such an emerging market.

E. Country Rating

23. I have not so far touched on the issue of country rating. When the issuers and the investors are from the same country, the question of country rating is not relevant. It becomes relevant only when residents of one country borrow from other countries. With the increase in cross-border lending, foreign direct investment decisions and project financing, assessment of country risks has assumed greater importance. The ability to repay external debt depends not only on solvency and liquidity of the borrower, but also that of the country. There can be occasions when even if the debtor is willing and able to pay, the government may not be able and willing to make available the foreign exchange to effect the payment. It is for this reason that the country rating sets an upper limit on the rating of any borrower from that country. The determination of country rating is more difficult and complex than commercial rating of a borrower. The number of factors that need to be taken into account in the case of country rating are not only large but are also capable of differing interpretations. Country rating depends not only on economic strength but also on political, social and cultural factors. Thus, in the evaluation of country rating, judgement plays a greater role. It becomes, therefore, imperative on the part of international credit rating agencies to exercise this judgement with wisdom and without prejudice.

24. Before I close, may I say a few words on the current Indian economic situation? The Indian economy has come a long way from the crisis years of 1990 and 1991. Perhaps the most impressive aspect of the turnaround has been in relation to the external sector. The foreign currency assets of the Reserve Bank of India have reached the level of US $ 17.7 billion. This is in addition to the gold holdings of US $ 4 billion. One of the reasons for the substantial accretion to the foreign exchange reserves has been the investment inflow. During 1993-94, portfolio investment through FIIs resulted in an inflow of US $ 1.6 billion. In addition, there were Euro–issues in the form of convertible bonds of the order of US $ 914 million and inflows through the GDRs amounting to $1.6 billion. Taking into account the direct foreign investments of US $ 620 million, the overall inflow under the various investment channels was US $ 4.8 billion. The accretion to the foreign exchange reserves has also been helped by the fact that India's current account deficit in 1993-94 is estimated to be only around US $ 313 million. The substantial improvement both in the trade account and the invisibles account of India's balance of payments in fact, needs special mention. The recent decision of India to liberalise the current account payments and to accept Article VIII status of the International Monetary Fund is an affirmation of our ability to manage the external situation. The fairly substantial inflow of funds under the various investment channels reflects the growing

confidence of the foreign investors in India. On the whole, the reform process has begun to yield results. GDP is expected to grow by 5 per cent in 1994-95. Industrial production which has been sluggish during the past three years has shown definite signs of recovery. A country of India's magnitude has several problems to face. But I believe, there is a growing confidence in our ability to solve these problems.