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SEBI's guidelines for enhanced disclosures by credit rating agencies: Creating a more transparent credit market

We look at SEBI's recent announcement and explain what these will mean for the market

Securities and Exchange Board of India (SEBI) published its 'Guidelines for enhanced disclosures by credit rating agencies,' on 13 June 2019. These are focussed on disclosures relating to computation of cumulative default rates and introducing probability of default benchmarks. The guidelines focus on liquidity indicators - usually taken for granted, the absence of liquidity has debilitating consequences for those holding the paper. These guidelines introduce the suffix 'credit enhanced', ask rating agencies to focus on credit spreads and disclose at a broad level of operating and/ or financial performance matrices that could trigger a rating change. Finally, SEBI will engage with rating agencies regarding the definition of default – a perennially subject of debate.

Probability of Default benchmarks to be published

A big change is introducing the probability of default benchmarks.

Ratings symbols in a sense capture the relative credit risk. State Bank of India at 'AAA' is safer than Andhra Bank at 'AA' and both carry relatively lower risk than IDBI Bank at 'A - '. Analysts don't look at companies to calculate the probability of default. Having arrived at the rating, CRA's looked at ratings assigned over the years to arrive at the probability of default (Exhibit 1).

But SEBI now wants ratings to communicate the probability of default. They expect that a 'AAA', within bounds, should not default over 3 years, a 'AA' over two and a 'A' over a one-year period.

While ratings are said to be forward looking, a dominant share of their analysis relates to the past financials, and a limited portion is based on expectations about the future. For equity markets, it is the reverse.

Now, they need to look at the future, but only through the prism of default. This puts rating agencies in a pickle. When should the analyst bake in the expectations of a capital raise or the sale of a business into the leverage profile? Is it when commitments are received, when it is imminent or after money is in the bank? This will reduce the element of discretion from the analysis and shrink the number of higher rated entities. It will also increase the divergence between the debt and equity markets.

Exhibit 1: Sample Corporate Finance Average Cumulative Default Rates: 1990-2018

(%)	Year One	Year Two	Year Three	Year Four	Year Five	Year Ten
AAA	0.12	0.25	0.38	0.51	0.66	1.48
AA	0.05	0.05	0.06	0.06	0.06	0.09
A	0.05	0.15	0.27	0.37	0.48	1.48
BBB	0.13	0.39	0.70	1.03	1.42	3.24
BB	0.66	1.83	3.08	4.24	5.10	9.11
B	1.94	4.71	6.99	8.83	9.93	13.10
C	21.68	27.60	31.88	34.01	36.32	41.47
Investment Grade	0.09	0.24	0.42	0.60	0.81	1.85
Speculative Grade	2.52	4.67	6.55	8.04	9.05	13.01
All Global Corporate Finance	0.69	1.32	1.90	2.36	2.73	4.09

Data is without modifiers '+' and '-'

Exhibit 1 shows the average cumulative default rates. In other words, it gives the likelihood of a 'AAA' defaulting over one year, between 1990 and 2018, was 012% and over ten-years at 1.48%.

Computation of cumulative default rates

CRA's use the history of ratings transitions to derive cumulative default rates. Therefore, how the rating agencies measure and publish rating transition is critical. Most Indian rating agencies began publishing these matrices voluntarily, but these have now become mandated.

A few sample Transition and Default Studies are shown below.

Exhibit 2 shows the one-year transition matrix for 2018. It shows that of the 15 'AAA' credits all remained in the category over a one-year period. And of the 1,222 'BBB' credits, 0.16% were upgraded to 'AA' and 1.88% to 'A'. Further 2.7% were downgraded to 2.7%.

Exhibit 2: Sample One Year Transition Matrix 2018

#	(%)	AAA	AA	A	BBB	BB	B	C	D	WD
15	AAA	100.00	-	-	-	-	-	-	-	-
136	AA	-	92.65	0.74	-	-	-	-	-	6.62
788	A	-	0.76	91.37	3.55	-	-	-	-	4.31
1,222	BBB	-	0.16	1.88	91.73	2.70	-	-	-	3.52
599	BB	-	-	-	3.67	79.63	8.01	0.50	0.17	8.01
409	B	-	-	-	0.24	7.34	75.55	3.18	0.98	12.71
49	C	-	-	-	-	-	12.24	32.65	32.65	22.45

EXHIBIT 3: Sample Average Annual 15-year Transition Matrix (2004-2018)

#	(%)	AAA	AA	A	BBB	BB	B	C	D	WD
823	AAA	88.09	5.35	0.24	-	-	-	-	0.12	6.20
5,730	AA	0.10	85.76	8.85	0.35	0.02	0.02	-	0.05	4.85
17,274	A	0.01	1.60	88.42	5.26	0.39	0.05	0.03	0.05	4.19
18,870	BBB	0.01	0.12	2.89	87.41	3.35	0.36	0.11	0.13	5.63
7,588	BB	-	0.03	0.11	7.14	76.59	6.06	1.09	0.66	8.32
5,612	B	-	-	0.21	0.29	7.56	75.84	4.35	1.94	9.82
904	C	-	-	-	0.22	1.66	17.48	47.35	21.68	11.62

EXHIBIT 4: Sample Average Ten-year Transition Matrix 2018

#	(%)	AAA	AA	A	BBB	BB	B	C	D	WD
675	AAA	20.74	14.22	8.00	2.96	-	-	-	1.48	52.59
4,403	AA	0.25	27.69	28.73	6.09	1.41	0.25	0.02	0.09	35.48
10,090	A	-	4.93	32.12	18.11	2.78	1.14	0.21	1.48	39.25
8,525	BBB	0.07	0.43	9.47	34.44	5.49	1.94	0.41	3.24	44.52
3,216	BB	-	0.09	2.08	19.81	13.50	7.00	1.09	9.11	47.33
2,305	B	-	-	0.39	9.41	7.90	11.84	1.69	13.10	55.66
434	C	-	-	0.46	4.15	5.76	11.52	0.46	41.47	36.18

Exhibit 3 shows the one-year study, but over 15 years. 88.09% of the entities rated as ‘AAA’ remained ‘Triple-A,’ 5.35% were downgraded to ‘AA’, 0.24% to ‘A’, 0.12% defaulted and 6.2% were withdrawn. Exhibit 4 shows the same, except rather than capture ratings at the beginning and end of one calendar year, they have been captured at the beginning and end of a every ten-years.

But do bear in mind that CRA’s put the data together based on the number of ratings and not the amount outstanding. Else, the IL&FS default could have played havoc with the statistics.

To ensure consistency across agencies, SEBI has specified how to calculate and present this data in a rather granular manner. The more statistically inclined can study the minutiae, the broad changes are as under:

- Whether you invest in a ‘AAA’ rated mortgage-backed-security (MBS) or a ‘AAA’ rated bank, it needs to communicate the same level of risk. Lending to a ‘AAA’ rated bank cannot be safer than to a ‘AAA’ MBS. Consequently, there will be only one study for each rating agency. This however is not a global practice where each segment (- Corporate, Sovereign, Structured, Public Finance etc.), has its own dataset. The rating agencies will do well to maintain and even publish separate studies, till the robustness and user case for an aggregate study is established.
- Some rating agencies showed a corporate ‘SO’ rating as a part of the corporate default study and others as a part of the structured default study. Now only securitized paper will be in the structured

data set. However, since there is only study, this will help maintain the integrity of underlying data. And useful for undertaking disaggregated studies if need be.

- For the longest, withdrawing a rating and not capturing it in the study improved the quality of the CRA's ratings. This is why data from Credit Suisse's House of Debt report does not show up in the default data of rating agencies. While these can now be excluded, over the past many years SEBI has put in place guidelines for withdrawing Bank Loan Ratings (BLR's) – only when all banks give a NOC and ratings of market instruments have to be kept alive till the instrument is redeemed. This too is housecleaning, but maybe this will need to be revisited.
- A company fearing downgrade, may stop cooperating with a CRA. A non-cooperative rating was not included in the T&D study bolstering the quality of a CRA's ratings. Now it needs to be.
- SEBI has now restricted the number of ratings for each rated entity that can be included in the transition and default study to three. This reduces the number of ratings considered in the study reducing the count of outstanding ratings in the denominator and the CRA's ability to massage the data.

Credit enhancements and liquidity indicators

At times, a company's rating may get bolstered on account of a guarantee. Right now, these ratings have a 'SO' suffix attached.

SEBI has proposed that the 'SO' suffix be restricted to securitized products and explicit guarantees be denoted by a 'CE.' Here the agency will need to give the stand-alone and the supported rating where there is explicit support.

Through this, the regulator is pushing CRA's to bring clarity to investors. It will also push CRA's to spell out their assumptions for parental support. At present, while a subsidiary's rating may get an uplift because of the parental support, the parent's rating was left unchanged, irrespective of the quantum of backing that it provides – implicitly or explicitly. Now, at least in cases of explicit support the subsidiaries ratings will get pulled-up while the parent's' is pushed-down or the two will remain at their stand-alone ratings.

Recognizing that the absence of liquidity can have a marked impact on the realizable value of an asset at the time of its sale, SEBI asked CRA's to comment on the liquidity available to a company. Based on the experience garnered over the last two quarters, SEBI has now specified liquidity indicators that need to be disclosed i. Superior/Strong ii. Adequate iii. Stretched and iv. Poor. These have been defined.

A high rating is not consistent with stretched or poor liquidity, but a lower-rated paper can have superior/strong liquidity.

Other requirements

CRA's are now expected to track bond spreads and factor it into their rating calls. They are expected to have more explicit rating triggers defined in their rating announcements. And what surprisingly continues to elude consensus, work with SEBI to define default.

These guidelines are a welcome addition for the orderly development of the credit market. They will no doubt make rating agencies more accountable. But it is equally important that all players – regulators, auditors, trustees and even investors pull in the same direction. That alone will give us the vibrant market we seek.

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