Standing Committee Report Summary

Strengthening of the Credit Rating Framework in the country

- The Standing Committee on Finance (Chair: Dr. M. Veerappa Moily) submitted its report on 'Strengthening of the Credit Rating Framework in the country' on February 13, 2019. A credit rating agency is a body corporate which is engaged in the business of rating of securities offered through public or rights issue. Key observations and recommendations of the Committee include:
- **Regulatory framework:** The Committee noted that credit rating agencies in India have progressed from rating simple debt products to complex debt structures, covering a wide range of products and services like securities, bank loans, commercial papers, and fixed deposits. In India, the Securities and Exchange Board of India (SEBI) primarily regulates credit rating agencies and their functioning. However, certain other regulatory agencies, such as the Reserve Bank of India (RBI), Insurance Regulatory and Development Authority, and Pension Fund Regulatory and Development Authority also regulate certain aspects of credit rating agencies under their respective sectoral jurisdiction.
- The SEBI (Credit Rating Agencies) Regulations, 1999 provide for a disclosure-based regulatory regime, where the agencies are required to disclose their rating criteria, methodology, default recognition policy, and guidelines on dealing with conflict of interest. The Committee noted that SEBI is among the few regulators globally to mandate public disclosure of rating criteria and methodology by the agencies.
- **Change in regulations:** The Committee noted that rating of an instrument or entity is being increasingly relied upon by capital markets, bankers and investors and constitutes a key input for financial decision-making. In the Indian context, the credibility of credit rating has come into question in the crisis involving the Infrastructure Leasing and Financial Services Limited (IL&FS), a major infrastructure development and finance company of systemic importance, with a debt obligation of Rs 91,000 crore. The credit rating agencies ignored the rising debt levels at IL&FS, and continued rating it AAA, indicating the highest level of creditworthiness. In this regard, the Committee recommended that the regulators (such as SEBI and RBI) should review their regulations and suitably modify them to ensure greater objectivity, transparency and credibility in the whole credit rating framework.
- The Committee also recommended that the Ministry of Finance should seek a factual report from the concerned regulators regarding the enforcement of the regulations. In particular, the Ministry should assess the action taken by the regulators against the credit rating agencies who had been giving stable ratings to IL&FS prior to the default crisis. Further, it suggested that the disclosures being made by credit rating agencies should also include important determinants such as: (i) extent of promoter support, (ii) linkages with subsidiaries, and (iii) liquidity position for meeting near-term payment obligations.
- **Issuer pays model**: Currently, the credit rating agencies follow the 'issuer pays model', under which the entity issuing the financial instrument pays the agency upfront to rate the underlying securities. However, the Committee observed that such a payment arrangement may lead to a 'conflict of interest' and could result in compromising the quality of analysis or the objectivity of the ratings assigned by the agencies. Therefore, it suggested that the Ministry of Finance or the regulators may consider other options as well, such as 'investor pays model' or 'regulator pays model' after weighing the relevant pros and cons. Alternately, within the existing framework, the appropriate rating fee structure, payable by the issuer may be decided by SEBI, in consultation with RBI and the credit rating agencies.
- **Rotation of credit rating agencies:** Under the current framework, there is no provision for the rotation of credit rating agencies. The Committee recommended that mandatory rotation of rating agencies should be explored. This would aid in avoiding negative consequences of long term associations between the issuer and the credit rating agency. This is particularly significant considering the recent instances of failure of credit rating agencies identifying trouble in their client-entities. Further, the Ministry may also provide for ratings to be compulsorily carried out by more than one agency, particularly in respect of debt instruments or bank credit above Rs 100 crore.
- Currently, there are only seven credit rating agencies in the country. To increase competition, the Committee recommended that the existing threshold for registration of such agencies may also be suitably lowered with a view to encouraging more entities, particularly start-ups with the requisite capability and expertise.
- **IL&FS**: The Committee noted that the central government has intervened in the IL&FS crisis and reconstituted the Board (the matter being under National Company Law Tribunal). However, the Committee recommended a comprehensive commission of enquiry into the crisis, which will assess: (i) the role of credit rating agencies that had overrated the entities, and (ii) the role of the Life Insurance Corporation of India, the largest institutional stakeholder in IL&FS.

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