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Role of Credit Rating Agencies in Reducing NPAs in Banks

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Abstract

Banking sector plays an important role in the economic development of a country. Hence the stability of banking sector is pivotal for the development of an economy. The Primary and foremost function of the bank is to lend credit to various sectors such as agriculture, industry, personal and housing in order to make productive use of funds. Now a daysbanks are very cautious in lending loans, the reason being rapid increase in non-performing assets. Non-performing assets means an asset on which the borrower has not paid interest and principal during a specified period of time. The paper underlines the role of credit rating agencies their models of business and feasibility of umbrella model under which multiple credit agencies are regulated. It further discusses the importance of SEBI as regulator of credit rating agencies and RBI regulations concerned with credit rating agencies. Finally, conclusion and suggestions are put forth regarding the functioning and improvement in regulatory framework of credit rating agencies so they may act more effectively in reducing the level of NPAs in banking sector.

Keywords: Non Performing Assets, Gross Non Performing Assets, Securities and Exchange Board of India, Insurance Regulatory and Development Authority, Pension Fund Regulatory and Development Authority.

Introduction

All over the world in developed countries or in developing country banking sector plays a vital role in facilitating financial resources to capital-incentive sectors namely infrastructure, iron and steel industry, automobile industry, and to growing sectors such as pharmaceuticals and healthcare. In the present day economy banks are not only treated as financial intermediaries but also they carry additional responsibility of achieving government’s social agenda. Due to this close relationship between banking and economic development, the overall economy is correlated to the health of banking industry.

Indian economy and industry has witnessed a significant transformation since 1991. The economy moved away from state controlled to a competitive market economy. The most remarkable change has been noted in the financial sector especially in banking sector. The financial stability report of Reserve Bank of India revealed the continued rise in NPA in the Indian Banking Sector. The Gross Non Performing (GNPA) of Indian banks increased by 0.1% from 4.5% to 4.6% during the six months period between September 2014 and March 2015. During this period the volume of restructured stressed assets also increased. The total stressed assets of India’s banking sector stood at 11.1% of total advances at the end of March 2015.

On analyzing the sectoral data it was observed that the stressed advances ratio in the industry sector was highest at 17.9%. During a period of nine months (April to December 2014) the advances both to industry and Agriculture sectors depicted a worsen position as compared with the service sector and retail sectors. According to RBI report five major industrial sectors–Mining, iron and steel, textiles, infrastructure and aviation contributed to 53.1% of stressed assets to public sector Banks and 51.1% for all scheduled commercial banks. Upto December 2014 nearly one third of loans given by SCB’s to infrastructure sector were stressed and about 30.9% in case of Public sector banks. Due to huge amount of Bad debts Indian banks were compelled to reduce lending rates despite of green signals from RBI. To sum up it can be said that Indian financial sector is at a delicate stage as a result banks are anxiously looking for an increase in demand from borrowers who in turn are wating for an increase in consumer demands and spending. Thus, Indian Economy is caught in a vicious cycle. Here the role of credit rating agencies plays vital role in identifying the stressed assets and resolving issues relating to credit risks in banking sector.

Objectives

Some of the major objectives of the study are as follows

1. To discuss conceptual framework of NPA in banking sector.
2. To highlight the role of CRAs and its effectiveness in reducing credit risks in banks.
3. To explore remedies for the efficient management of NPAs in banks through CRAs and laying down suggestions how to mitigate them.

NPA Life Cycle in Banks

There are three stages of the life cycle of NPAs in banks. The first stage consists of identification of stressed assets and NPAs. The second stage consists of investigation by measurement and the last and third stage consists of resolution through crisis management and revitalization of stressed assets. RBI has laid an emphasis on banks to be proactive in recognizing stress level and to take remedial measures in order to preserve the economic value of assets. Under the guidelines of RBI Special Mention Accounts (SMAs) classification has been introduced recently, coupled with defining a time bound procedure for deciding the course and nature of remedial actions. In addition, RBI has also taken various steps in strengthening the NPA resolution ecosystem in India which includes an increase in foreign participation rules in ARCs in India and bringing a sunset clause to regulatory forbearance accorded to restructured accounts up to March 2015.

Early Warning System and Credit Risks

Since the last decade the credit monitoring system has occupied and important position in banks as it has direct impact on the profitability and liquidity of credit portfolios. This system has attained an important position due to following reasons:

Dynamic Portfolio Mix

Analyzing the condition of the market and its changing behavior a sound credit monitoring system allows the bank to cope up with changing market situation by adopting risk strategy.

Sound Capital Management

The profitability of the banks are adversely affected by the provisions and reduction in profits which effects equity and vice-versa effects the capital structure.

NPAs and Slippages

Slippages and increase in NPAs reflects low asset quality which leads to credit and reputational risks for banks.

Efficient and Effective Cost Management

The recovery of NPAs could lead to incremental and operational cost for the bank.

Early warning systems can also be helpful in reducing credit risks through proactive monitoring. A good early warning system includes such parameters which can indicate hidden problems. Early warning system includes four major key elements i.e. financial, operational, attitude of borrowers and others. The financial element includes irregularity in installment and insufficient payments, unpaid overdue bills, declining current ratio and diversion of funds. The operational element includes information about borrower, overdue receivables, and frequent changes in plan and nonpayment of wages. The attitude of borrowers includes use of personal comfort, avoidance of contract with bank and problem between partners. The last element consist changes in government policies, death of borrower and competition in the market. Thus, the key to success of EWS depends upon identifying, triggering and customizing the problems. The basic idea is to develop proactive monitoring across the asset portfolio lifecycle with continuous monitoring of assets from sanction till closure of loan account.

Role of Credit Rating Agencies in the Assessment of Credit Risks in Terms of Information Value

Since the last decade the levels of NPAs and stressed assets have grown considerably in the economy as a result credit risk management, credit administration and monitoring became an important tool in the assessment of credit risk. Credit rating agencies across the global are increasing and are considered as an important component in the value chain of credit risk assessment. Credit rating is an indicator to measure the credit worthiness of borrowers and acts as an intermediary between the issues (borrower) and investor (banks) to minimize information asymmetries about the riskiness of investment products on offer. Credit rating provides a third party with independent information on default risk i.e. likelihood of default of an issue on a debt instrument.

The informational value of credit ratings is being debated across the globe. The question arises whether the credit rating agencies are being able to predict the default risks better then the markets. It was concluded that markets are in better position is process information than to conduct credit rating exercise which depends on the historical data.

In sanctioning loans, banks use ratings as a filter and sometimes perform an additional check through independent due diligence review on credit matrix. Thus banks may use credit ratings issued by CRAs during credit appraisal. As per RBI regularly framework the banks are required to depend upon then own credit risk assessment framework and not to rely only on rating assigned by credit rating agencies on contrary the Indian Banking System mandated reliance on external credit rating limiting it to capital adequacy and analyzing market risk under standardized approach of Basel II. However, credit rating information by CRAs is important due to following reasons: -

1. It is suitable for corporate or financial institution which does not trade in markets, thus providing significant information for banks.
2. Good and effective credit rating may reduce information asymmetry and thus enhance more liquidity in the market by increased trading as investors become more confident.
3. Corporate may approach credit rating agencies to get their bank loans rated as this will help them to explore alternate sources of funds and also provide an information base for banks and other investors about default risk.

CRAs and Business Models

The business models of CRAs need to ensure that credit ratings are of high quality credit worthiness and should be accurately measured. An inaccuracy in rating may pose a threat to financial stability by under estimating the risk of investments of regulated entities. In case of bank loan rating of borrower, the problem of underestimation of risk can lead to inaccurate capital calculation due to inflated ratings and could pose a significant threat to financial stability of individual financial institution as well as the whole financial system.

There are mainly three business models:-

Issuer Pay Model

Under this model investor pays for the rating; however the risk includes higher cost for the investor. This model does not eliminate the conflict of interest it only shifts the source of conflict from issuer to investors.

Government or Regulatory Pay Models

In this model there is no structural incentive for bias in either direction. However, potential risk includes market hazards as this may appear to be an approval of the government policies and also the use of public money.

Exchange Pay Model

Under this model exchange pay for the ratings and recover the cost through additional trading fee. This model is one of the best models as it eliminates biasness but it can be applied only on trading entities.

Need of an Umbrella Regulator

In India CRAs operate in domains regulated by different entities. SEBI recognized CRAs who rate instruments that are purchased in capital markets (regulated by SEBI) including banks (regulated by RBI) insurance companies (regulated by IRDA) pension funds (regulated by PFRDA). All CRAs in India are registered with SEBI and most of their revenues currently emanate from capital markets. However, with Basel-II guidelines, ratings of banks loans have also significantly improved. RBI has carried out evaluation of Indian CRAs before granting them the status of 'External Credit Assessment Institution' for rating bank loans under Basel-II. Other regulators like IRDA and PFRDA have also incorporated ratings into the investment guidelines for entities they regulate.

The multiplicity of regulators has necessitated the need for inter-regulatory co-ordination. The policy makers are aware of the apprehensions about regulatory arbitrage taking advantage of lack of co-ordination among various regulators. It is imperative on the part of policy makers to identify the areas where they could facilitate an optimal environment for removal of asymmetric information. This relates to the design, structure and extent of the regulatory structure pertaining to the operations of CRAs, and an enquiry as to whether the prevailing policy regulatory regime has helped or harmed their functioning.

The financial sector Legislative Reforms Commission was formed to look into the regulatory gaps, inconsistencies, overlaps and regulatory arbitrage that exist in the current system. It suggested a code which establishes a single framework for regulatory governance across all agencies.

SEBI in its report had proposed that the CRAs registered with it will be registered to acquire further accreditation with other regulators (RBI, IRDA, PFRDA etc.) for rating products that come under the domains of other regulators. It also proposed that inspections of CRAs should be carried out by only one team, which should have representation from all concerned regulators to observe the areas of activities governed by them.

The policy makers should consult the stake holders regarding the role of SEBI and other alternative present to mitigate the credit risk environment prevailing in the banking sector. From policy formulation perspective the feasibility of an umbrella regulator is definitely a suitable alternative.

Steps taken by SEBI to Strengthen the Regulatory Framework of CRAs

On the basis of their findings in 2009, SEBI has taken multiple steps in the last few years to strengthen the regulatory framework of CRAs. The following are the steps taken by SEBI:-

1. CRAs has to document the rating process in detail enlisting the various underlying factors affecting the rating, summary of discussions with all stakeholders, decision of the rating committee including any dissent note, and rationale for any material difference with the quantities model used. The records need to be kept for five years after maturity of the instrument.
2. SEBI has also mandated that every CRA to formulate the policies and internal code for dealing with the conflict of interest.
3. CRA should disclose other relationship with income from their rating clients.
4. For unsolicited ratings CRAs have to monitor and disclose the ratings as is done in the case of solicited ratings.
5. The regulator has also mandated the CRAs to conduct an internal audit twice a year covering operations and procedures including investor grievance redressal mechanism and compliance with the SEBI Act.

In India the efficacy of CRAs need to be looked from holistic perspective were all participants in the ecosystem, the regulators, CRAs, corporate and investors (banks) need to work jointly towards a better system of credit risk assessment and monitoring. The banks need to move towards risk based pricing where they can use ratings more than just a mandatory exercise by identifying greater incentives for them to adopt ratings.

Conclusion and Suggestion

Since the last decade Indian economy is witnessing downward trends, the banks have been shattered with high NPAs and restructured assets. Macro-economic dynamics may be a major contributor, however it is believed that inadequate credit assessments and monitoring during the upturn in the economy has also contributed to the same. All participants in the ecosystem, the banks, regulators, borrowers and CRAs need to take responsibility. While nothing can be done to undo the mistakes or errors that have been committed in terms of credit assessment and monitoring, sound and effective steps are needed to be taken and a holistic approach is the best way forward. All stakeholders in the ecosystem need to proactively contribute towards a better credit assessment and monitoring framework with the regulator enabling such initiatives.

Suggestions

1. Bank should make effective use of early warning systems as the monitoring mechanism to proactively detect and resolve issues related to the credit risk of the borrower. For the resolution of NPAs, an end to end NPA lifecycle management can also help.
2. A sound regulatory framework should be created for credit ratings along with an umbrella regulator.
3. The opportunity of regulatory arbitrage should be minimized.
4. Working of CRAs should be monitored by the regulator from time to time by adopting remedial measures for resolving conflict of interest of CRAs.
5. Now a day's banks also monitor market risks, however it is imperative that banks should also use this information with credit assessment in order to have a true evaluation of the borrower.
6. Policy should be drawn in order to encourage banks to develop their own internal rating models and validate these ratings by comparing them with publicly available ratings and may also seek more information from the rating agencies, if necessary to be doubly sure of their credit assessment process.
7. Centralized platform should be created for credit ratings, where issuer can approach to get them rated and allocation of work can be done to CRAs based on industry expertise and previous experience amongst others. This will also reduce the conflict of interest and can prevent rating shopping by borrows.
8. The credit rating agencies should be advised to make an effective use of market information's in their credit rating methodology so that the conflict between the borrowers and the investors are minimized.

Conclusion

Thus, undisputedly it can be said that CRAs play a major role in financial markets by minimizing any conflict between lenders and investors on one side and issuer on the other. Rating of an investment puts a security on global radar thereby attracting foreign investors. For emerging market economies like India credit rating can be considered as necessary tool to attract foreign investors. The credit rating agencies help the market regulators in promoting and maintaining stability, efficiency and transparency.

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