R Gandhi: Growing NPAs in banks – efficacy of ratings accountability and transparency of credit rating agencies

Speech by Mr R Gandhi, Deputy Governor of the Reserve Bank of India, at the Conference conducted by ASSOCHAM (Associated Chambers of Commerce and Industry of India), New Delhi, 31 May 2014.

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Shri Jajodia, Shri Narang, Shri Dubey, Shri Kulkarni, Shri Dogra, Shri Khanna, Shri Pathak, other distinguished speakers, Ladies and Gentlemen, a very good morning to everyone! To start with I would like to commend ASSOCHAM for this seminar, for bringing together experts from banking and rating industry, to discuss and debate upon this very pertinent and challenging subject of NPAs and credit rating. A subject like this needs a lot of discussion and thinking, because there are evidently no easy answers; if they existed, we would not be in this state. In a way the last three years were wake-up calls for us; with the downturn in economic activity, the cracks in our credit appraisal and monitoring system have appeared and we should get our act together to repair the structures. This Conference provides an opportunity to get additional insights into credit risk assessment and mitigation in addition to getting to know the views of such a diverse and experienced panel of industry experts.

Asset quality

As the conference is being held in the context of growing non-performing assets (NPAs) of Indian banks, let me begin with few statistics relating to NPAs to put things in perspective.

Before 2008, asset quality of SCBs was improving on a secular basis, following implementation of Prudential Guidelines since mid 1990s. The GNPA ratio had declined sharply from 12.0 per cent as at end March 2001 to 3.5 per cent as at end March 2006 and thereafter this ratio was flat till March 2011. However, since then, the NPA of the banks has been increasing; as at the end of Dec 2013, the Gross NPAs of the domestic banking system was 4.40 per cent of Gross Advances. The final figure for Mar 2014 is yet to be known; While some may view this ratio as reasonable given the economic conditions prevalent in the country and elsewhere, the total stressed assets in the banking system (which includes NPAs and restructured standard assets) as at Dec 2013 was 10.13 per cent of the gross advances of the banks, which is a cause of concern for the Reserve Bank.

Why are NPAs increasing?

Growing NPAs is the biggest challenge for the banking industry. A slowing economy is bound to see an increase in NPAs. Notwithstanding the economic weakness, the NPAs of banks have registered increases since FY 2012 which is a cause of concern for us. The NPA increases have been more pronounced in case of the public sector banks. There are various factors affecting the asset quality of SCBs adversely, such as the current slowdown- global and domestic, persistent policy logjams, delayed clearances of various projects, aggressive expansion by corporate during the high growth phase etc. However, it is the shortcomings in the credit appraisal, disbursal and recovery mechanism of the banks, besides the economic slowdown that can in large part be held responsible for their high levels of NPAs. Lack of robust verification and screening of application, absence of supervision following credit disbursal and shortfalls in the recovery mechanism have led to the deterioration of asset quality of these banks.

Credit ratings and asset quality

Let us now see the relationship between credit ratings and asset quality of the banks. Credit ratings are forward looking opinion expressed by a credit rating agency on the ability and willingness of a borrower to pay his dues in full and on time. More specifically, credit ratings are relative ranking of borrowers based on the credit rating agency's assessment of creditworthiness of the borrowers within a given universe. Credit ratings may also indicate the credit risk associated with a specific credit facility or a specific security.

How does a credit rating differ from credit scores assigned by credit information companies? Both credit rating and credit scores are a measure of credit risk and reflect the varying level of probability of default of a given borrower. The difference is in the methodology used by them to assess the credit risk. While credit ratings are forward looking opinion about credit risk, credit scores assigned by credit bureaus are based on credit history of a borrower. Credit ratings take into account the risk that a borrower may face during a given time horizon in the future, whereas credit scores are based on the past performance of a borrower with regard to servicing of debt. The second difference is that credit scores are assigned to a particular borrower while credit ratings can be assigned to a specific facility.

While credit rating generally denotes a rating assigned by a credit rating agency, there is also a mechanism of internal ratings by banks. A mechanism of internal credit rating of borrowers was in existence in banks much before external credit rating of bank loans were introduced under Basel II regulations. Reserve Bank's guidelines on "Risk Management Systems in Banks" issued in October 1999, indicated that measurement of credit risk through credit rating/scoring receive the top management's attention. Further, the "Guidance Note on Credit Risk Management" issued in October 2002, stated that:

> "A Credit-risk Rating Framework (CRF) is necessary to avoid the limitations associated with a simplistic and broad classification of loans/exposures into a "good" or a "bad" category. The CRF deploys a number/ alphabet/ symbol as a primary summary indicator of risks associated with a credit exposure. Such a rating framework is the basic module for developing a credit risk management system and all advanced models/approaches are based on this structure……"

The credit rating assigned by a bank could be used for the following:

a. Individual credit selection – to decide whether to lend or not to a particular borrower.

b. Pricing (credit spread) and specific features of the loan facility – While risk based pricing is an essential component of credit risk management, available evidence suggest that competitive factors influence the pricing of a bank loan more than the risk rating. However, for traded debt instruments, like commercial paper, there is still link between rating and credit spreads.

c. Portfolio-level analysis.

d. Surveillance, monitoring and internal MIS.

e. Assessing the aggregate risk profile of bank/ lender. These would be relevant for portfolio-level analysis. For instance, the spread of credit exposures across various CRF categories, the mean and the standard deviation of losses occurring in each CRF category and the overall migration of exposures would highlight the aggregated credit-risk for the entire portfolio of the bank.

In line with Reserve Bank's guidelines, banks in India have put in place an internal credit rating framework. Internal rating frameworks available with many of the banks are based on solutions developed by external service providers. However, the effectiveness and sophistication levels of internal rating framework vary from bank to bank. While difference of opinion is essential to avoid "herding", large variance in ratings by banks using similar models could put a question mark over the stability of the models or the ability of users to use the models appropriately.

In addition to the internal credit rating framework, which are generally used to rate corporate clients, banks also use simple credit scoring models to rate smaller borrowers and retail borrowers. Credit scoring models for retail customers generally look at the following four groups of indicators – demographic indicators, financial indicators, employment indicators and behavioural indicators.

Since credit ratings/scores are a measure of credit risk, it has a strong link with NPAs. Loans extended by banks are classified as NPAs when the bank considers that borrower has not serviced his debt or is unlikely to service his debt as per the terms and conditions of the contract. As such NPAs are manifestation of credit risk. Since credit ratings are relative measure of credit risk, the likelihood of default of a borrower with a higher credit rating should be lower than a borrower with a lower credit rating. As a corollary, a higher proportion of borrowers with good credit rating in the books of a bank should translate into lower level of NPAs. Whether that assertion is true or not requires us to evaluate the credit ratings assigned by a credit rating agency by juxtaposing them against the actual default experience.

Another important factor that needs to be kept in mind while comparing the ratings by a CRA with that by a bank is what constitutes a "default"? Credit rating agencies recognise default even if there is a default of one rupee or a delay of one day in servicing the scheduled debt obligations. As far as banks are concerned, an asset is treated as non-performing asset only when a scheduled payment remains overdue for a period of more than 90 days. The definition of default is different as the purpose of recognition of default is different.

What should banks be doing ?

There is growing need for banks to strengthen their internal credit appraisal system i.e. on their credit assessment and risk management mechanisms. At the same time, banks should also consider using external credit appraisals in conjunction with their own assessment. This would mean getting the house in order and at least on this score, banks would be on stronger ground. Banks would still be vulnerable to other factors such as economic slowdown, or policy changes or wilful defaults. But, one area of concern would be plugged. This is where credit rating agencies can play an important role given their experience as well as steady track record over the years.

Regulation of CRAs

In the Indian context, the general superintendence and regulation of credit rating agencies are carried out by the SEBI under Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999. The regulations issued by SEBI cover various aspects viz., registration of rating agencies, fit and proper criteria for rating agencies, rating process and methodology and its records, transparency and disclosures, avoidance of conflict of interest, code of conduct, etc. While these regulations were initially applicable to rating of debt securities by credit rating agencies, they have been extended to cover all rating activities including bank loan ratings.

Additionally, the accreditation for a credit rating agency to qualify as an eligible External Credit Assessment Institution under Basel II framework is issued by the Reserve Bank of India. Such accreditation by the Reserve Bank of India is issued after evaluating a credit rating agency's ability to adhere to the standards prescribed under the Basel II framework. Reserve Bank of India has so far accredited six credit rating agencies viz., Crisil, ICRA, CARE, India Ratings, Brickwork Ratings and SMERA Ratings. While accrediting credit rating agencies Reserve Bank has been mindful of the need to have an optimum level of competition in the ratings market.

In this regard, certain studies on effect of competition among credit rating agencies have indicated that increased level of competition may lead to "rating shopping" and thus affect the quality of ratings. Anil K Kashyap and Natalia Kovrijnykh (September 2013) have shown that "…competition among CRAs causes them to reduce their fees, put in less effort, and thus leads to less accurate ratings". However, in order to avoid predatory pricing, Reserve Bank has mandated that credit rating agencies should disclose the nature of their compensation arrangements with the rated entities on their websites. The disclosure should include the minimum fee that a credit rating agency will charge and factors determining the fee charged.

Credit rating agencies' eligibility is assessed against various qualitative and quantitative parameters. These requirements are grouped into the following six criteria: Objectivity, Independence, International access/Transparency, Disclosure, Resources, and Credibility.

Objectivity: Basel regulations prescribe that the methodology for assigning credit ratings must be rigorous, systematic, and subject to some form of validation (back testing etc.) based on historical experience. Further, the ratings should be subjected to continuous surveillance.

Reserve Bank assesses this criteria in terms of factors like credit rating agency's definition of default and action taken on default, historical default rates, ordinality of default rates (i.e., lower the rating higher the default probability), stability of the ratings (i.e., probability that a given rating remain unchanged during a given period), predictive ability of the ratings, improvement to the rating methodology to reflect current trends etc. Reserve Bank looks into the default studies, transition matrices, Gini Coefficient etc. of credit rating agencies to conduct the above assessment.

To ensure standardisation of default rates, the Reserve Bank of India has mandated that all rating agencies shall use a uniform definition of default as far as the bank loan ratings are concerned.

Independence: Basel norms state that a credit rating agency should be independent and not subjected to political or economic pressures while rating. The rating process should also be free from conflict of interest that may arise due to shareholding pattern or composition of board of directors.

To assess whether a rating agency is independent, Reserve Bank of India evaluates the ownership and organisation structure (presence of independent directors in the Board & rating committees), Independence of individuals i.e. conflict of interest-between rating fee and quality of ratings, conflict of interest with shareholders, conflict of interest at rating committee level, separation of business development and rating activities, separation of rating business from other business activities.

International Access / Transparency: Under this parameter, Reserve Bank evaluates whether a credit rating agency makes necessary disclosures with regard to rating methodologies and rating rationales to both domestic as well as international users without any differentiation.

Disclosure: During the accreditation process, the Reserve Bank assesses whether a credit rating agency makes the following disclosures: rating methodologies, including the definition of default, the time horizon, and the meaning of each rating; the actual default rates experienced in each rating category; and the transitions of the rating. In addition the Securities and Exchange Board of India has also mandated a detailed set of disclosures by credit rating agencies.

Resources: Access to sufficient resources is an important factor in determining a credit rating agencies ability to furnish quality ratings. Reserve Bank makes an assessment as to whether a credit rating agency has sufficient capabilities in terms of human resources i.e., number of employees, their qualifications and experience etc. Further, Reserve Bank also looks into the technological capabilities of the credit rating agencies before deciding upon their accreditation. In addition, Reserve Bank requires credit rating agencies to have access to various sources of information on economy, sectors, companies, etc.

Credibility: Credibility of a rating agency is assessed based on the degree of acceptability of ratings of a rating agency by independent parties viz., investors, insurers, trading partners etc. Reserve Bank also looks into the internal procedures put in place by the credit rating agencies to prevent misuse of confidential information acquired by them during their rating exercise. Credit rating agency's adherence to code of conduct prescribed by Securities and Exchange Board of India, International Organisation of Securities Commissions (IOSCO) and Association of Credit Rating Agencies in Asia (ACRAA) are also analysed to determine the credibility of a credit rating agency.

In addition to accrediting credit rating agencies, Basel II framework requires that the ratings assigned by credit rating agencies shall be mapped to appropriate risk weights available under the standardised risk weighting framework. Basel II framework requires that national regulators should decide which rating categories correspond to which risk weights. The mapping process should be objective and should result in a risk weight assignment consistent with the level of credit risk reflected in the ratings. In India the Reserve Bank has prescribed uniform risk weights for all rating agencies. Such uniform risk weights are prescribed due to relatively low penetration of ratings and absence of sufficient historical default data.

In addition to the detailed assessment at the time of accreditation, the Reserve Bank of India also conducts an annual review of accreditation of credit rating agencies to assess their eligibility for continued accreditation under Basel II framework. During the review exercise, Reserve Bank evaluates the processes as well as the outcomes. The cumulative default rates of rated portfolio of individual rating agency is evaluated in comparison with the benchmark cumulative default rates proposed under the Basel II framework. The cumulative default rates of the bank loan ratings in India are higher than the benchmarks provided by Basel II framework.

How to merge banks credit appraisals and CRAs' assessments?

There are essentially four issues here where banks and CRAs need to work together which will also help banks to de-risk their own portfolios as well as monitor their loans more effectively.

First, Indian banks in conformity with the Basel II norms have been extensively using the credit assessment opinion of external rating agencies for calculating risk based capital requirements. Even though banks do not require credit rating by external rating agencies for calculating their capital requirement for all loans (only loans above ₹ 10 crore require credit rating), some are seemed to be asking companies to get a rating.This evidently is being done to enhance their credit assessments. Quite clearly, there is recognition of the value brought to the table by CRAs for banks which is being used for purposes beyond capital adequacy. However, banks should take into account the cost to the companies and balance it against the benefits.

We talk of sharing of credit information, which is vital given the frequent occurrence of business cycles and their consequences. We have institutions called credit information companies which provide such information to banks on the individual companies. Further, a transition story of how ratings have been moving over time is also available which the bankers should monitor and pick up and regularly draw a parallel rating map of CRAs which they should compare with their own models and rating. This will be one useful check which banks can create for their entire portfolio.

Second, I do see a lot of use in the products offered by CRAs and there is need to see how we can further integrate the two models of credit risk assessment of banks and CRAs. There is a suggestion that banks should de-risk their own portfolio by asking companies looking for long term finance to partly borrow from the corporate debt market. This way the market intelligence of CRAs which is mandatory for bond market borrowing would be an additional input that would come in handy for banks when they are lending money to the entity. This is even more pertinent today because of ALM issues and the demand for funds that would arise once the economy picks up and infrastructure starts to boom. Banks may not be able to fully meet the demand for funds to the borrowers. We have to start working out in detail the implications of such a move, but in this forum it is worth germinating such a thought considering that we have experts from both banks and CRAs present here.

Thirdly, one segment which particularly becomes vulnerable to economic shocks is the SME segment. They are disadvantaged on account of their size and also are the first ones to get affected when the downturn takes place. CRAs have models in place for rating of SMEs and the NSIC scheme gives a subsidy to SMEs for the rating. It will be a good idea for banks to require a rating from these SMEs before giving a loan so that there is a check in place before the loan is disbursed. Given the large number of SMEs in our space, it may not be possible for banks to do a due diligence for one and all. This is where the systems organized by CRAs can be harnessed by banks so that there is some homework already done which is useful for banks.

Fourth, as you may be aware, recently we have given guidelines on banks offering credit enhancement on infra bonds issued subject to certain conditions. This is definitely one measure that we would like to pursue which will also work towards developing the bond market. At the same time, we see an important role for CRAs here too. This is an example of a case of the bond market, banks and CRAs all working together for an optimal solution which will finally benefit the economy.

The development of corporate bond market is very critical for leveraging the synergies between banks and CRAs which can address the issue of growing NPAs in the system.

Therefore, I do see CRAs playing a very important role in the operations of banks that go beyond just capital adequacy and Basel II. The final decision as well as the credit appraisal has to be done by the bank and what the CRA provides will only be additional information that can be used. Banks will also be looking towards the CRAs to shape up their capital requirements under Basel III as they have to raise tier II bonds for shoring it up. But that will be more as a market borrower rather than a lender.

Although the road has been set for Indian banks to migrate to an internal rating based approach for evaluating their credit risk, the ability and preparedness of these banks to migrate to the internal rating approach is expected to be contingent on banks being in a position to test data based on the models to be used for this purpose. Banks would thus necessarily have to rely on external credit ratings for their calculation of credit risk until all the systems are in place.

Accountability of CRAs

Now let us look at the issue of accountability and transparency of credit rating agencies. Why should there be accountability and transparency of credit rating agencies? This brings us to the moot point of who pays for the credit ratings. There are two conventional models. These are: "investor-pay" model, where the investor or banker commissions the credit rating and "issuer-pay" model, where the issuer of the security or borrower pays for the rating. Of late, a new model is being proposed: "society-pay" model, where a neutral third party, i.e., Government, Regulator etc., pays for the rating of a debt.

Each model has its own advantages and disadvantages. Let us analyse the "issuer-pay" model further as that is the most prevalent model currently in our country. As said earlier, in the issuer pay model, the issuer of the debt or the borrower commissions the credit rating either voluntarily or to comply with regulatory requirement. In India, as far as public issue of debt is concerned, regulations by the Securities and Exchange Board of India and Reserve Bank of India make it mandatory for the issuers to obtain a credit rating. As far as the bank loans are concerned there is no such mandatory requirement, even though the capital requirements of banks with regard to corporate loans are dependent on credit ratings. Banks may at their discretion require borrowers to obtain credit ratings.

The advantages of issuer-pay model is that, ratings once assigned and accepted, are disclosed publicly and is available for users at free of charge. Small investors and individuals who wish to invest in debt securities need not pay for accessing the credit ratings. Another advantage of this model could be that issuers may be more forthcoming in sharing information as they are the ones who have commissioned the rating. However, there is an inherent conflict of interest in this model. Since the income and profits of credit rating agencies are dependent upon the volume of ratings they assign, there may be a tendency to assign inflated ratings to acquire and retain clients.

The Financial Crisis Inquiry Commission (2011, Page 212), which went into the causes of the financial and economic crisis in the United States, has concluded that "….the business model under which firms issuing securities paid for their ratings seriously undermined the quality and integrity of those ratings; the rating agencies placed market share and profit considerations above the quality and integrity of their ratings". Such conclusions on the contribution of credit rating agencies to the recent financial crisis have led to calls for tougher regulatory oversight on credit rating agencies.

To conclude, we can see that among the proactive steps that a bank can take to stem the problem of increasing level of NPAs and stressed assets, use of credit ratings is an important one. Banks can use the external ratings as third party, professional assessment, either as a stand-alone basis or in combination with their own internal ratings. However, banks need to balance the use of external ratings, as the recent financial crisis has highlighted the dangers of over dependence on ratings.

I am sure today's deliberations will result in a lot of suggestions that can be used by regulators like RBI and SEBI to bring in improvements in the policy frameworks. I look forward to receive them from the organizers.

Thanking you all for your patient attention.