INTERVIEW VIVEK KULKARNI, MD, BRICKWORK RATING AGENCY

Rating agencies should not structure deals, only rate them

The recent credit market turmoil has raised questions on the role of rating agencies in precipitating the crisis. In this background, Vivek Kulkarni, MD of Brickwork Rating Agency, the fifth rating agency to start operation in India, spoke to ***Bijith R*** of ***The Financial Express*** on the role of rating agencies in the recent crisis, lessons learned from it and the additional due diligence that can be taken. Excerpts.

Post global credit market crisis, questions have arisen regarding the quality of CRA ratings and the integrity of the rating process. So, has the industry been able to allay the fears of financial market participants and what is your take on it?

The global credit crisis has exposed weaknesses in many financial intermediaries - reckless lending by commercial bankers to sub prime borrowers, selling of such loans by the investment bankers via securitisation, loose monetary policy by central bankers, loose investment guidelines by fund managers and soft auditing by chartered accountants among others. In particular the rating agencies helped the issuers of such exotic securities to both structure and also rate. In my opinion, the rating agencies should not structure any deals, but simply rate them. Some foreign agencies grew over 800% in three years and this abnormal growth resulted in quality problems.

We have learnt the lessons from the mistakes other rating agencies committed in the past and have set up processes to maintain the quality and integrity of ratings. Most regulators around the world have also responded in their own ways to license new rating agencies and demand more quality.

What are the extra due diligences that the rating agencies could potentially bring in to be more accurate and unbiased?

IOSCO code of conduct that defines the processes for rating agencies world wide can be a good guide to adopt. If implemented well, the rating could be more accurate and unbiased. In addition, we believe that external rating committees act as an additional factor that can improve the quality more effectively. The internal rating committees made up of rating company executives could be biased towards issuer, who pays the rating fees. The external committee that has no business interest in the rating agency enhances credibility of a rating agency.

Learning from our previous experience, don't you think there is a need for assessing the performance of rating that the CRA has assigned?

Performance of all financial intermediaries has to be measured and rating agencies can not be an exception to the rule. Rating is a business of credibility and if the market comes to impression that rating is more for issuer and not for investor, they lose credibility instantly. The market continuously evaluates agencies and only credible ones can be successful. Large and respectable companies prefer credible agencies.

In India, grading has been made mandatory for all IPOs, which are based on their fundamentals. But past experience shows that irrespective of grading companies share prices have fallen uniformly across the board. So, is grading any longer relevant to investing community?

The share prices of companies will depend on market condition, liquidity, global factors and as such all stocks could go down in tune with such factors showing up simultaneously. Any investor choosing to invest in equity has to consider several factors - the investment horizon, the fundaments of the company, the risk profile as well as possible return. The IPO grading looks merely at the fundamentals of the company and grades from 1 to 5 are issued for each IPO, with 5 being the best grade with strong fundamentals. The fundamentals of the company consider the business risk, industry risk, financial risk as well as management risk. In India, with scare information it is very hard to define and distinguish bad management quality. However we try to identify such fundaments to identify strong companies and eliminate fly by night operators.

Over a period of time, fundamentals of the company changes. Similar to debt market, do you think there is a need for a continuous grading of listed companies?

IPO grading is valid just for initial offering and we do not do any surveillance. World over, the equity grading is not a common practice, since discriminating good and bad equity is highly complex. Globally, grading is technically meant for debt market as there is a fixed payment obligation. Continuous rating is required throughout the instruments maturity period since the probability of default in debt payment is always there. Distinguishing investment and speculative grade debt is far better researched with discriminant analysis models.

However, the case of equity shares is entirely different by its inherent nature. But I believe grading equities could be a good idea for Indian companies that do not disclose mush information. Many brokers do provide research often unsolicited and also criticised for the inherent bias in such reports that promote trading income for brokerages. Many regulators and stock exchanges all over the world have promoted the concept of independent research by third parties. In my view periodical grading of equities by rating agencies can serve the purpose of independent research.

We have seen a lot of regulatory measures and steps introduced to protect the interest of investors in the equity market. What is your sense of the IPO market now?

World over issuing new equity via IPO is the last option. Most companies prefer bank loans and corporate bonds. In India, there is a feeling that the equity especially IPO money is cheaper than bank borrowings. Many promoters feel that the cost of equity is just the cost of dividend yield, typically 2%. Such market psychology would mean some fly by night operators; vanishing companies take advantage of slight bullishness and raise money via IPO. Indian investors have already learnt lessons in the past and I believe the investors are much wiser now. In mid nineties we used to have thousands of merchant bankers and presently a fraction of those have survived. I believe wise investors and relatively better quality merchant bankers would bring fair issues to the market. Every time we see the signs of bullishness, it is time for regulators and rating agencies to be more watchful.