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FORUM VIEWS

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1. What is background of credit rating industry? Explain about Brickwork Ratings.

The genesis of credit rating roots back to 1837 financial crisis in United States. The formal recognitions were received in 1900s at the time of development of railroad bond market. Although the credit rating industry has more than hundred years of history, in India, they are just twenty five years old. In India, the rating industry began with major Development Financial Institutions (DFI) starting one agency each in late eighties. However, with liberalisation the government converted the DFIs into regular commercial banks. The rating agencies are now owned by the foreign rating agencies or foreign institutional investors. India also has a hundred percent foreign entity as a rating agency.

SEBI was the first regulator that came up with Credit Rating Agencies (regulations) in 1999. The four agencies who were operating in India at that time were naturally registered with SEBI. Unlike these four rating agencies, Brickwork Ratings is a rating agency with 100 percent Indian ownership. The agency was set up by former government bureaucrats, professors and bankers. Brickwork also has investment from a major Bangalore based public sector bank.

Brickwork (BWR) was set up in 2008 and is headquartered in Bangalore, now known as Bengaluru. It has offices in Ahmedabad, Chennai, Delhi, Hyderabad, Kolkata and Mumbai. Brickwork is the first credit rating agency to set up an office in Guwahati recognising the importance of North East India.

2. Who takes the rating decision in Brickwork and what are the checks & balances for conflict of interest?

The final rating decisions are taken by the rating committees. We have Internal and External Rating committees. Based on the issue size and company's networth, the rating cases are allocated to different committees. The role of rating analyst is to come up with rating recommendation after following due process. They then present it to the Internal Rating Committee. For the cases of larger companies, cases are presented to the External Rating Committee having members who have no financial interest in the company. BWR has complied with IOSCO Code of conduct and other regulations prescribed by SEBI and RBI.

3. Your views on the Global Financial Crisis of 2008 and India's position

The Global Financial Crisis of 2008 began in the US and spread like wildfire to Europe and later to Asian markets. The primary cause was that the Mortgage Backed Securities (MBS) guaranteed by the Federal Agencies like Fannie Mae, Freddie Mac, well known investment bankers were defaulting. The investors were more puzzled since over 95% securities rated AAA by International credit rating agencies defaulted. The commercial Banks, investment banks who held them in their portfolio were going bust. Lehman Brothers was shut down. The US Governments took over a few systemically important banks. AIG a large insurer, who had guaranteed the mortgage bonds and derivatives has to be rescued by the government.

The US slipped into recession. The housing prices declined and borrowers who till then used to flip houses could not repay. The MBS securities were downgraded and the investors were sustained severe losses. Many European banks and a few Asian ones who held US MBS in their portfolio lost value and had to be supported by the respective Governments.

The international credit rating agencies could not understand the MBS and derivatives fully. The US government and many state governments sued them for the same. Luckily India was in relatively strong position in 2008 and the mortgage crisis did not have immediate impact. However, due to weak US, Europe and other Asian markets the Indian exports declined and the country's growth rate suffered till 2013.

This crisis showed the importance of credit rating agencies to the economy. CRA blind faith in their models created huge disturbances in the world economy. Well - functioning CRAs help the economy. Dysfunctional CRAs can hurt the economy.

4. How can the rating agencies help development of the Indian capital market?

Two important roles CRAs play in capital markets are reducing information asymmetry by dissemination of information in simplest form to market participants and facilitate to form investment rules. Rating is a most crucial element of investment rules set by institutional investors. In a CFO's survey, on the factors affecting the decision of debt issue, credit rating has been given second importance followed by Financial Flexibility. For smaller companies, rating is a decisive parameter in their financial planning.

Most Indian companies begin with own money or funds from family and friends. They then borrow from the banks who come up with many project specific conditions. Once the companies attain certain size they can access the capital markets. SMEs can raise capital via equity platform of BSE that has been growing rapidly. The SMEs can access funding from VCs in India and from foreign private equity too. It would certainly benefit from undertaking rating exercise before entering capital markets.

SME are rated under SME-1 to SME-8 scale. SME-1 denotes excellent fundamentals and will probably succeed well in the capital markets. National Small Industries Corporation also has a scheme that gives 75% subsidy to small scale Industries for taking up credit rating exercise. The rating distinguishes companies in terms of both operational and financial excellence.

The bigger companies can borrow from the Bonds market. They can issue NCD that require credit rating. These debt instruments have to be listed in the debt market segment of BSE and NSE. Large number of realty players have taken advantage of this route and crores of foreign private equity money has flown in. The relevant rating scale is from AAA, AA,A,BBB, all investment grade and BB,B,C & D all speculative grades.The companies with high rating above 'A' category are able to borrow at rates below than that offered by banks. The firms with higher reputation can access short term capital by issuing commercial paper. The relevant scale is A1,A2,A3,A4, and the commercial paper market is limited to borrowers with A1 rating only.

Companies could issue PPMLD (Principal Protected Market Linked Debentures) where they let the investors participate in their growth by offering higher interest rates if their share prices go up.

5. How can companies improve their credit ratings?

Companies can improve their credit ratings by increasing revenues, profits and decreasing bank loans and other debt. Brickwork looks at debt equity ratio, interest coverage ratio, debt service coverage ratio amongst other ratios. Firms with low debt equity and high interest coverage ratio get higher ratings. Companies that are large in net worth tend to receive higher ratings. Companies in growth sectors will get better ratings compared to those in Industries with declining prospects.

The SMEs are better off by incorporating companies under the Companies Act. They get higher rating with professional directors, clear and responsible promoter and good succession planning if the company is managed by family members.

6. Does Brickwork rate equity?

Brickwork does not rate equity at all. The basic principle of rating requires the probability of a company that fails to meet the promised debt repayment and payment of interest. In case of equity, there is no requirement of any fixed dividend to be paid to investors. The company pays dividends only ifit makes substantial profits. Even when Brickwork publishes IPO grading, it looks at only company's fundamentals and does not comment on price. Investment in shares is a function of company fundamentals, investment horizon, asset allocation, risk profile and expected returns by the investor. Brickwork IPO grading is not a recommendation to buy or sell a stock. Rating is not an audit but just an opinion basedon information from the company.

The IPO grading scale is 1 to 5 where 1 denotes firms with Poor fundamentals and Grade 5 means Strong fundamentals.

7. What are Gradings? Does Brickwork have grading products?

Brickwork does grading of many entities like Schools, Colleges-Engineering and MBA courses, ITIs; Real Estate projects, Hospitals, NGO, Tourism facilities, Vendor gradings etc. Brickwork gradings primarily look at fundamentals of the entity and arrives at relative ranking of the entity with reference to peers. Each grading has a set of criteria and the grading is based on these defined parameters. The grading criteria for hospitals has an acronym RESPECT where R stands for Resources, Efficiency, Safety (Patient care & infrastructure), Patient Centeredness, Equity, Clinical Excellence and Timeliness. The government of Karnataka has approved BWR as the recognized agency to grade Tourism facilities like hotels, travels, home stays etc. in the state. Brickwork Real Estate grading evaluates the builder, his past track record, levels of transparency and ability to deliver projects on time.

8. What are career opportunities in the rating industry?

Brickwork Ratings offers jobs as rating analysts, who are required to study individual companies, interact with banker, management, and auditor, examine financial statements and any other documents on record and arrive at a rating. They then present it to Internal Rating Committees and if the company is large to another committee called External Rating Committee.

Brickwork Ratings also provides work opportunities for candidates enrolled to take up BFA Level I and Level II exams that are offered every year on second Saturdays of April. Such candidates are tested in concepts related to banking, investment and risk management. BFA stands for Banking and Financial Analyst. Students wishing to take the exam can do so by self-study, or enrolling for online classes or attend weekend classes at Bangalore. Those who have enrolled in Bangalore classes may apply for work experience as rating analyst either as trainee, junior or rating analyst role.

Students from all over India from good colleges undertake BFA Level I and Level II exams. Usually 70 percent of them already hold an MBA and 15 percent are CA and part CFA of CFA Institute. Usually about 65 % of those who take BFA level I pass and only 35 % of those who appear for BFA level II pass the exam. Brickwork is committed to maintain strict quality in the examination.

9. What is the future of credit rating agency?

Across the globe, the CRAs have been perceived as most powerful financial institutions as they can make Government Shutdown and politicians tremble. Even after exploring all the options to reduce this power, the Governments in different countries could not find alternatives to the credit rating. In continuation of this attempt, the Governments are trying to reduce the oligopoly of credit rating agencies. Many countries like, Australia, China, Russia, European Union, as well as the US etc. have started encouraging new and domestic credit rating agencies. This resulted in two fold increase in number of CRAs after the 2008 financial crisis. This will eventually end the global oligopoly in credit rating industry.