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# EVIDENCE OF RATING CONVERGENCE ACROSS LEADING RATING ENTITIES

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In June 2019 Securities and Exchange Board of India (SEBI) came out with a set of wider disclosure norms for External Credit Rating Agencies (ECRA). Subsequently, ECRAs were advised to disclose a matrix on the probability of default (PD) for various rated instruments both for short-run and long-run. The purpose of the SEBI approach was primarily two-fold, (a) to bring in comparability of ratings across issuers and (b) introducing an element of conservatism in rating agencies assigning higher ratings to corporates.

The good news is that 3 years later, the Cumulative Default Rate (CDR) reveals that long term long run CDR (over 10 years) of ECRA for 1 year, 2 year and 3 year largely confirms to the benchmarked PD primarily for rating agencies CRISIL and ICRA across all rating domains. In fact, there were a couple of defaults because of unexpected legal events that had introduced a minor upward bias in CDR for ECRA. Otherwise, the numbers largely confirm to the benchmark PD that has been mandated by SEBI. The long term short run CDR however reveals that the convergence to PD is still an ongoing process. However, the long term short run (over shorter time periods) CDR are not strikingly different from the benchmark PD at least for CRISIL and to a some extent ICRA. **The onset of pandemic in 2020 may have introduced an uncertainty and thus it may be better to look through the longer cycle at this point of time.**

A couple of data points are, however, in order.

**First** , rating outstanding numbers from all ECRAs, only 0.76% of the rating universe is AAA rated while 3.13% is AA as on February'22.

**Second**, the share of new rating assignments in investment grades improved from 25.3% for FY19 to 60% in FY22 (upto January'22), which also reflects improved corporate health in investment category, a trend observed during pandemic.

**Third,** within the universe of bond primary issuances, the share of AAA rated bond has declined from around 75% in last two years to around 68% in FY22. This is a good omen and clearly reflects some early conservative approach in bond rating specially in the AAA category.

Going forward, with an improvement in credit rating of corporates during pandemic, it will be interesting to look at the transition of AAA rated corporates in terms of benchmarked PD. The current geo-political conflict may also act as an important factor in influencing credit profile in future.

It is also imperative that the continued improvement in corporate balance sheet and aggressive provisioning by banks have ensured that the latter are ready to fund the next phase of growth cycle. Ideally, banks may also look at re-defining its risk appetite framework with the corporate balance sheet now looking more squawky. Such risk appetite framework might enable a balanced growth of the credit book to meet organization strategic goals and to meet larger objectives of kick starting growth keeping in mind the risk tolerance positions.

## BENCHMARKING OF PROBABILITY OF DEFAULT

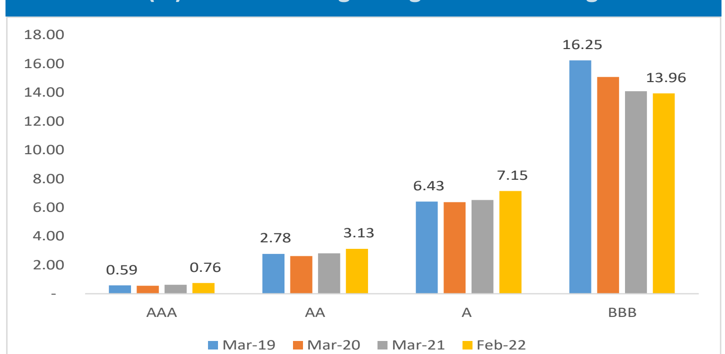
- In June 2019 Securities and Exchange Board of India (SEBI) came out with a set of wider disclosure norms for External Credit Rating Agencies/ ECRA, to arrest rising instances of defaults and investors concerns around the role of rating agencies in timely evaluation of the possible risks, sudden transition of rating, deteriorating credit profiles of firms etc.
- Under the new framework, ECRAs were advised to disclose a matrix on the probability of default (PD) for various rated instruments for one-year, two-year and three-year cumulative default rates, both for short-run and long-run. Additionally, a uniform Standard Operating Procedure (SOP) was also made operational for all ECRAs in respect of tracking and timely recognition of default.
- ECRAs were also asked by the markets regulator to disclose the standardised and uniform PD benchmarks on the website for ratings of long-term and short-term instruments on a consolidated basis for all financial instruments rated by an agency by December 31, 2019.

**Benchmarking PD**

| Rating | AAA | AA | A |
|---|---|---|---|
| Tolerance Level | Zero for 1-year and 2-year default rate | Zero for 1-year default rate | Zero for 1-year default rate with a tolerance level of 3%. |
| | Zero for 3-year default rate, with a tolerance level of 1%. | Zero for 2-year default rate with a tolerance level of 2%. | - |

Source: SEBI; SBI Research

**Share (%) of outstanding rating in investment grade**




Source: SBI Research; CRISIL

- Interestingly, rating outstanding numbers from all ECRAs, suggest only 25% of the all rating are over investment grade i.e. BBB and above and rest 75% are below investment grade. Further, only 0.76% of the rating universe is AAA rated while 3.13% is AA as on February'22.

## PD BENCHMARKING : LOOKING BACK

- The purpose of the SEBI approach was to bring in comparability of ratings across issuers, to an extent even across countries and more scrutiny and accountability in light of disclosure requirements put in place.
- However, as a logical corollary this should have ideally also resulted in rating agencies going conservative to comply with the directions, in assigning rating which may lead to higher risk weights and so the capital requirements for the banks.
- One view is that the new guidelines would ideally moderate ratings and our country would have lesser number of AAAs and AAs. Additionally, it should also raise the requirement of bank capital requirements.
- Thus benchmarking play a very important role and will go a long way in building investors trust on ratings.
- Further, recognition of default in a timely and consistent manner helps achieve the following objectives:

  A) Present accurate performance statistics such as default rates

  B) Help investors and other stakeholders compare performance of CRAs using objective metrics and consistent default monitoring/recognition practices.

## PD BENCHMARKING: LOOKING AHEAD

- With the benchmarking of PDs being already published since Dec'2019, the disclosures reveal long term short run and long term long run cumulative default rate (CDR). The long term short run CDR are estimated based on 24 months, 36 months and 48 month cohorts. The long term long run CDR are estimated over a 10 year period.
- For year ending March'21 we have mapped the CDR of major rating agencies against the respective benchmarks.
- The CDR reveals that long term long run CDR of ECRA for 1 year, 2 year and 3 year largely confirms to the benchmarked PD for rating agencies CRISIL and ICRA across all rating domains. In fact, there were couple of defaults because of unexpected legal events that had introduced a minor upward bias in CDR for ECRA like CRISIL. Otherwise, the numbers largely confirm to the benchmark PD that has been mandated by SEBI.
- The long term short run CDR, however, reveal that the convergence to PD is still an ongoing process. However, the long term short run CDR are not strikingly different from the benchmark PD at least for CRISIL and to a some extent ICRA. The onset of pandemic in 2020 may have introduced an uncertainty and thus it may be better to look through the cycle.

**Long Term Short Run Average Cumulative Default Rate year ending March'21**

| Category/ ECRA | CRISIL | ICRA | CARE | India Rating | BRICKWORK | Benchmark PD |
|---|---|---|---|---|---|---|
| **One Year** | | | | | | |
| AAA | 0.07% ^ | 0.20% | 1.70% | 0.51% | 2.36% | 0.0% |
| AA | 0.18% * | 0.20% | 1.50% | 0.50% | 2.70% | 0.0% |
| A | 0.05% | 0.10% | 0.50% | 0.46% | 2.27% | 3.0% |
| BBB | 0.39% | 1.40% | 1.70% | 3.14% | 4.02% | 3.9% |
| BB | 2.08% | 3.40% | 4.50% | 4.37% | 3.86% | 10.5% |
| B | 4.46% | 5.10% | 6.90% | 7.43% | 5.41% | 19.6% |
| C | 12.05% | 15.20% | 34.60% | 43.58% | 26.38% | 100.0% |
| **Two Year** | | | | | | |
| AAA | 0.31% ^ | 0.70% | 4.00% | 1.06% | 5.56% | 0.0% |
| AA | 0.53% | 0.40% | 3.20% | 1.35% | 5.07% | 2.0% |
| A | 0.21% | 0.80% | 1.70% | 1.69% | 4.60% | 4.3% |
| BBB | 1.68% | 3.30% | 5.10% | 6.63% | 7.98% | 7.1% |
| BB | 4.07% | 6.70% | 8.80% | 7.95% | 7.41% | 17.1% |
| B | 8.76% | 9.80% | 13.40% | 12.78% | 10.70% | 35.3% |
| C | 20.18% | 23.60% | 48.10% | 50.09% | 44.40% | 100.0% |
| **Three Year** | | | | | | |
| AAA | 0.55% | 1.00% | 6.20% | 1.28% | 8.01% | 1.0% |
| AA | 0.70% | 0.70% | 4.20% | 2.18% | 6.45% | 2.4% |
| A | 0.53% | 1.70% | 3.50% | 3.53% | 7.31% | 6.5% |
| BBB | 3.03% | 5.30% | 8.60% | 9.95% | 11.75% | 12.1% |
| BB | 6.14% | 9.50% | 13.10% | 10.89% | 10.88% | 23.2% |
| B | 12.55% | 13.80% | 19.80% | 17.84% | 16.23% | 48.2% |
| C | 31.23% | 28.10% | 52.50% | 53.75% | 54.60% | 100.0% |

Source: ECRA, SBI Research; 24, 36 and 48 most recent cohorts, respectively; ^On account of one default in fiscal 2020 that occurred due to an unexpected legal event *Since fiscal 2020, there were two defaults due to an unexpected legal event and Covid-19 pandemic.

**Long Term Long Run Average Cumulative Default Rate year ending March'21**

| Category/ ECRA | CRISIL | ICRA | CARE | India Rating | BRICKWORK | Benchmark PD |
|---|---|---|---|---|---|---|
| **One Year** | | | | | | |
| AAA | 0.01% ^ | 0.10% | 0.70% | 0.21% | 0.55% | 0.0% |
| AA | 0.09% * | 0.10% | 0.50% | 0.19% | 1.18% | 0.0% |
| A | 0.18% | 0.30% | 0.60% | 0.90% | 1.81% | 3.0% |
| BBB | 0.71% | 1.70% | 1.50% | 2.59% | 2.49% | 3.3% |
| BB | 2.87% | 4.30% | 4.60% | 4.36% | 2.71% | 8.7% |
| B | 6.21% | 6.20% | 7.70% | 6.54% | 3.93% | 17.2% |
| C | 17.25% | 23.30% | 32.00% | 29.14% | 18.71% | 100.0% |
| **Two Year** | | | | | | |
| AAA | 0.07% ^ | 0.20% | 1.50% | 0.44% | 1.65% | 0.0% |
| AA | 0.25% | 0.20% | 1.20% | 0.59% | 2.70% | 2.0% |
| A | 0.78% | 1.1% | 1.8% | 2.45% | 3.82% | 3.5% |
| BBB | 1.91% | 4.0% | 4.1% | 5.96% | 5.73% | 6.0% |
| BB | 5.75% | 8.1% | 9.4% | 8.37% | 5.72% | 14.4% |
| B | 11.74% | 11.5% | 14.5% | 12.60% | 8.35% | 33.1% |
| C | 28.27% | 34.00% | 46.50% | 39.00% | 33.44% | 100.0% |
| **Three Year** | | | | | | |
| AAA | 0.15% | 0.4% | 2.6% | 0.62% | 2.91% | 1.0% |
| AA | 0.40% | 0.40% | 2.10% | 1.15% | 4.06% | 2.0% |
| A | 1.5% | 1.9% | 3.5% | 4.37% | 5.85% | 5.4% |
| BBB | 3.28% | 6.1% | 7.1% | 9.42% | 9.35% | 10.5% |
| BB | 8.41% | 11.1% | 13.9% | 11.97% | 9.10% | 19.6% |
| B | 16.03% | 15.8% | 20.1% | 17.79% | 13.41% | 45.3% |
| C | 36.29% | 38.50% | 54.80% | 43.95% | 44.63% | 100.0% |

Source: ECRA, SBI Research; Last 10-financial year's period; ^On account of one default in fiscal 2020 that occurred due to an unexpected legal event *Since fiscal 2020, there were two defaults due to an unexpected legal event and Covid-19 pandemic.

## DIVEREGENCE IN STABILITY RATES ACROSS RATING AGENCIES

- Stability rate or transition rates indicates the proportion of rating that remain unchanged over a period. It is observed that CRISIL and ICRA have high stability rates of close to 99% for AAA rated borrowers.
- The stability rate, however, varies for AA rated and below rated papers. Higher stability rate indicates lower volatility.

## BOND ISSUANCES—DOMINATED BY AAA CATEGORY

- Around 95% of bond issuances (private placement) by amount are rated AA and above.
- It is important to mention that share of AAA rated bond has declined from around 75% in last two years to around 68% in FY22. This is a good omen and clearly reflects conservative approach in bond rating specially in the top notch i.e. AAA category, the intended purpose of PD benchmarking. Simultaneously, in AA category the share increased to 27.8% in FY22 as compared to around average 16% in last three years. Rating wise distribution of bond issuances during last four years is given in the table alongside.
- One consequence of such lesser number of AAA rated borrowers is **that it will result in diversification of ratings across categories**. For example, most of the corporate issuance in India is currently of top credit quality, with AAA papers accounting for about 67% of all issuances. This shows that the corporate bond market is largely accessible to the top rated borrowers. Thus MSME have no recourse to corporate bond markets in India and have to rely on banks for credit. Hopefully, a better diversification of ratings could help MSMEs to tap markets.

## NEW RATING ASSIGNMENTS IS IMPROVING

- It is pertinent to mention that share of new rating assignments in investment grades improved from 25.3% for FY19 to 47.73% in FY21 and further around 60% in FY22 (upto January'22), which also reflects improved corporate health in investment category. This is a clear acknowledgement that the pandemic has clearly inserted a better rating culture across corporates.
- The share of AAA rated entities increased from 0.51% in FY19 to 2.03% in FY22. Similarly, new rating assignments in AA category improved by 400 bps i.e. from 2.33% in FY19 to 6.33% in FY22.

**Average one-year transition rates for long-term ratings for the last 5-Financial year period ending FY2020-21**

| Category/ ECRA | CRISIL | ICRA # | CARE | India Rating $ | Brickwork |
|---|---|---|---|---|---|
| AAA | 98.70 | 98.90 | 96.64 | 97.75 | 88.57 |
| AA | 97.13 | 95.00 | 92.24 | 95.33 | 88.73 |
| A | 93.19 | 90.50 | 90.99 | 88.38 | 87.97 |
| BBB | 91.95 | 88.40 | 90.25 | 87.11 | 82.12 |

Source: ECRA; SBI Research; $ long term rating includes rating on structured instruments; # all the entities rated by ICRA (non-financial, financial and structured finance) have been included

**Ratingwise share (%) of issuances of Bond in last four years**

| Credit Rating | FY19 | FY20 | FY21 | FY22 |
|---|---|---|---|---|
| AAA | 71.7 | 75.3 | 75.1 | 67.9 |
| AA | 16.4 | 13.2 | 18.5 | 27.8 |
| A | 3.9 | 2.6 | 3.5 | 2.5 |
| BBB | 1.0 | 0.8 | 0.6 | 1.0 |
| Below BBB and unrated | 7.1 | 8.1 | 2.2 | 0.9 |
| Total | 100 | 100 | 100 | 100 |

Source: SBI Research; Primedatabase, Bond Private placement;FY22 upto Jan'22

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