

Setting up and Running a Ratings Agency in India

The CRISIL Experience

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Abstract

It is well known that credit rating agencies' success depends on the level of credibility they are able to build in user markets. This poses significant challenges for pioneering agencies in developing markets, where debt markets are in an incipient stage, concepts are new, and the agency's track record is yet to be established.

This brief paper examines the experience of the Credit Rating Information Services of India Ltd (CRISIL), India's leading credit rating agency. We look at the history and actions of the agency in its history of over a decade, and understand the systems put in place to generate reliable ratings, and to disseminate to the market the rigorous processes by which these ratings are arrived at.

Studies of rating agencies from the standpoint of credibility have so far focused on the Global agencies, and we believe this account of a domestic agency's experiences and processes will introduce a valuable developing-market perspective in the field. Entities setting up and operating rating agencies in developing markets will benefit from the analysis of a viable pathway to self-sustaining success, while the experience in general will be useful for students of the financial markets.

This document is organised into the following sections:

Section 1 introduces the paper, and sets out the rationale for documenting the CRISIL experience and systems

Section 2 details the History and Development of CRISIL, from the time when it was set up as a new agency in an uncharted market, to the present position of market leadership.

Section 3 maps out the internal structures and processes put in place to maintain the credibility of CRISIL and its rating processes

Section 4 draws conclusions from CRISIL's history and processes, and independently applies the proposed SEC NRSRO criteria to CRISIL, as an indicator of where the agency stands as of today.

Section 1: An introduction to this paper

The pivotal role played by credit rating agencies in the development of deep and vibrant financial markets is unquestioned. Considerable analysis in recent times has focused on the criticality of this role, primarily relating to two parameters: the desirability of greater regulation of credit ratings and rating agencies, and of lowering entry barriers in this segment. Effort has also been focused on the evolution of best practices for rating agencies, with some commendable results¹. Similarly, there are comprehensive codes of conduct for Rating Agencies².

Study of agencies' role

For historical reasons, the activities of Global Credit Rating Agencies (GCRAs)³ have dominated most analyses of industry structure. This can be attributed to the size and scope of the US Markets, where these agencies are effectively the only ones to operate. The track record of these agencies in terms of continuous years of rating experience (over a century in case of Moody's, 87 for S&P), and the large amount of ratings data available for these agencies over several years (readily lending itself to statistical analysis), have also undoubtedly contributed to this phenomenon.

Focus on GCRAs

The majority of studies and papers we have reviewed point out that market acceptance of an agency's ratings are a product of the agency's perceived credibility⁴. This creates a significant non-regulatory entry barrier for potential entrants. In our experience, this problem is exacerbated in developing markets by participants' lack of exposure to credit rating concepts, methodologies and utility, and by the small size of existing debt markets. A pioneering rating agency in a developing market therefore faces the doubly difficult task of creating a market for its rating products, and creating a reputation for itself as a credible purveyor of those products.

Market Acceptance

We have found a lack of examples in the current literature on the process of successfully setting up and managing rating agencies in developing nations. It is

¹ The 2002 Best Practices Checklist of the Association of Credit Rating Agencies in Asia (ACRAA) represents a particularly notable effort in this direction. Readers can also refer to the April 2001 APEC Best Practices effort. Such efforts actively contribute significantly to a worldwide improvement in ratings standards.

² Some excellent examples exist, including the Code of Ethics prepared by ACRAA, and the code drawn up by the Securities and Exchange Board of India, the Indian securities market regulator.

³ Standard & Poor's Rating Services, Moody's Investor Services and Fitch Ratings, which are also the three extant agencies granted recognition as Nationally Recognized Statistical Ratings Organizations (NRSROs) by the US SEC.

⁴ Recent examples include 'Private Ordering of Public Markets: the Rating Agency Paradox', Prof. Steven L. Schwartz, Pub. in The University of Illinois Law Review, 2002, I B: 'The Role of Rating Agencies', and 'The Credit Rating Industry: an Industrial Organization Analysis', Lawrence J. White, Stern School of Business, New York University, June 2001: Sections V-C and V-D, 'Moral Hazard Behavior' and 'Efficacy' respectively.

*Relevance of
this case
study*

generally acknowledged that the presence of Domestic Credit Rating Agencies (DCRAs) greatly helps in the development of domestic capital markets: such agencies are acknowledged⁵ to bring significant local knowledge and perspective to the table, besides being in a position to execute small rating mandates which may not be cost-effective for a GCRA. We therefore believe that a case study of setting up and running a successful and well-regarded rating agency in a developing market would be of value in:

- Mapping out a sustainable and replicable pathway for other agencies in developing nations
- Understanding and analysing the growth and maturing of a rating agency, particularly in an emerging market
- Benchmarking and diagnostics in comparable cases
- Sharing and comparing experiences across agencies and countries

⁵ For instance the results of a survey of local institutional investors from 11 Asian economies quoted in "Development of Regional Standards for Asian Credit Rating Agencies: Issues, Challenges and Strategic Options," in *Journal of Banking and Finance*, Volume XV, No. 2, 2000., where over 90% of respondents agreed with this conclusion

Section 2: History and Background of CRISIL

The Credit Rating Information Services of India Ltd (CRISIL) began operations in 1987, offering credit rating services in a market where the concept was totally new. Interest rates at that time were government determined, and CRISIL's business was therefore built entirely on guiding the market for its investment decisions. CRISIL had the challenge of building a new business in an unknown area from a zero base.

*Founding of
CRISIL*

CRISIL faced several other challenges in its effort. At the time of founding of CRISIL, secondary markets for debt in India were at an embryonic stage, and a source of automatic demand for ratings was therefore denied the agency. Studies undertaken by GCRA had indicated that the market size in India would not support a rating agency. To add to this, CRISIL was starting out entirely on its own, without backing or expertise from any of the Global agencies, and was therefore obliged to develop methodologies and criteria, and train its pool of analytical talent, entirely on its own.

Challenges

CRISIL identified the following immediate and long-term objectives:

- To assist investors in making investment decisions
- To assist issuers in raising funds from a wider investor base
- To provide a marketing tool to entities placing debt with clients
- To provide regulators with a market driven system for bringing about the development of the capital markets.
- To institutionalise a viable and market-driven system of credit rating in India
- To facilitate individuals in investing in financial instruments rather than in non-productive assets.

Objectives

The strategy that emerged was three-fold:

- Creating awareness of the concept amongst all market participants
- Winning credibility, confidence and trust of participants
- Generating ratings business that would increase in size as a system of market driven interest rates came into play

Strategy

In this very difficult market, CRISIL attained profitability in its first quarter of operations, and has remained profitable ever since. CRISIL issued 400 ratings in its first two years of operations. Around 1992, the Reserve Bank of India and the Securities and Exchange Board of India (the main regulators of India's financial markets) made ratings mandatory for various classes of debt instruments, which helped boost revenues. As of November 2002, CRISIL had rated a total of 4303 instruments, totaling INR 4.31 trillion (over US\$ 85 billion).

*Performance
and volume of
ratings*

Today CRISIL's Ratings group has a staff strength of 76 analysts, and is one of the world's five largest rating agencies. The extent of development of the markets can be gauged from the fact that in recent times, 95% of privately-placed debt issues – where ratings are not mandatory – have been rated, signaling strong investor demand for ratings.

Apart from establishing its position of credibility and leadership in the Indian market, CRISIL has also been involved in providing assistance for two rating agencies viz. Rating Agency Malaysia and The Israel Securities Rating Company Limited (MAALOT). A brief description of the scope of services provided by CRISIL in setting up of these agencies follows:

Rating Agency Malaysia (RAM) Berhad

The Rating Agency Malaysia, RAM, was set up with technical assistance from CRISIL. The whole process of setting up RAM including assisting the same in stabilising of operations and training of the analysts was done over a period of two years spread over 1991 to 1993.

The assignment in Malaysia included the preparation of a detailed feasibility report, identification of the range of possible debt instruments to be rated and evaluation of the potential for ratings, recommendation of measures which could be taken by Government authorities to develop the market for rating services, examination of investment policies of major local institutional investors, assistance in the determination of the rating scale and recommend rating categories for different debt instruments, and gradations within each of these categories, suggesting a realistic scale of rating fees and fee structure, recommending of an organisation structure for the proposed rating agency, making detailed recommendations relating to the rating methodology, the rating process and operations of the proposed credit rating agency, examining accounting and auditing standards to determine their adequacy for credit analysis, and recommending methods for information dissemination of ratings to the investor community.

Besides the areas mentioned above, special emphasis was laid on training of the analysts and providing assistance on taking rating decisions.

The Israel Securities Rating Company Limited (Maalot)

CRISIL has also provided assistance to MAALOT in establishing a credit rating agency in Israel. This assignment was carried out in 1993. CRISIL provided training inputs to analysts and constant inputs were provided by Senior CRISIL officials to the senior management of MAALOT. CRISIL's Managing Director

visited MAALOT to provide guidance on various operational parameters.

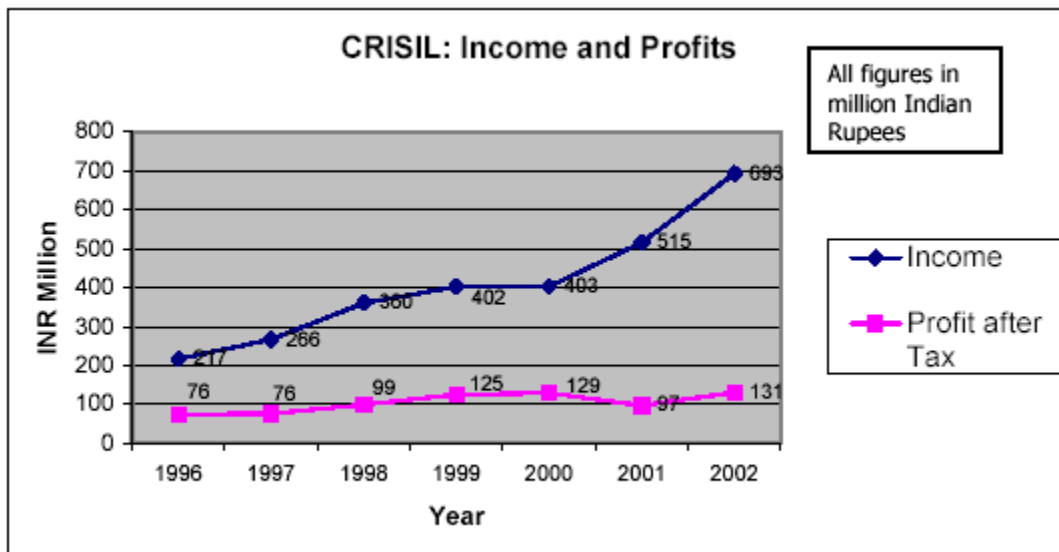
Participation from a GCRA came about in 1995, when Standard & Poor's (S&P) entered into a strategic alliance with CRISIL, well after CRISIL was established in the Indian markets as a credible rating agency. S&P also picked up a 10% equity stake in CRISIL in 1996-97, and the relationship has subsequently matured into a close and fruitful one, with increasing collaboration between the two companies on a number of projects.

*GCRA
Participation*

As part of CRISIL's association with S&P, several CRISIL analysts have been on secondments to S&P offices, or have been trained at S&P. CRISIL has provided assistance to S&P in the past in setting up and maintaining equity indices, and has ongoing collaborations on several S&P projects. CRISIL has also benefited greatly from exposure to international rating markets, and from access to rating processes and methodologies established over long years at S&P.

Financials

CRISIL's revenues have been rising steadily over the last six years, as the chart below shows. Profits have increased significantly in the last financial year (ended 31st March 2002).



Financials

CRISIL has, over time, built up a reputation for superior analysis, which is today widely accepted and respected by the investor community. CRISIL's sustained campaign to enhance awareness amongst issuers, investors and other market entities has undoubtedly contributed to this, as have CRISIL's rating actions, which have proved to be a good lead indicator for many economic measures like growth rate of GDP and growth rate of the Index of Industrial Production (IIP). CRISIL's investor franchise has also benefited from timely rating actions taken in

Market Standing

recent years. For many Indian investors, the CRISIL name is virtually synonymous with ratings.

In keeping with its franchise, CRISIL has always been at the forefront of development of the industry in India. A few noteworthy achievements:

- CRISIL was the world's first agency to develop criteria for rating instruments carrying partial guarantees
- CRISIL was the first agency in India to develop criteria for rating banks, state governments, and urban local bodies
- CRISIL introduced ratings for structured finance instruments in India
- CRISIL introduced performance ratings for
 - Real estate developers
 - Capital market brokers
 - Parallel marketers of petroleum products
- CRISIL also introduced ratings of healthcare institutions on quality of delivered care

Thought leadership

Other major innovations include the creation of a software model for assessment and measurement of borrower risks, which has been productised and sold to major Indian banks and institutions.

One very significant recent achievement has been the introduction of Corporate Governance & Value Creation (GVC) Ratings, a globally unique product which rates companies based both on the strength of controls and processes, and on the extent of balanced wealth creation and the quality of wealth management.

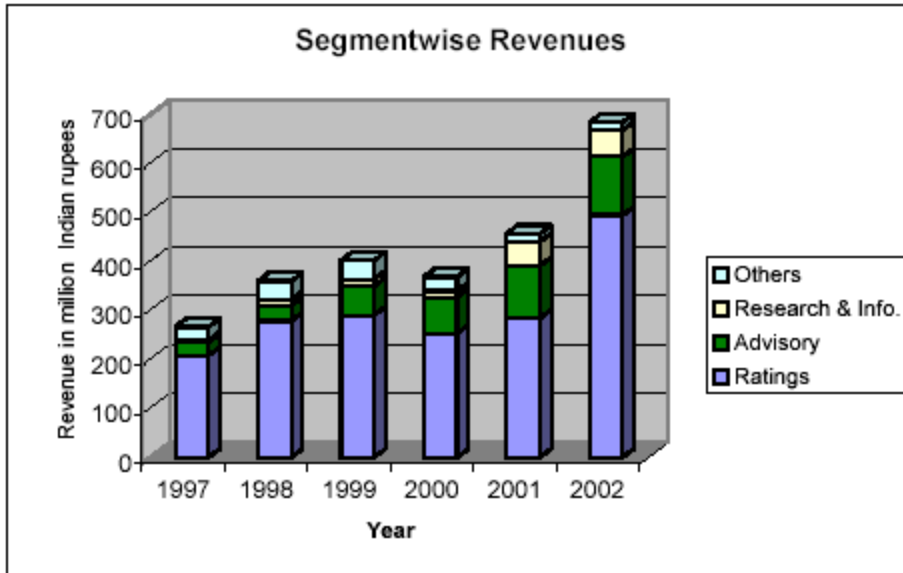
GVC Ratings: a recent innovation

In keeping with its franchise, CRISIL has always followed a premium pricing strategy, which has been accepted by the market as a concomitant of superior delivered value

Pricing

Starting in the mid-90s, CRISIL embarked on a diversification program. The objectives of this exercise were three-fold: to diversify cash flows, leverage existing capabilities, and generate synergies with existing businesses. The first major move was into Advisory and Information businesses. On the Advisory front, CRISIL has built up a strong franchise in Energy and Infrastructure sector consulting. The Information Services business has been boosted by the acquisition of INFAC (now CRIS INFAC, a subsidiary of CRISIL), India's leading provider of Industry and Company information. The setting up of Global Data Services of India Ltd, a specialised company for providing accurate and reliable company data and analysis, was a further step in this regard. In the Financial Year 2001-02 (ended 31st March 2002), Advisory Services and Information Services contributed 17.5% and 7.9% respectively of CRISIL's revenues.

Diversification



CRISIL's next major move was to set up a subsidiary (now known as CRIS-RISC), for providing information and related services, primarily over the internet. CRIS-RISC operates with a strong and continuing revenue focus. Under the CRIS-RISC umbrella, CRISIL runs CRISIL Market Wire (CMW, an online news and information service, recently acquired), and a capital markets research group which has designed and delivered software products for valuation of debt portfolios and grading of mutual funds.

Being in advisory and information businesses, CRISIL is always alive to the potential for conflicts of interest, and has a mix of structural and procedural safeguards in place to protect itself against them. A few of these are discussed below:

Need to manage information flows

As a ratings agency, CRISIL is often privy to confidential information. As a conscious choice, therefore, the information businesses within CRISIL have been maintained as subsidiaries, with dedicated employees. As a further check against unintentional spread of information, these groups are housed in separate facilities from the CRISIL Ratings group. While CRISIL's ratings group uses the products of the information services subsidiaries to enhance its understanding about the economy, industries, and specific companies, the system has been configured to ensure that there are no reverse flows of information.

Information flows from information services subsidiaries

Advisory services, too, are looked after by separate and dedicated teams within CRISIL, and are different in focus from the areas covered by ratings. CRISIL's advisory activities focus mainly on infrastructure development and financing, and on risk management for financial sector entities. Assignments are accepted only after potential conflicts of interest with the ratings activity have been addressed.

Managing conflicts of interest with advisory services

Section 3: Internal Processes and Dynamics

Ownership and Management

Ownership

CRISIL's promoters represent a broad cross-section of the financial sector. The list includes major Indian Financial Institutions such as ICICI and HDFC, a large mutual fund (the Unit Trust of India), a number of Indian and foreign banks, and the Asian Development Bank (ADB), Manila. This distinguished and broad-based parentage ensured an initial market perception of CRISIL as a credible, professional and independent entity, an image that CRISIL strives to maintain.

A clear and comprehensive account of the ownership has been circulated in the public domain, and is updated whenever there are significant changes in the ownership.

Management

CRISIL is a professionally-managed company, where the management is independent of the ownership. The members of the CRISIL Board are distinguished professionals. Executive Directors, and other senior managers of CRISIL, are financial professionals who have exhibited excellence in their respective fields, and have a track record of significant achievement behind them in CRISIL.

Details (age, qualifications, experience, other directorships) of the key Senior Management, and all Board Members, have been published, and are available in the public domain.

Independence of the ratings process

CRISIL has taken a number of steps to ensure that the rating process remains insulated from the business side of CRISIL. These include:

- i) All rating decisions are taken by the Ratings Committee, an independent body. The rating committee includes only independent professionals; shareholders are not represented.

Rating Committee

Names and Details (age, qualifications, experience, other directorships) of the Rating Committee members, including backgrounds and qualifications, have been published, and are available in the public domain.

- ii) Business development in CRISIL is a separate function, not carried out by rating analysts. There is thus no business pressure on the rating analyst.

Rating rigour and integrity

- i) CRISIL has clearly specified and publicly available processes and criteria for arriving at a rating. These criteria are updated from time to time, and are available on the CRISIL website, besides being published by CRISIL in printed format
- ii) A team of at least two analysts (including a designated lead analyst) goes for each management meeting.
- iii) The rating team has to satisfy an exhaustive list of process parameters, maintaining the rigour of the process and minimising the likelihood of error or oversight.
- iv) CRISIL has a strict policy with regard to individuals trading in securities, to preclude conflicts of interest at the individual level.

Some of CRISIL's measures to safeguard the rigour and integrity of the ratings process

Best Practices

CRISIL is an integral part of the Best Practices effort of the Association of Credit Rating Agencies in Asia (ACRAA), with the CEO of CRISIL being the Chairman of the Association's Best Practices Committee. CRISIL has proactively implemented several practices which are part of the ACRAA Best Practices checklist. These include:

- i) A clear statement of what the ratings issued by the agency mean (probability of default of the rated debt instrument)
- ii) A published document detailing the limitations of the ratings process
- iii) A clear and comprehensive account of the ownership has been circulated in the public domain, and is updated whenever there are significant changes in the ownership
- iv) Publication of the names, qualifications and experience of CRISIL Directors, Senior Management and Members of the Rating Committee (these are put up on the CRISIL website)
- v) Publication of rating process and criteria for all categories of ratings and types of issuers
- vi) Published policy on time to be taken to disseminate a rating which has been assigned / accepted
- vii) Published policy on time to be taken to release rating rationale (summary rationales are released along with the rating), along with guidelines on what the rationale will contain
- viii) CRISIL's default and transition statistics are compiled regularly and are

CRISIL's position on components of the ACRAA Best Practices Checklist

- available to users for a fee
- ix) Published policy on dependence on third parties
 - x) Published and explicit review and appeal process
 - xi) Published policy on unsolicited ratings: CRISIL does not undertake them
 - xii) Published policy on rating withdrawals (Barring certain exceptional cases, CRISIL ratings are withdrawn only when the rated instrument is fully repaid or extinguished: specifically, ratings are not withdrawn due to issuer non-cooperation, except in extreme cases of information unavailability)
 - xiii) Published policy on disclosure of unaccepted ratings (which are not disclosed, except in response to regulatory requirements)
 - xiv) Published policy on surveillance of current ratings
 - xv) Published policy on preserving confidentiality of privileged information (and exceptions for regulatory queries)
 - xvi) An explicit code of ethics signed and adopted by each member of the agency
 - xvii) Published policy on the period of validity of ratings
 - xviii) Published policy on working relationship with regulators

Quality and Innovation

CRISIL has put in place a separate group, CRISIL's Centre of Excellence. This is a full-time function, and is charged with reviewing the quality and consistency of ratings. It constantly engages senior practitioners and analysts within the ratings division.

The Centre of Excellence also works on refining rating criteria and developing new rating products, and is key to maintaining CRISIL's intellectual edge.

Section 4: Conclusions

We have seen in the preceding account how CRISIL managed the process of growth of the ratings business, taking measures which enabled it to set and maintain very high standards of rating rigour and independence, while at the same time growing the market and maintaining credibility. This involved a conscious mix of structure, process and disclosure. We will conclude with an attempt to apply an independent and strict set of criteria to examine CRISIL's standing in the markets in which it operates.

As a set of criteria on which to assess an agency's credibility in its markets, it is interesting to examine CRISIL's performance on the SEC's proposed⁶ (1997) criteria for accreditation of NRSROs. While these have not been formally accepted as yet, we believe they provide an efficient set of yardsticks against which to measure progress and achievement.

- i) National recognition: in the Indian context, CRISIL's ratings are benchmarks universally recognised by banks, fixed income market participants, investors and a host of other entities. This recognition is geographically universal, and applies across all categories and scales of issuers.
- ii) Adequate staffing, financial resources and organisational structure: CRISIL is today the largest credit rating agency in India, and among the world's five largest. CRISIL's diversified shareholding, and separation between ownership, management and the rating process, insulate it from pressure from ownership interests. Similarly, its diversified client base and activity profile protect CRISIL from client pressure on rating decisions.
- iii) Use of systematic rating procedures that are designed to ensure credible ratings: as mentioned before in this document, CRISIL has explicit methodologies and criteria for different categories of instruments and issuers, all of which are in the public domain. Process integrity is always strongly maintained.
- iv) Extent of contacts with management of issuers, including access to senior level management of issuers: CRISIL has, in its years of rating experience, built its franchise as the rating agency of choice in virtually all sectors of the economy. CRISIL's opinions on economic issues, sectors and entities are listened to with respect, and aggregative rating actions have in the past proved good predictors of economic trends. CRISIL has rated issuances by most of India's large corporates, financial sector entities, state governments and urban local bodies.

⁶ Ref. Capital Requirements For Brokers Or Dealers Under The Securities Exchange Act Of 1934', Proposed Rule dtd. 12/18/1997, pp 23-35

- v) Internal procedures to prevent misuse of non-public information and compliance with these procedures: as explained before, CRISIL has strong internal safeguards in place to ensure probity and propriety on the part of those involved in the ratings process.

We believe that the experience of setting up and running CRISIL is a valuable one, and can be fruitfully used as a roadmap in studies of setting up and running rating agencies in developing countries, and more broadly in the task of transplanting concepts from developed markets into those that are still gaining depth and sophistication.