Regulatory alert: SEBI introduces guidelines for enhanced disclosures by credit rating agencies

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Summary

The Securities and Exchange Board of India (SEBI) has issued guidelines for credit rating agencies (CRAs) to strengthen the existing disclosures regime and enhance the rating standards followed by CRAs. The guidelines include introduction of the following new disclosure requirements for CRAs:

- Computation of cumulative default rates
- Probability of default benchmarks
- Press release disclosing the rating sensitivities
- Alignment of methodology of computation of cumulative default rates
- Standard operating procedures (SOP) in respect of tracking and timely recognition of default
- Rating symbol for instruments having explicit credit enhancement feature, disclosure on liquidity indicators and tracking deviations in bond spreads

Introduction

CRAs provide ratings to security or instrument by evaluating the financial strength of the issuer. They help investors to identify issuers' ability to pay debts and their level of risk. CRAs in India are regulated by the SEBI (Credit Rating Agencies) Regulations, 1999.

The SEBI, from time to time, issues guidelines for CRAs. These guidelines are mandatorily required to be followed by CRAs. In this regard, SEBI has recently issued guidelines[1] for enhanced disclosures by CRAs.

Computation of cumulative default rates (CDRs)

With a view to align methodology for calculation of default rates with those followed globally, the revised guidelines prescribe following manner for computing default rates:

- **Approach for rating:** CDR shall be calculated issuer-wise using the
  - Marginal default rates approach and
  - Monthly static pools

  The above may be adjusted for ratings withdrawals[2].

- **Disclosure norms for CRA:** Based on the above, a CRA is required to make annual disclosure of weighted average 1, 2 and 3-year cumulative default rates of
  - Long-run average default rates of the last 10 financial years
  - Short-run average default rates of 24, 36 and 48 most recent cohorts respectively

  The above disclosures shall be made on a consolidated basis for all financial instruments rated by a CRA.

  In addition to the above, following aspects are also required to be disclosed on each CRA's website:
  - 10 years' historical data on default rates disclosed every year

[1] SEBI Circular SEBI/ HO/ MIRSD/ DOS3/ CIR/ P/ 2019/ 70 dated June 13, 2019

[2] For securities, the withdrawn rating shall be included in computation of default rates till, earlier of, completion of cohort or maturity. Further, ratings of non-cooperative issuer shall be included in the cohorts under the rating category in which the instrument is being rated.

- SOP[3] for tracking and timely recognition of default

Probability of Default (PD) benchmarks

- **Disclosure norms for CRA:** In order to enable investors to evaluate the performance of CRAs viz. a standardised PD benchmark scale, CRAs, in consultation with SEBI, shall prepare and disclose standardised and uniform PD benchmarks for each rating category on their website, for 1, 2 and 3-year CDR, both for short and long runs. The benchmarks shall be disclosed on a consolidated basis for all financial instruments rated by a CRA by 31 December 2019.

- **Principles for preparing PD benchmarks:** The guidelines prescribe principles to be followed while preparing the above PD benchmarks. Some of the key principles are:
  - Shall be prepared using marginal default rate approach using monthly static pool, for the last 10-year period
  - Short-run benchmarks may have a wider bank computed on a confidence interval of 99.7%
  - Long-run benchmarks band should be narrower computed on a confidence interval of 95%
  - Rating withdrawals rules as applicable on computation of CDR may be applied

- **PD benchmark for certain rating categories:** The guidelines prescribe the following PD benchmarks with certain tolerance levels:

For AAA	Zero for 1 and 2-year default rate, and zero for 3-year default rate with a tolerance level of 1%
For AA	Zero for 1-year default rate and zero for 2-year default rate with a tolerance level of 2%
For A	Zero for 1-year default rate with a tolerance level of 3%

3 Standard Operating Procedures to be framed by the CRA in consultation with SEBI

Rating symbols for instruments having explicit credit enhancement feature

- **Assign suffix 'CE':** The guidelines provide that while rating instruments have explicit credit enhancement feature, CRA shall assign the suffix 'CE'. Further, the guidelines prescribe revised definition of ratings.

  However, for existing outstanding ratings, the CRA shall
  - Disclose new rating symbols and definition on its website
  - Update rating lists on the website
  - Inform clients about change in rating symbols and definitions

Other key changes

- **Disclosure of rating sensitivities in press release:** In order to improve transparency, the CRA shall have a specific section on 'rating sensitivities' in the press release, which shall explain the broad level of operating and/or financial performance levels that could trigger a rating change upward and downward. Such factors shall be disclosed in quantitative terms to the extent possible, discernible to the investors, and should not read like a general risk factor.

- **Disclosure of liquidity indicators:** The guidelines mandate disclosure of liquidity indicators using the following standardised terminology
  - Superior/strong
  - Adequate
  - Stretched
  - Poor

  Further, the guidelines provide an indicative description for these liquidity indicators.

Our comments

The new norms should provide deeper visibility of the credit worthiness of entities to the stakeholders These steps will ensure that investors are able to make a better judgement about the entity after viewing the rating given by the CRAs.

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