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# Watching the Gatekeeper: Credit Rating Agencies and their Regulations

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## ABSTRACT

*A gatekeeper serves to play a role akin to that of a journalist, which involves assembling information and navigating through communication channels in order to make decisions regarding what shall pass through. In a similar way, a credit rating agency acts as a gatekeeper which is responsible for keeping investors updated and informed about the issues relevant to the securities that they might invest in. CRAs are a critical cog in the wheel of the marketability of securities which also be traded on secondary markets. The ratings are granted after a comprehensive analysis of every relevant objective and subjective factor revolving around the business and the financial management of the company, bringing out the weaknesses or strengths of the latter. In India, CRAs function under various regulations of SEBI and RBI. The biggest concern stemming from the way in which the CRAs function (issuer-pays-model) is that of conflict of interest. This is because CRAs are being paid by those very entities that they undertake to evaluate. This has often resulted in major crisis like situations in the market. The article highlights further concerns that stem from the former. It concludes by providing recommendations that could be utilized for curtailing the impact of the abovementioned deficiencies.*

**Keywords:** rating, sebi, credit.

## I. INTRODUCTION

A gatekeeper serves to play a role akin to that of a journalist, which involves assembling information and navigating through communication channels in order to make decisions regarding what shall pass through. In a similar way, a credit rating agency acts as a gatekeeper which is responsible for keeping investors updated and informed about the issues relevant to the securities that they might invest in. They screen a humungous amount of information about the entity that issues securities and conveys the relevant portion to the potential investors.

Therefore, gatekeeping can be described as a process of “culling and crafting countless bits of information into the limited number of messages that reach people every day... This process determines not only which information is selected, but also what the content and nature of the

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messages, such as news [or ratings], will be”<sup>2</sup> A credit rating agency performs this role by issuing appropriate ratings to respective instruments of debt. This includes identifying the creditworthiness of the issuers and to make the investors who might not have a considerable level of requisite knowledge or time for scrutinizing or evaluating the quality of the instruments, aware about the capacity of a corporation to meet their commitments with respect to the interest and the principal sum that will be advanced at maturity.

When investors make decisions about buying corporate securities especially on the basis of favorable securities that are issued by CRAs they assume them to be trustworthy and hence the expectation of being subjected to losses is marginal. Regulators seek to safeguard the investors by establishing rules that make the credit rating agencies as gatekeepers. Given the significance of the gatekeeping role of the CRAs in the market environment, it regulating their functions assumes immense importance.<sup>3</sup>

## **II. FUNCTIONING & UTILITY**

A credit rating agency’s ascertainment regarding the stability or associated risks of a security are transformed into ranges of Triple A to D. While a AAA rating indicates that the possibility of defaulting is virtually zero, the ratings starting from BB and below are designated as being speculative and junk. Thus, CRAs are a critical cog in the wheel of the marketability of securities which also be traded on secondary markets. The prominent credit rating agencies at the global level include, Moody's, Standard & Poor's and Fitch.

However, it has to be noted that a credit rating is neither indicative of the liquidity of the debt security nor its price in the secondary market. It does not stand as a guarantee for its credit quality or the future credit risk. CRAs are dependent on the data that they obtain from the company that subscribes to it for issuing and maintaining credit rating. Such information is scrutinized based on the financial statements, audit reports, rating methods and information that may have been received by independent sources. The rating includes the profile of the company, which assists the investors or creditors to estimate the scope and potential of the companies that they might get involved with. However, they do not look for fraud or undertake any audit for the companies they rate.<sup>4</sup>

The ratings are granted after a comprehensive analysis of every relevant objective and subjective factor revolving around the business and the financial management of the company,

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<sup>2</sup> Pamela J. Shoemaker, Timothy Vos *Gatekeeping Theory*, Routledge (2009)

<sup>3</sup> Mohammed Hemraj *Credit Rating Agencies Self-Regulation, Statutory Regulation And Case Law Regulation In The United States And European Union*, Springer (2016)

<sup>4</sup> Id.

bringing out the weaknesses or strengths of the latter. The framework of analysis deployed for rating comprises of Business Analysis which includes a breakdown of the risks related to the industry the company operates in, its position in the country's market, potential demand/supply factors, operating efficiency and the legal position. The others include financial analysis which evaluates the liquidity management, profitability, taxation issues and asset quality.<sup>5</sup> Given the importance of the ratings that CRAs provide, several regulatory authorities have mandated their use for several crucial matters.

### **(A) SEBI**

As per SEBI (Mutual Fund Regulation), 1996<sup>6</sup>, the mutual funds have been prohibited from making investments of more than 15% in a security instrument which might be issued by a single issuer whose rating is below the investment grade and not more than 10% can be invested in an unrated security. In a circular<sup>7</sup> that was dated September 30, 2003, SEBI has made it mandatory for each public and right issue of debt instruments which have a tenure of an year more than to be rated by an a CRA that is approved. SEBI (Disclosure and Investors Protection) Guidelines<sup>8</sup>, 2000 which is concerned with primary issues of shares, debentures, and various other financial instruments has proscribed any public issue or rights issue of convertible debt instruments as long as a credit rating has not been received from at least one SEBI registered CRA. Regulation 10 of the SEBI ICDR Regulations, 2018<sup>9</sup> provides a mandatory requirement from the issuer of a convertible debt instrument in case of IPO, to get a rating from a CRA and to reveal all the grades that were obtained by the CRAs which the issuer approached in a red herring prospectus. As per the SEBI (Collective Investment Scheme) Regulation 1999<sup>10</sup>, agro or plantation bonds cannot be issued by an entity unless a rating from a SEBI registered CRA has been obtained.

### **(B) RBI**

NBFCs having a net owned fund worth 25 lakhs and above need to have a minimum investment grade to be granted by an approved CRA every year in order to be allowed to accept deposits from the public in accordance with NBFCs Acceptance of Public Deposits (Reserve Bank)

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<sup>5</sup> Mr. Ramdas Lad, Credit Rating Agencies In India

<sup>6</sup> Seventh Schedule Securities And Exchange Board Of India (Mutual Funds) Regulations, 1996 [Regulation 44(1)] Restrictions On Investments

<sup>7</sup> Sebi/Mrd/Se/At/36/2003/30/09, September 30, 2003

<sup>8</sup> [https://www.sebi.gov.in/legal/guidelines/Aug-2008/Sebi-Disclosure-And-Investor-Protection-Guidelines-2000-Amended-Upto-August-28-2008-\\_14237.html](https://www.sebi.gov.in/legal/guidelines/Aug-2008/Sebi-Disclosure-And-Investor-Protection-Guidelines-2000-Amended-Upto-August-28-2008-_14237.html), Visited 28<sup>th</sup> April 2022

<sup>9</sup> [https://www.sebi.gov.in/legal/regulations/Sep-2018/Securities-And-Exchange-Board-Of-India-Issue-Of-Capital-And-Disclosure-Requirements-Regulations-2018-\\_40328.html](https://www.sebi.gov.in/legal/regulations/Sep-2018/Securities-And-Exchange-Board-Of-India-Issue-Of-Capital-And-Disclosure-Requirements-Regulations-2018-_40328.html), Visited 28<sup>th</sup> April 2022

<sup>10</sup> [https://www.sebi.gov.in/legal/regulations/Aug-2021/Securities-And-Exchange-Board-Of-India-Collective-Investment-Scheme-Regulations-1999-Last-Amended-On-August-03-2021-\\_34730.html](https://www.sebi.gov.in/legal/regulations/Aug-2021/Securities-And-Exchange-Board-Of-India-Collective-Investment-Scheme-Regulations-1999-Last-Amended-On-August-03-2021-_34730.html), Visited 28<sup>th</sup> April 2022

Directions, 1998.<sup>11</sup> RBI has made it compulsory for all residuary NBFCs to make an investment of at least of 20% of a combined amounts of liabilities in certificate of deposits or fixed deposits in financial entities or commercial banks having not below the AA+ rating.<sup>12</sup> All the primary dealers in government securities are required to mandatorily invest only in those non-government securities that are credit-rated. Their non-governmental securities portfolio cannot have more than 10% unrated securities.<sup>13</sup> In a securitization transaction, the securities that might be issued by the SPV are mandated to be rated by a registered CRA which shall not be older than 6 months.<sup>14</sup> As per the Basel II norms that are issued by the RBI, external credit ratings obtained from the CRAs under “Standardized Approach” would be the basis of credit risk scrutiny and for different types of debtors, their ratings have been in line with their risk weights. In addition to this, even IRDA makes use of CRA ratings via its IRDA (Investment) Regulations, 2000, according to which it is compulsory for all the insurance companies to invest their assets of the general annuity, pension only in highly rated securities.

### **III. CONCERNS & FALLIBILITY**

The biggest concern stemming from the way in which the CRAs function (issuer-pays-model) is that of conflict of interest. This is because CRAs are being paid by those very entities that they undertake to evaluate. This has often resulted in major crisis like situations in the market. Such economic turmoil can drive the markets into a downward spiral ultimately having detrimental consequences for the economy as a whole. On a global level, the biggest financial catastrophe where CRAs had a huge part to play was the 2008 subprime crisis. They ended up underestimating the credit risk to be attributed to the structured credit products having an international ripple effect over institutions and investors that had a stake in such instruments. A large number of subprime mortgage products were given highest ratings which gave rise to misassumption about their suitability. Moreover, even after the market started plummeting, CRAs did too little too late as far as adjusting the ratings appropriately was concerned.

The failure of the CRAs in playing their role as gatekeeper can be captured in the Financial Crisis Inquiry Report finding, that by granting AAA ratings to complicated, insecure asset-backed securities as well as other derivatives which resulted in amplification of the financial shock with the ultimate bursting of the housing bubble, CRAs had an active hand in stimulating

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<sup>11</sup> Notification No.Dfc.118/Dg (Spt)-98 Dated January 31, 1998

<sup>12</sup> Prudential Guidelines On Investment In Non-Government Securities, <https://www.rbi.org.in/scripts/Notificationuser.aspx?Id=1534&Mode=0> Visited 28<sup>th</sup> April 2022

<sup>13</sup> Id.

<sup>14</sup> Guidelines On Securitization Of Standard Assets, <https://www.rbi.org.in/scripts/Notificationuser.aspx?Id=2723>, Visited 28<sup>th</sup> April 2022

the bogeyman of mortgage-backed securities to the extent that it became.<sup>15</sup> Thus, CRAs were castigated for their weak performance in financial forecasting, for their creeping speed of identifying the nosediving trends, pursuing things not soon enough to modify their ratings and downgrading the companies after the house was burnt.

Some of the reasons for such misgivings have been pointed out which include they had been acquainted with the management of the companies more than required which might have created situations of undue influence or even susceptibility of being hoodwinked by the face value of company, doing away with the need of scrutinizing the elucidations by the companies. Another issue was the lack of incentive to take a cautious approach in the since the need for accountability was almost non-existent rooted in the absence of a deterrent consequence or a distress of their reputation taking a hit. Their prime concern revolved around ensuring that their issuers were pleased in order to warrant a consistent flow of earnings in the future.<sup>16</sup>

The market situation has not been insulated from the fallibility of the CRAs even close home. In 2012, which saw one of the first cases of such extent, CARE had granted some of the highest ratings to DCHL's financial instruments which was continued even after the company has committed short term default on their creditors, leading to the company being able to borrow sums in excess of 4300 crore.<sup>17</sup> Then in 2015 the quality of the bonds of Amtek Auto was missed by some CRAs along with JP Morgan's bond fund holdings' quality. This led to the redemption crisis, leading Amtek Auto on the verge of defaulting on bond repayments costing almost Rs.800 crore.<sup>18</sup> In the recent past, it was IL&FS, whose high rating maintained by CRAs despite of flagged elevated leverage became an issue of concern. None of the agencies took cognizance of the situation when a AAA rated company failed to clear dues and was not invoking its promoters' "line of credit". The rating of the paper was of investment grade for pension and insurance institutions.<sup>19</sup>

## **IV. Regulations in the world & India**

### **(A) IOSCO**

In view of the various concerns surrounding the working of CRAs, certain principles have been

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<sup>15</sup> Financial Crisis Inquiry Report 2011, <https://www.govinfo.gov/content/pkg/GPO-Fcic/Pdf/GPO-Fcic.Pdf>, Visited 28<sup>th</sup> April 2022

<sup>16</sup> Supra Note 2

<sup>17</sup> <https://indianexpress.com/article/india/india-others-do-not-use/deccan-went-on-borrowing-spree-rating-agency-was-mute/>, Visited 28<sup>th</sup> April 2022

<sup>18</sup> <https://indianexpress.com/article/business/companies/jp-morgan-mutual-fund-settles-amtek-auto-case-with-sebi-5112366/>, Visited 28<sup>th</sup> April 2022

<sup>19</sup> [https://www.business-standard.com/article/companies/il-fs-default-did-rating-agencies-failure-to-connect-dots-lead-to-crisis-118092800364\\_1.html](https://www.business-standard.com/article/companies/il-fs-default-did-rating-agencies-failure-to-connect-dots-lead-to-crisis-118092800364_1.html), Visited 28<sup>th</sup> April 2022

evolved in the form of IOSCO code, which was espoused by the international regulatory authorities of securities. This was based on discussion among the members of IOSCO, Basel Committee on Banking Supervision's Committee, an international body of insurance supervisors along with the market stakeholders such as issuers, investors and other participants. The Code lays out the duties that the CRAs owe to their issuers, wherein maintaining the integrity of the rating mechanism and thereby advancing protection of investors, has been underlined as their core purpose. Even though there might be various other entities making use of CRA ratings, however the code acknowledges that it is the investors who are the primary beneficiaries who rely on these ratings before making investments to a large extent. Thus, it becomes imperative for the CRAs to maintain a respectable degree of distance from the issuers in order to ensure their continued independence. It lays stress on the obligations of CRAs towards the issuers by mending the quality of credit ratings as well as their utility to the investors. It aims to be useful to all kinds of business models relied on by the CRAs since there is no hint of any sort of inclination preferring one business model over another.<sup>20</sup>

### **(B) Dodd Frank Act**

It has been described as a response of the U.S Congress to the situation of “too big to fail” and was established in the aftermath of what the entire period of Wall Street operating without any shred of accountability led to. It laid stress on revamping the regulatory system of the U.S in various arenas, one of them being the regulation over CRAs. It seeks to achieve this through corporate governance guidelines, eliminating the conflict of interest issues to as low as possible and deploying improved controls & enhanced transparency to attain a refined rating process. The Dodd-Frank Act, works to enlarge the oversight and enforcement authority of Securities Exchange Commission. In this way, the possibility of the investors bringing in lawsuits against CRAs can be facilitated. An attempt is made at a reduction in reliance over the ratings as a benchmark for credit quality, preferring wider criteria incorporating numerous factor over the former. The Act entails the Commission to embrace various new rules covering multiple issues ranging from the requirement of annual reports concerning internal control to conflict of interest in the arena of marketing and sales, along with the “lookbacks” while the departure of credit analysts from the NRSRO. These new regulations will clear the path for pressing penalties or fines, disclosure with regard to statistics related to performance, disclosure of methodologies adopted by CRAs along with their application, disclosure of the data and assumptions that form the root of the credit ratings, disclosure about due diligence by 3<sup>rd</sup> party, training & testing of

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<sup>20</sup> <https://www.iosco.org/library/pubdocs/pdf/Ioscopd482.pdf>, Visited 28<sup>th</sup> April 2022

analyst. This will be complemented with a regular application of symbols and definitions of rating as well as supplementary & unambiguous disclosure of ratings that might be associated with the asset backed securities products.<sup>21</sup>

## **V. INDIAN CONTEXT**

### **(A) Accreditation by RBI**

Basel II Framework assigns the risk weights to the exposure of banks on the basis of their credit ratings and the capital that it needs to maintain is connected to the total risk weighed assets of the bank. Therefore, a credit rating has a significant bearing on the capital that a bank needs to maintain for a particular loan portfolio. In order to ensure that the ratings issued by credit rating agencies could be relied upon, 4 domestic CRAs were given accreditation as approved External Credit Assessment Institutions in 2006. These included Credit Rating Information Services of India Limited, Investment Information & Credit Rating Agency of India Ltd., Credit Analysis and Research Limited & India Ratings. Later their ranks were joined by Brickwork Ratings, Acuite Ratings & Research Limited and Infomerics Valuation and Rating Private Limited.

RBI has been undertaking a yearly review of the accreditation of these agencies since the year 2009-10, the most recent being in 2017-2018. While exercising the authority of conferring accreditation and reviewing it periodically, certain elements are taken into account. These include objectivity which underlines the importance of the methodology being thorough, rigorous and in-depth which shall be based on some form of justification rooted in a historical understanding. Such agencies are required to be independent in terms of being free from any kind of political or economic influence that might reflect on the rating. The resources possessed by the CRAs should be adequate to embark on a top notch assessment. The assessment would be truly reliable when they deploy methodologies that take into consideration both quantitative & qualitative perspectives.

### **(B) Regulation landscape under SEBI**

The regulatory framework overarching CRAs has been provided under the aegis of SEBI. They're governed under the following statutes:

1. "Securities Exchange Board of India (Credit Rating Agencies) Regulations, 1999"
2. "Securities and Exchange Board of India (Criteria for Fit and Proper Person) Regulations, 2004"

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<sup>21</sup> Supra Note 2

3. “Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002”
4. “SEBI (Investment Advice by Intermediaries) (Amendment) Regulations, 2001”

### **(C) Establishment**

As far as the mechanism for their creation is concerned in order for the CRAs to be set up and initiate their operations, it is mandatory for them to be approved by the SEBI. The certificate will remain valid for 3 years after which it requires to get renewed. To get the required approval, a company has to meet certain criteria which involves “rating activity” as one of its primary stated goals in its MoA with a minimum net worth of around Rs.5 crores. It needs to be accompanied with appropriate infrastructure to facilitate the procedure of providing ratings as per the rules & regulations of the Act. The applicants and its promoters should be equipped with relevant professional expertise, financial reliability and a general understanding of ethics & integrity in business dealings to the full assurance of SEBI. With regard to the key persons associated with the company, there has to be a lack of engrossment into any proceedings either legal or involving charges of moral turpitude in relation to securities markets & economic offences. No persons connected to the company should have been either denied a certificate by SEBI under these regulations or be in contravention of any rules or regulations that are part of the Act.

### **(D) Promoter**

It is compulsory for the promoters of the applicants to belong to any of the categories such as a public financial institution, a scheduled commercial bank, a foreign bank, a foreign CRA, a company with a consistent net worth of at least 100 crore reflected in its audited annual accounts for the last 5 years. It cannot rate an entity associated with its promoter in terms of credit or being its subsidiary in case there is an overlap of employees, chairman or directors.

### **(E) Liabilities**

There is a liability upon the CRAs to undertake a consistent monitoring over the securities that they rate during their entire lifetime while conveying information about the updated ratings and modifications in previous ratings through appropriate communication channels. In case, the securities belong to a company that is listed, corresponding information shall also be disseminated to the relevant stock exchanges. The CRAs are required to maintain a suitable repository containing all important documents & accounts related to the companies and the ratings for at least last 5 years.

**(F) Rating Mechanism**

As a pre-requisite to rate securities of a company, there needs to be written agreement between both the parties. The specifications about the rating process have to be filed with the Board along with a copy of any alterations made in the relevant period. All the rating decisions shall be taken by a dedicated committee which must encompass members with sufficient qualifications and knowledge base to grant ratings. Unless the Board has been informed, the definition or structure of the rating cannot be changed by a CRA.

**(G) Restraints**

CRAs are not permitted to issue rating for the securities that they might issue themselves or by their promoters. If there is a situation wherein its promoter happens to be a lending institution then there shall be no overlap among the members who serve in the capacity of Chairman, employee or director of the two entities or even the rating committee.<sup>22</sup>

**(H) Code of Conduct**

As per Regulation 13 of the 1999 Regulations, the CRAs are mandated to abide by certain codes of conduct and ethics. There is prohibition on a CRA from getting involved in an unfair competition or acquiring clients of their rivals on account of making assurances of higher rating and giving hyperbolic statements to the clients. The CRAs have to be cautious regarding not being associated with the initiation of any false market, revealing any price sensitive material to unnecessary parties giving it the color of being unethical. They have to be wary of rendering any implicit or explicit statements publicly akin to being an investment advice concerning a security. Any occurrence related to material breach or non-compliance shall be duly communicated to the Board. A code of conduct has to be developed at an internal level to monitor the in-house operations while laying down a set of apposite standards to be followed by its employees.

**(I) Investigation**

In case there arises a necessity for an investigation, then SEBI shall take an appropriate action which can include penalty such as cancellation of registration certificate under “Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002”. Such situations include the CRA being involved in a fraud or being held liable for an offence related to moral turpitude or economic offence.

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<sup>22</sup> Shreya Prakash Aditya Ayachit Shreya Garg, “Regulation Of Credit Rating Agencies In India”, Vidhi Centre For Legal Policy

Apart from this, CRAs need to appoint a Compliance Officer who has to report independently to the Board. Disclosures have to be made revealing any conflict of interest which might become an obstacle in their way of achieving fairness and objectivity of their operations.<sup>23</sup> Every CRA is required to adopt comprehensive guidelines on the nature of compensation mechanisms that might be worked out with entities being rated in case of appeal by them in conflict with the ratings that were granted to their securities. This has to be disclosed on the website of the CRAs along with their policy related to putting the ratings on credit watch, rules regarding what encompasses non-cooperation, gift & confidentiality policy and the ones on outsourcing of functions & provisional ratings.

#### **(J) Non-acceptance & delay in review**

In case there is a situation where the ratings are not being accepted by an issuer, the CRA has to disclose all the information about the ratings that were granted on their website which must include the name of the user, the kind of instrument, its size, rating and outlook. In case there is a delay in undertaking the periodic review, the CRA is required to disclose the details of such ratings wherein the review was not completed as per the given timelines even after it became due.

#### **(K) Non-Cooperation**

If there is an act of non-cooperation by the issuer either in the form of refusal to convey relevant information or non-payment of required fees, the CRA has to continue with the assessment of the instrument throughout its life based on the best use they can make from the information that is available as per their rating policies. Subsequent to this, if that issuer goes to another CRA for being rated, the latter has to disclose the issue of non-cooperation in its press release.<sup>24</sup>

## **VI. AMENDMENTS IN REGULATIONS**

The regulations governing the CRAs have been regularly amended keeping up with pace of the developments and requirements of the financial markets. In 2003, the amendments provided the discretion to CRAs regarding rating a security issued by its associate which might have common independent director provided that such director is not a participant in the rating decisions & a proper disclosure is made in this regard. 2018<sup>25</sup> amendments increased the minimum threshold

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<sup>23</sup> Himanshu Bhushan, "Credit Rating Agencies In India: Have We Done Enough?", 22 *Dlsu Business & Economics Review* 37-53 (2013)

<sup>24</sup> *Id.*

<sup>25</sup> Securities And Exchange Board Of India (Credit Rating Agencies) (Amendment) Regulations, 2018, [https://www.sebi.gov.in/legal/regulations/may-2018/securities-and-exchange-board-of-india-credit-rating-agencies-amendment-regulations-2018\\_39183.html](https://www.sebi.gov.in/legal/regulations/may-2018/securities-and-exchange-board-of-india-credit-rating-agencies-amendment-regulations-2018_39183.html), Visited 29<sup>th</sup> April 2022

related to net worth from 5 crores to 25 crores, the promoter of the CRA is required to maintain at least 26% shareholding in the agency until after a minimum of 3 years from being granted the certificate of registration, foreign CRA were made eligible to be a promoter of a CRA after being incorporated in the jurisdiction of an FATF member and being registered under their law. A CRA's shareholding or voting rights in another CRA shall not exceed 10% directly or indirectly and there is a prohibition on having representation on another CRA's board. A CRA is allowed to withdraw rating only after 5 years have elapsed after rating it or at least 50% of its tenure, whichever is higher. CRA have to separate out their activities from the rating of financial instruments. The 2019<sup>26</sup> amendment made it compulsory for a CRA's client to coordinate with it with regard to certain procedures such as periodic reviewing, disclosure related to information, offer documents. An explicit consent has to be provided by the client to acquire information associated with "current & future borrowings, repayment, delay, and default in borrowings from both statutory and non-statutory creditors". Under the 2021<sup>27</sup> amendment of regulations, the CRAs are allowed to rate only those securities which are either listed or planned to be listed on a stock exchange that is recognized by the Board. Further, it vests the Board with the right to initiate an inquiry upon the complaints obtained by the investors or any other stakeholder in relation to the above securities. In the 2022 amendment<sup>28</sup>, SEBI has expanded the operational arena of the CRAs by opening up the entities that can be rated to the ones that may be specified by it.

## VII. PENALTIES

In an appeal that was filed before the Securities Appellate Tribunal by CARE Ratings Ltd. against the penalty imposed by SEBI.<sup>29</sup> The Appellate authority observed that an inappropriate rating conveying erroneous information not only produces adverse effects for the investors but impacts the overall development of the securities market itself. Thus, the obligation of the CRA cannot be insulated by being restricted to a mere personal opinion but something that must have a scientific basis rooted in the comprehensive analysis of the financials and performance of the issuers. The responsibility of the CRA does not stop at grant of rating, rather it is a continuous process which involves constant monitoring leading to appropriate modifications. In case a

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<sup>26</sup> Securities And Exchange Board Of India (Credit Rating Agencies) (Amendment) Regulations, 2019, [https://www.sebi.gov.in/Sebi\\_Data/Meetingfiles/Sep-2019/1567767964398\\_1.Pdf](https://www.sebi.gov.in/Sebi_Data/Meetingfiles/Sep-2019/1567767964398_1.Pdf), Visited 29<sup>th</sup> April 2022

<sup>27</sup> Securities And Exchange Board Of India (Credit Rating Agencies) (Amendment) Regulations, 2021, [https://www.sebi.gov.in/Legal/Regulations/Aug-2021/Securities-And-Exchange-Board-Of-India-Credit-Rating-Agencies-Amendment-Regulations-2021\\_51668.Html](https://www.sebi.gov.in/Legal/Regulations/Aug-2021/Securities-And-Exchange-Board-Of-India-Credit-Rating-Agencies-Amendment-Regulations-2021_51668.Html), Visited 29<sup>th</sup> April 2022

<sup>28</sup> Securities And Exchange Board Of India (Credit Rating Agencies) (Amendment) Regulations, 2021, [https://www.sebi.gov.in/legal/regulations/jan-2022/securities-and-exchange-board-of-india-credit-rating-agencies-amendment-regulations-2022\\_55534.html](https://www.sebi.gov.in/legal/regulations/jan-2022/securities-and-exchange-board-of-india-credit-rating-agencies-amendment-regulations-2022_55534.html), Visited 29<sup>th</sup> April 2022

<sup>29</sup> Appeal No. 454 of 2020, [http://sat.gov.in/english/pdf/E2021\\_JO2020454.PDF](http://sat.gov.in/english/pdf/E2021_JO2020454.PDF), Visited 29<sup>th</sup> April 2022

CRA falls short of performing their duty, suitable measures need to be taken by it, the absence of which indicates a serious lack of due-diligence by the CRA since it is one of the primary criteria relied on by the investors. In view of this, ratings cannot be restricted to being a subjective opinion based completely on the information that is provided by the issuer but has to be accompanied by an independent professional judgement. Thus, in the case the authority was of the view that the CRA had failed to monitor their ratings and downgrading them subsequently when the situation changed for the company.

In the IL&FS matter, SEBI imposed a penalty of 1 crore each on the agencies responsible for extreme monetary losses by the investors due to lapse on their part in relying more than required on the statements provided by IL&FS.<sup>30</sup>

### **VIII. RESOLUTIONS & RECOMMENDATIONS**

While various jurisdictions have become cognizant of the significance that the credit rating agencies carry in the financial markets and their subsequent regulations, the markets are still susceptible to being affected by the oversight by these gatekeepers.

One of the solutions proposed involves creating deterrent consequences for the rating agencies discouraging them from issuing the abysmal level of ratings. A way of achieving this could be exposing these agencies to the possibilities of “disgorgement of profits” that are a result of the ratings on instruments which turned out to be detrimental, unless and until such quality is revealed while making the rating. This removes the need for investigation into the “intent of the agency” to mislead or the post-mortem manner of inquiry into the reasonableness of its ascertainment. There is a need to scale up the disclosure standards. Since SEBI defines the rating as an opinion, CRAs resort to putting disclaimers expressing that such ratings are not akin to recommendations for buying or selling securities. There could be remedied by making them establishing their express liability to investors for causing any act of fraud or negligence. An alternative to issuer pay model could be found in investor pay or regulatory pay model. In the latter, the regulatory bodies such as SEBI or RBI could pick the first CRA to rate any instrument which could be done on a random basis. This could further be supplemented by other agencies but the possibility of rating shopping in regard to the first CRA could be done away with. However, this model comes with its own inherent limitations such as increased responsibility on the authorities to ensure the quality of the CRAs and their suitability for

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<sup>30</sup> Avneet Kaur, *IL&FS: Sebi enhances penalty to ₹1 crore on 3 credit rating agencies*, MINT (2020), <https://www.livemint.com/market/stock-market-news/il-fs-sebi-enhances-penalty-to-rs-1-crore-on-3-credit-rating-agencies-11600824065515.html> (last visited Feb 28, 2023).

particular securities.<sup>31</sup>

In this regard, a standing committee was constituted under the chairmanship of M. Veerappa Moily which submitted its report titled “Strengthening of the Credit Rating Framework in the country”, which has advanced certain recommendations. Firstly, the Committee observed that suggested the Ministry of Finance to seek out a factual report from the regulatory authorities about the extent of enforcement of regulations by them. A special mention was made about the need to evaluate the measures taken by latter against those rating agencies which had given misrepresentative ratings to IL&FS in the period leading up to the crisis. The disclosures made by the agencies should include factors such as the level of support from promoter, interconnections with their subsidiaries as well as the liquidity position in relation to meeting impending financial commitments.

Further, there was a recommendation regarding compulsory rotation of rating agencies. This would serve to do away with the disadvantages that are appended with the long term continuous association between issuing entities and the agencies. At present, there are only 7 CRAs, in this background the committee recommended that prevailing standards for entry could be appropriately lowered to promote competition. This can be complemented by providing a level playing field of regulations to CRAs regardless of the time period they’ve spent in the operations or revenue. Practices leading to unhealthy competition such as rating shopping turned to by issuers as well as underselling of rates should be curtailed by providing a floor limit for the fees to be paid.<sup>32</sup>

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<sup>31</sup> Lawrence J. White Kaufman, “Credit Rating Agencies: An Overview”, 5 Annual Review of Financial Economics 93-122 (2013)

<sup>32</sup> Standing Committee On Finance (2018-19) Sixteenth Lok Sabha Ministry Of Finance (Departments Of Economic Affairs And Financial Services) And Ministry Of Corporate Affairs Strengthening Of The Credit Rating Framework In The Country Seventy-Second Report [Http://164.100.47.193/Lsscommittee/Finance/16\\_Finance\\_72.Pdf](http://164.100.47.193/Lsscommittee/Finance/16_Finance_72.Pdf), Visited 29<sup>th</sup> April 2022