India Deserves Better Ratings in a New World

By Invitation

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Credit rating agencies and the very idea of credit rating find themselves at the cross-roads in the wake of the financial crisis of 2008. There is a broad consensus on the fact that the rating agencies failed miserably in their role as gatekeepers to the global debt markets (and the various structures that build on debt) and as forecasters of balance sheet stress either for a company or a sovereign. Their aggressive optimism on synthetic products that were created around patently high-risk subprime mortgage loans had a major role in precipitating the financial meltdown of 2007-2008. The fact that they continued to maintain an investment grade rating on Lehman Brothers on the day that it collapsed must qualify as one of the biggest ironies of the crisis.

The problem is that as the crisis has morphed from a problem related to the insolvency of heavily leveraged investment banks to that of overleveraged sovereigns neither their due diligence nor their methodology has risen to the challenge. Seeing the turn of events over the past couple of years, it is not entirely unfair to suggest that rating agencies have turned a blind eye to a deficit in regulatory oversight or perhaps even actively colluded with regulators to allow problems to fester. The result is the sovereign crisis in Europe with the added risk of a systemic crisis for banks. The US — not much better off — has just averted a sovereign default and US banks have gaping holes in their balance sheets, drilled into them by impaired mortgage loans.

At this stage, some hard questions need to be answered. Why didn't the rating agencies raise a red flag when the European Central Bank released stress test results in July 2010 that to most analysts, seem patently doctored? These results released just about a year back claimed that recapitalisation needs of European banks added up to a ludicrous €2.5 billion. Today, independent agencies estimate the actual recapitalisation requirement at close to a trillion euros.

Despite the massive ₹15-trillion sovereign debt of the US and a continuing political impasse over how to reduce and consolidate this debt, why did only one rating agency (S&P) have the gumption to downgrade US sovereign debt and that too by one notch? Even if we were to buy the somewhat dodgy argument that since the dollar is the preferred reserve currency, the US government is unlikely to default and somehow get away with its excesses, can the argument be extended to US banks? Bank of America is known to be sitting since 2008 on a pile of non-performing mortgage loans ever since it took over Countrywide. Its problems have been growing since then culminating in a loss of ₹8.8 billion in the second quarter of 2011 alone. A giant like BoA's problems could not have been compounded in isolation. It is simply not possible to conceive of a situation where the rest of the US banking system remains immune. Then why did rating agencies have to wait until the third week of September this year to downgrade BoA's credit ratings along with Citigroup and Wells Fargo? Was it because of an irrational faith in the principle that these banks were simply 'too big to fail'? How many other banks need to be downgraded before we get a correct picture of the stress in the US banking industry?

If credit rating agencies are to efficiently and ethically deliver on their remit, they need to bear the following things in mind. Let's focus on Europe first. First, they need to monitor the sovereign regulators and ensure that the nature and enormity of the problems are made transparent and not obfuscated by a cosmetic and purely short-term manipulation of regulatory standards.

The only real solution for Europe, going forward, will have to be a combination of managed default coupled with either euro bond support or purchase of sovereign debt. You would also need standard fiscal and banking policies for all countries, going forward. The earlier Europe realises this and fixes its problems, the lower will be the cost. Otherwise, we will see a snowballing cost of contagion. Second, the banking system in Europe needs capital infusion and a liquidity back-stop from its central bank. Here again, a realistic assessment of the magnitude of the capital and liquidity needs and a quick solution is a must.

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Third, in their assessment of the economic and fiscal strategy for Europe, rating agencies have to get away from cookie-cutter models of fiscal consolidation and think out of the box. The fetish for fiscal austerity in these times of dire fiscal stress, for one thing, is entirely misplaced. The standard remedy of cutting government expenditure and selling the family silver through fire-sale privatisation will not work as the countries will not be able to handle the social unrest. In the good old days, we would have had another world war. But now, we will have to come up with a less extreme economic solution.

What are the lessons then? We need to reconcile to the fact that Europe is in for a substantial slowdown and restructuring. This will definitely affect the US and then the rest of the world in varying degrees. Specifically for the US, it will lead to an economic slowdown in the US as well as US banks need to grapple with the humongous amount of credit default swaps that they have written on European sovereign debt as well as their large exposure to European money markets.

US money market mutual funds hold $360 billion of European financial paper while major US banks hold upwards of ₹100 billion as indirect exposure (CDS or default insurance sold) to the peripheral economies in Europe. This will come on top of their own problems that stem from their mortgage portfolios and the complex web of litigation that they are entrapped in.

If both Europe and America are likely to be in the throes of a slowdown for some years to come, who will shore up the global economy? The answer, now well known, is that emerging economies like India and China will have to lend a helping hand. This is the process of global rebalancing that will only intensify, going forward. Financial institutions need to realise this and have their ears to the ground to gauge the changes that this entails.

However, growth needs capital and this capital needs to be priced correctly for growth to sustain and reach its potential. Credit ratings, principally, for regulatory reasons, often form the benchmark for pricing capital. However, a quick glance at the ratings for emerging countries versus their Western counterparts shows a clear bias in favour of the latter that is often not underpinned by fundamentals, be it broad macroeconomic variables or specific markers like liquidity ratios that are known to presage balance-sheet stress of default. The current economic crisis that is entirely a problem of the developed Western world should prove beyond doubt that this assessment of relative credit-worthiness was fundamentally flawed.

Specifically, for India, the case for an upgrade rests on many legs. For one, financial markets that more often than not provide the most accurate 'prices' of capital, tell a completely different story about the risk profile of Indian debt than credit ratings. A useful measure is the credit-default swap (CDS) spread, roughly the cost of insuring debt against default. While India is yet to make a sovereign issue, an average of the CDS spreads of large companies whose debt is traded on international markets serves as a useful proxy. Table 1 shows that India's CDS spreads are significantly lower than those of a number of economies that have a higher credit rating.

In short, the markets signal the fact that India's debt is far less risky than what its ratings score of Baa3 (Moody's) or BBB- would suggest. It is about time that India's ratings converged to the market pricing of India's debt.

Finally, a comparison of some of the standard macro parameters that are used by leading rating agencies as a crucial benchmark to generate credit ratings indicates that India is better placed than some higher rated countries. Take the case of Italy for instance (see Table 2). The country appears significantly more vulnerable than India in terms of external solvency (at 117% of GDP the external debt of Italy is higher than that of India) and liquidity (short-term external debt as a proportion of both GDP and exports is higher for Italy) and yet enjoys a substantially higher credit rating. Further, while India's fiscal deficit is admittedly larger than that of Italy its debt is much lower and more sustainable supported by strong growth and a low exposure to foreign funding.

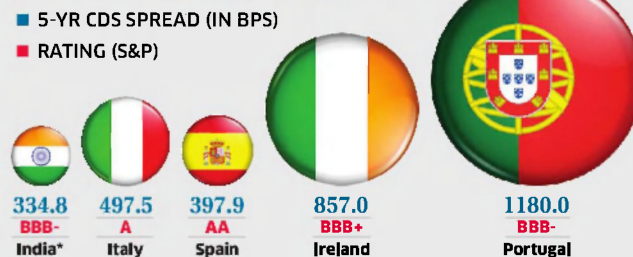
Most rating agencies defend the gap between emerging market ratings and those of advanced countries on the basis of size and the level of development measured by things like per capita income or the value of the Human Development Index, citing that these parameters enhance the "economic resilience" of a country in a crisis event. However, research has shown that neither size nor the level of development accurately predict the solvency of an economy. Otherwise Italy or indeed its cohorts in Europe such as Ireland or Portugal would not be in the dire fiscal straits they find themselves. If instead, rating agencies paid close attention to the hard parameters such as external debt and liquidity, it would realize that India and its peers in the merging world deserve a far better rating than they do today.

(Views are personal)

India in Better Shape

Emerging Markets need to play more active role

Table 1: CDS spreads - A comparison



	India*	Italy	Spain	Ireland	Portugal
5-YR CDS SPREAD (IN BPS)	334.8	497.5	397.9	857.0	1180.0
RATING (S&P)	BBB-	A	AA	BBB+	BBB-

Note:* CDS spread for India is the average of the spread for State Bank of India and Reliance Industries
SOURCE REUTERS NOTE

Table 2: A comparison of macro-parameters

ALL FIGURES FOR 2010	ITALY	INDIA
Moody's Ratings	**Aa2**	**Baa3**
Nominal GDP (US$ b)	2,147.3	1,732.2
GDP per capita (US$)	35,403.0	1,499.0
HDI	0.9	0.5
External debt/GDP	117.4	15.9
Govt external debt/GDP	52.5	3.7
Short-term external debt/GDP	27.4	3.2
Short-term external debt/exports	10.2	0.2
Real GDP (% change)	1.3	8.6
Gen. Gov. Financial Balance/GDP	-4.5	-8.1
Gen. Gov. Debt/GDP	119.0	67.5
Gen. Gov. Int. Pymt/ Gen. Gov. Revenue	9.6	23.3
Current Account Balance/GDP	-3.2	-2.6

Note: 1.HDI is the UN Human development index. The higher the reading the higher the level of development 2. All figures in percentage unless otherwise stated
SOURCE MOODY'S

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