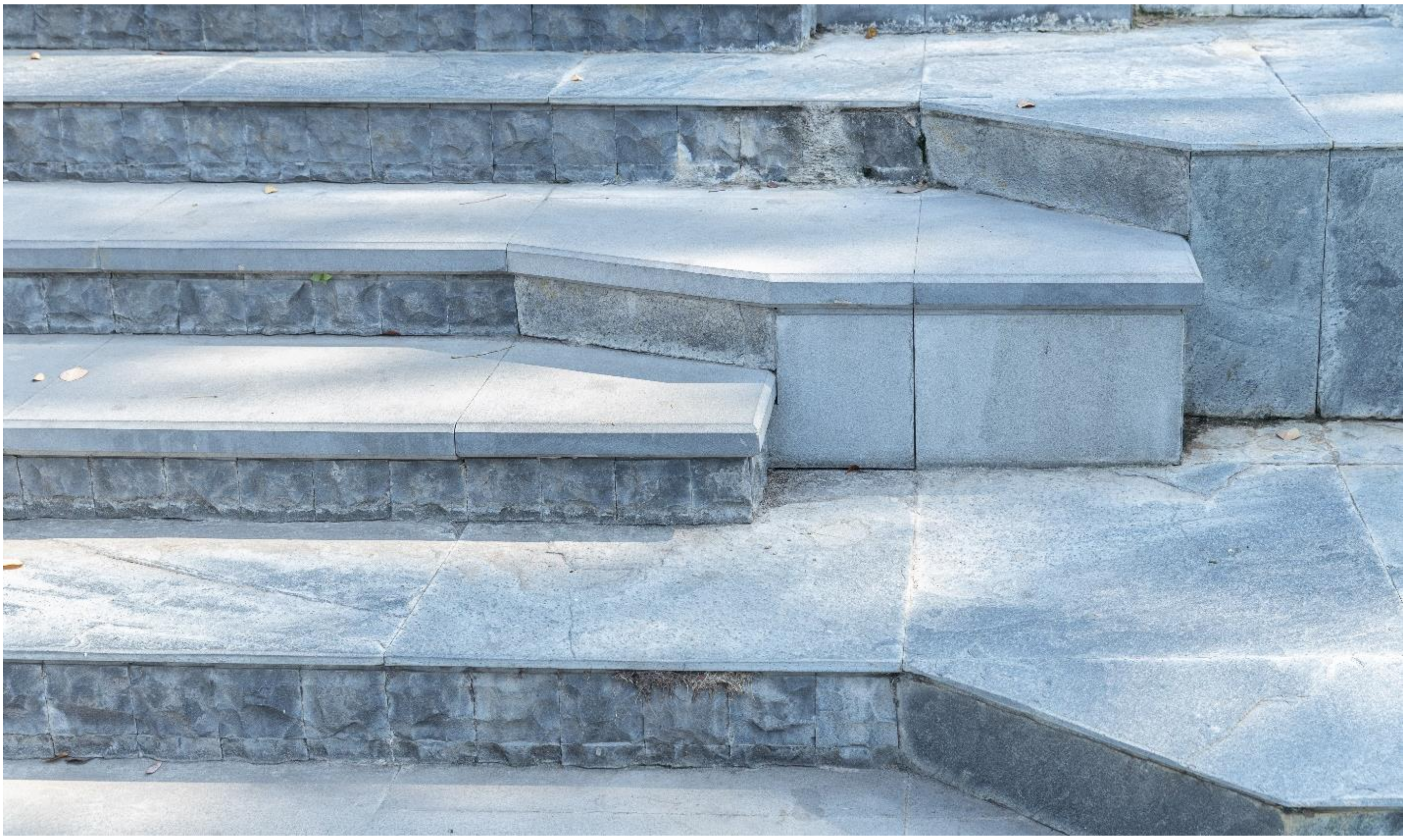
CRISIL
An S&P Global Company

The AAA ratings debate

32^0 Fahrenheit ≠ 32^0 Celsius

Global and national rating scales serve different needs

Absolute number of AAA ratings does not indicate quality, but default and stability rates do



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There has been a lot of debate recently on the relatively large number of AAA ratings that Indian credit rating agencies (CRAs) have assigned compared with their counterparts in developed countries such as the US.

Such a comparison is incorrect because it is an artificial construct.

It would be tantamount to equating the scale of a FIFA World Cup with Santosh Trophy.

Or Fahrenheit with Celsius.

Which begs answers to three obvious questions:

1. *Is it right to directly compare global and national scale ratings?*
2. *What are the reasons for the high number of AAA rated companies in India, or fewer on a global scale?*
3. *Does it necessarily indicate weak assessment standards?*

Before we come to the answers, it's important to remember these aspects:

1. Investors in developed economies consider investment options across the world. Credit risk assessments that benchmark issuers across the world on a global scale provides them with valuable and comparable information to make investment decisions.
2. A national rating scale provides a more granular benchmarking of issuers and factors in domestic realities such as support from stronger national or international parents, and from the government.
3. It is also important to consider the depth, width and angularities of each national debt market when assessing AAA rated companies by numbers.

We believe any informed discussion should begin with these aspects.

And finally, it is not the number of AAA rated companies that determines the quality of ratings or the underlying credit, but the probability of default that the ratings exhibit over a period of time. This is captured and quantified by the 'default and stability rates' put out by CRAs.

In the following pages, we look at all aspects of this debate in depth:

1 Global scale and national scale ratings serve different needs

Is 32º Fahrenheit the same as 32º Celsius?

Of course not.

Directly comparing global and local credit rating scales is similarly incorrect, too.

By construct, credit ratings can have – and do have – different scales. That's because they are *relative* assessments of credit risk. And the *relative benchmarking* can be *national, global or regional*.

Put another way, companies rated are benchmarked on a customised scale. There is no one-size-fits-all globally.

Typically, debt investors in developed economies such as the US and in Europe do not restrict themselves to domestic issuances, but also tend to invest in cross-border issuances. These investors would benefit from benchmarking of credit risk on debt instruments on a global scale. That is the role played by global CRAs such as S&P Global Ratings.

Global scale ratings are designed to ensure comparability across countries. Hence, country-specific risks such as political and economic, captured by the sovereign credit rating, play a significant role.

Typically, for investors seeking to lend to, or invest in, debt instruments of issuers operating in a country, sovereign debt offers the best credit risk, and also commands the finest pricing possible in that market.

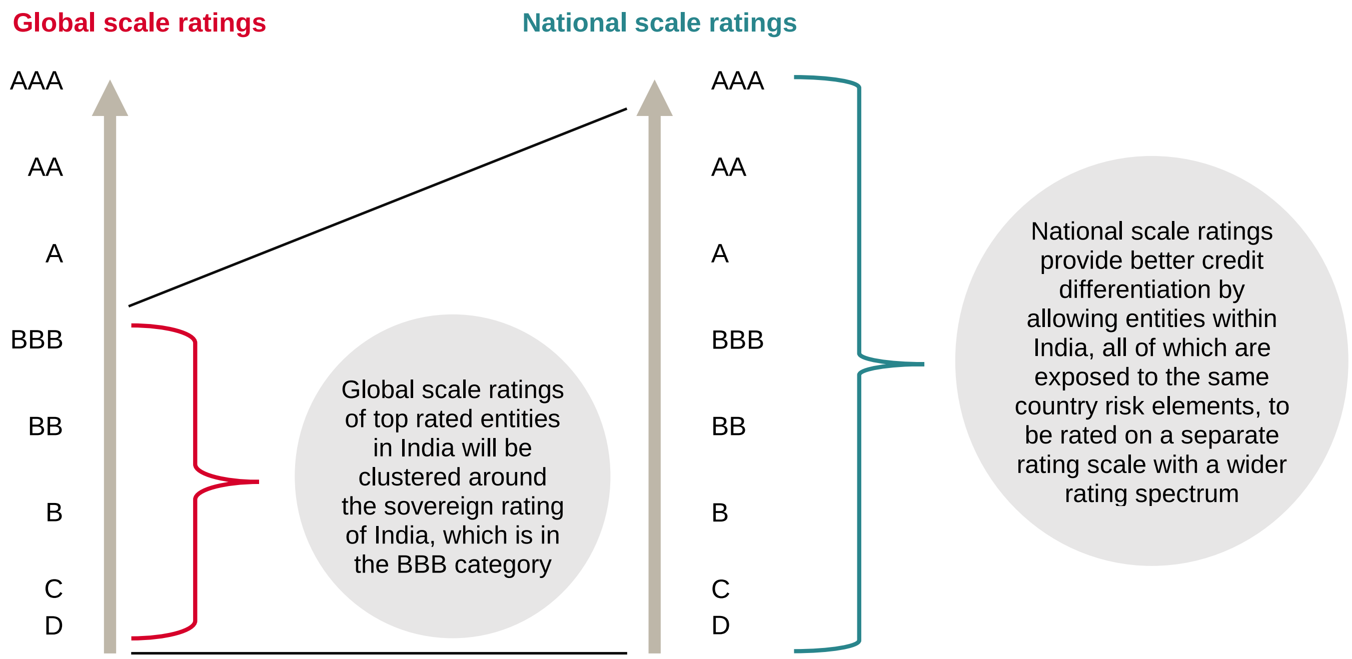
If the sovereign rating is in the 'BBB' category (as in the case of India, and assigned by S&P Global Ratings), it is unlikely that a company generating all its cash flows from India will have an AAA or AA on a global rating scale. Therefore, the highest-rated entities in any particular country (say India) will be clustered in a few rating categories around the sovereign rating – which in India's case is BBB-. If the global scale rating of BBB- is considered the starting point for all domestic companies, then most of the 32,500 extant ratings of Indian companies will have to be boxed inside the 'BBB' to 'D' categories on the global scale. Such a tight scale will not give investors the room to differentiate between the credit profiles of domestic companies.

Which is where domestic CRAs such as CRISIL come into the picture with their national scale ratings that assess the *relative creditworthiness* of companies *within a country* (in CRISIL's case, India), and provide a more granular differentiation of credit risk on a 20-point scale running from AAA to D. The sovereign, which has the flexibility to print money, is pegged at AAA on this scale.

This affords more granular information to the managers of a vast investible pool of funds from insurers, pension funds, banks and mutual funds, who look to invest in, or lend to, domestic companies operating in India, thereby enabling finer credit pricing.

India has a fairly large population of rated credits of ~32,500 issuers rated on the national scale across CRAs with rated debt (includes fund-based and non-fund based bank loan facilities, debentures, commercial paper and certificate of deposit) and amounting to ~US$1.5 trillion.

The illustration below highlights this well:



For instance, consider some of the best credits in India that are rated AAA on the national scale. On the global scale, they won't be rated so and would be clustered around India's sovereign rating, as shown below:

Company	National scale rating from CRISIL	Global scale rating from S&P Global Ratings (as on January 15, 2019)
Tata Consultancy Services Limited	Not rated	A
Infosys Limited	AAA	A-
Reliance Industries Limited	AAA	BBB+
Power Grid Corporation of India Limited	AAA	BBB-
Axis Bank Limited	AAA	BBB-
HDFC Bank Limited	AAA	BBB-
ICICI Bank Limited	AAA	BBB-
Kotak Mahindra Bank Limited	AAA	BBB-
State Bank of India Limited	AAA	BBB-

Source: CRISIL and S&P Global Ratings

A national scale rating cannot be compared directly with a global scale rating because the best credits within a country may not be of a similar quality as the best credit globally. The frame of reference would differ, as would the ratings.

That said, while the two rating scales are not directly comparable, an approximate mapping can be arrived at based on comparisons of default and stability rates, financial ratios, and common ratings.

For instance, a corporate with an A category rating on S&P Global Ratings' scale would typically map to a 'CRISIL AAA' rating in India. Hence, the default and stability rates of national scale ratings need to be benchmarked around the global scale A category rating.

2 Depth and width of bond market make a huge difference

As of January 1, 2018, S&P Global Ratings had AAA rating outstanding on 9[1] entities, while Moody's had 53[2], both less than a percent of their respective portfolios. However, ten years back, as on January 1, 2008, S&P Global Ratings had 89[3] issuers at AAA and Moody's 170.

The number of AAAs has come down because of the high cost maintaining it. For an entity to be rated AAA on the global scale, it has to enjoy an extraordinarily strong balance sheet so as to be able to withstand stresses, and manoeuvre complex business environments, on an international scale. This severely limits their debt levels and gearing headroom for growth.

Over the past many years, corporates have increasingly shown willingness to operate with higher leverage to expand businesses or to finance acquisitions. Increase in debt implies higher financial risks that, in turn, lead to a lower credit rating.

The trend of declining AAA rated companies manifested more in the era of ultra-low borrowing costs after the Lehman crisis. Managements in the developed world have relied on debt to increase shareholder value of companies, spurring a steady decline in the number of AAA rated companies. However, the offsetting factor is higher returns to shareholders.

Also, unlike India, in advanced economies such as the US, bond markets have material depth and width. The size of the US bond market is 120% of GDP, whereas in India it is around 16%. In terms of depth, investors in the US are willing to put money across the rating spectrum with active participation even in junk bonds.

Given such an appetite, the incentives for a US company (or any global one) to strive to maintain its AAA rating stands reduced – because even a lower rating affords access to funds at finer costs. It also lends strategic flexibility to improve shareholder returns. For instance, AAA rated companies contributed less than 5% of bond issuances in the US in 2017, while A and BBB ones accounted for more than 60%, and speculative grade companies around 20%.[4]

On the other hand, India, in line with other emerging markets, does not have a deep corporate bond market, and large investors, including insurers and pension funds, have mandates to invest only in highly rated paper. As a result, 85-90% of the bond issuances are in the AAA and AA rating categories (on the national scale). Beyond this rating category, the financial flexibility to tap capital market instruments drops drastically.

Therefore, in India, there is a strong incentive for a large number of companies to maintain a better credit profile at the top end of the rating spectrum on the national scale.

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[1] *As per S&P Global Ratings 2017 Annual global Corporate Default Study and Rating Transitions', dated April 2018; includes industrials, utilities financial institutions and insurance companies*

[2] *As per Moody's 'Annual Default Study' dated Feb 2019; includes financial institutions, nonfinancial companies and regulated utilities that have long-term debt ratings*

[3] *As per S&P Global Ratings Default, Transition, and Recovery: 2016 Annual Global Corporate Default Study and Rating Transitions*

[4] *As per 'U.S. Corporate Issuers: Fed Rate Hikes Haven't Stopped The Music For U.S. Companies', S&P Global Fixed Income Research, June 2018*

3 Using national scales of similar economies the right comparison

There are 276[5] entities rated AAA on the national scale by CRAs in India. However, the universe of rated companies is huge at ~32,500.

In that context, AAA rated companies in India is less than 1% of the universe (*see table below*). Companies rated A and higher account for just ~13% of the rated universe. On the other hand, they account for ~25% of the rated entities of S&P Global Ratings[6]. Such a rating distribution is mainly because debt markets are in differing stages of evolution in these geographies. *It is not a reflection of the quality of ratings assessment.*

Rating distribution in India (all CRAs, as of January 2019)		
Rating category	**Number of issuers**	**% of overall portfolio**
AAA	276	0.85%
AA	1,159	3.56%
A	2,725	8.38%
BBB	6,792	20.88%
BB	11,438	35.16%
B	7,853	24.14%
C	160	0.49%
D	2,131	6.55%
Total	**32,534**	**100.00%**

Source: websites of Indian CRAs

Further, the proportion of AAA ratings on the national scale assigned by CRAs in India is lower compared with national scale ratings assigned by domestic CRAs of other economies, as shown below.

Country	Rating agency	Number of ratings in portfolio	Number of AAA rating	AAA ratings as a % of portfolio	Year	Share in total rated issuers in the country
China	All CRAs	3,959 #	507	13%	2015	100%
India	**All CRAs**	**32,534**	**276**	**1%**	**2019**	**100%**
Taiwan	Taiwan Rating Corp	139	12	9%	2018	77%
Thailand	TRIS Ratings	167	8	5%	2017	75%
South Korea	Korea Ratings	423	71	17%	2019	68%
	Korea Investor Services	502	63	13%	2019	NA

Source: Websites of respective CRAs; for China info based on BIS Report of June 2017; market share info from respective websites/ Asia Credit Rating Guidebook 2018

 # The rated population in China is lower relative to the Indian market because of lack of bank loan ratings market in China. The number in the Indian portfolio includes both capital market and bank loan ratings.

[5] *Data from CRAs collated on a best effort basis; primarily covers issuers rated AAA, without external credit enhancement*

[6] *As per S&P Global Ratings 2017 Annual Global Corporate Default Study and Rating Transitions, April 2018; includes industrials, utilities financial institutions and insurance companies*

4 CRISIL AAAs have strong business risk profiles and/or robust financial risk profiles and/or strong parentage

CRISIL has AAA rating outstanding on 139 companies. Of these, 80 are due to strong parentage or government backing and as many as 20 of these have global parents with ratings of the global scale in the ‘A’ category or better. If strong parentage or government backing were to be taken out, the number would reduce to 59.

Sr number	Classification	Number of cases	Of which, part of strong parentage
1	PSU - financial sector	20	19
2	PSU – other than financial sector	19	18
3	Private Financial sector	48	35
4	Corporates	52	8
	Total[7]	**139**	**80**

Source: CRISIL

‘CRISIL AAA’ rated entities have either one or more of the following characteristics:

- Strong business risk profiles
  - These entities are generally market leaders in their respective fields. They have demonstrated track record of maintaining market positions over several economic cycles
  - High pricing power and excellent control over cost
- Robust financial risk profiles
  - Healthy cash-generating ability by virtue of their market positions and pricing power
  - Negligible debt or gearing
  - Surplus cash and liquidity
- Strong parents that extend business and financial support
- PSUs that enjoy government backing as they
  - Perform critical policy role on behalf of the government, or
  - Operate in strategically important sectors where government has a crucial role to play,
  - Operate in the financial sector where government support is essential to avoid any contagion effect

[7] *Primarily covers issuers rated AAA, excludes entities rated based on external credit enhancement*

5 AAAs should have low default probability

It is not the number of AAA ratings that determine the standards of rating of a CRA, but it is the probability of default. As shown in the table below, CRISIL AAA ratings have displayed strong credit quality over multiple business cycles spanning several years. The 1- and 3-year default rates of CRISIL AAA rated entities are 0.00%. These rates are marginal for international CRAs as well. And the 1-year stability rate for CRISIL AAA ratings in the last ten year period (2007-17) is also quite high at ~98%.

Average default rates of CRISIL's ratings (during 2007-17)		
Rating category	**One-year**	**Three-year**
AAA	**0.00%**	**0.00%**
AA	**0.00%**	**0.12%**
A	**0.18%**	**2.07%**
BBB	**0.93%**	**3.91%**
BB	**3.61%**	**11.28%**
B	**7.93%**	**21.28%**
C	**19.70%**	**41.98%**

Source: CRISIL default study

Conclusion

To conclude, therefore, it is not correct to compare credits rated on a global credit rating scale to those rated on a national rating scale. These are not like to like.

National rating scales provide more granular benchmarking of issuers and factor in domestic realities such as support from the government, or stronger national/international parents.

It is also important to take into account the depth and width of each market when assessing the number of AAAs.

In the end, it is not the lower number of AAA rated companies that determines the quality of assessment of a CRA, but the default rates exhibited over a period of time.

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Ratings

CRISIL Ratings is part of CRISIL Limited ("CRISIL"). We pioneered the concept of credit rating in India in 1987. CRISIL is registered in India as a credit rating agency with the Securities and Exchange Board of India ("SEBI"). With a tradition of independence, analytical rigour and innovation, CRISIL sets the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 24,500 large and mid-scale corporates and financial institutions. CRISIL has also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and microfinance institutions. We also pioneered a globally unique rating service for Micro, Small and Medium Enterprises (MSMEs) and significantly extended the accessibility to rating services to a wider market. Over 1,10,000 MSMEs have been rated by us.

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