

Impact of bank loan ratings on credit discipline in corporate

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One of the most important developments to have taken place in the banking industry over the last few years has undoubtedly been the implementation of Basel-II framework. The effect that it had on the rated universe is quite significant. Varied segments of industry and different type of entities, hitherto untapped, came within the rating fold. Of greater interest, however, is the impact that credit rating had on the overall credit discipline of the rated corporates.

An interesting observation of the impact of Basel-II guidelines has been the growing importance that corporates attach to the rating outcome. To understand this, let's try to understand the tenets of credit discipline in the context of credit rating.

As is known, credit rating is the logical culmination of risk assessment covering diverse facets of risks like industry, business, management, financial etc. that could potentially impact the credit profile of a company. A rating agency analyses these risks while assigning the rating and gives a detailed rating rationale that encapsulates the positive as well as the constraining factors that drove the rating. While the risk categories might seem diverse, risk assessment is also a derivative of the enterprise wide awareness of risk and is an important dimension of credit discipline.

Credit discipline could have varied definitions and interpretations. A simplistic definition would include timely repayment of debt by a borrower. In a broader sense, credit discipline should include many other facets which facilitate such orderly repayment. *Strong management information systems, sound corporate governance practices and transparency in operations, independence of ownership and management and independence of auditors* are some important facilitators of good credit discipline and form an integral part of a credit rating process. An overview of some such aspects generally highlighted by the CRAs could make the things more clear.

Repayment discipline: Increased penetration of rating of bank loans in the Indian debt market has drastically changed the way a delay or default is viewed. While banks are required to classify loans overdue beyond ninety days as a non-performing asset, credit rating agencies (CRAs) consider even one day missed payment as default, as per their published definition. However, the said difference in treatment between 'non performing assets' by banks and 'default' by rating agencies, understandably has many repercussions and has initiated wide ranging debate. Besides the payment of debt

obligations, timely deposit of the statutory dues like PF, service tax etc. by the company is also given due importance by the CRAs.

Efficient information system & internal controls: The difference in perception of banks and CRAs regarding delays by the borrowers calls for a paradigm shift in information systems and exacting standards of credit discipline. For example, in rudimentary terms, it calls for an entity to have proper systems of information about exact due dates of debt. Secondly, it calls for an appropriate planning and budgeting process within the entity to ensure adequate funds at the right time to avoid default. Thirdly, it requires the entity to observe strict credit discipline and treat it with the requisite seriousness, even if it was neglected in the past.

Corporate governance practices: Closely linked with the repayment discipline and need for efficient systems, is the requirement of sound corporate governance practices. Management's attitude towards risk – financial as well as business, determines the level of corporate governance in a company. Risk prone management generally dissuades active participation by the independent directors in policy areas and tends to circumvent critical issues by meticulous camouflage. This gets percolated in the management's response towards financial discipline as well. For CRAs, this forms a vital cog in the overall assessment.

When issues like these are highlighted by the CRAs in their rating rationale, most companies choose to monitor them more closely and initiate corrective measures. Information systems and internal controls are tightened so that hitherto 'accepted' delays in debt or statutory dues payment are avoided, management structure is strengthened and risks like project implementation etc. are appropriately attended to.

To a large extent, the tangible as well as intangible benefits of credit rating drive this. Why so? It is because that apart from the pricing benefit of a good credit rating, corporates also realize that a relative benchmarking of rating vis-à-vis their peers would be more closely watched by potential lenders/investors. In fact, as time goes by, the rating itself may become an effective marketing tool for the company in the eyes of a potential lender who would like to distinguish first, between the unrated and rated and second, see the ratings actually obtained to have an assessment of risk. This is all the more true in today's globalized world where companies have trade relationships with a foreign partner and rating becomes an important tool for projecting oneself to the outside world.



As such, on an overall basis, CRAs - an integral part of the financial system, are in their own way, helping instill credit discipline among corporates. Seen in the backdrop of constructive response of corporates, it also reflects the maturing of business management in the country.

- D.R. Dogra, MD & CEO, CARE Ratings.

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