RBI raises concerns on rating shopping among companies

Non-disclosure of indicative ratings by agencies makes it difficult to identify such instances: FSR

ANUP ROY
Mumbai, 28 December

ILLUSTRATION BY BINAY SINHA

The Reserve Bank of India's (RBI's) Financial Stability Report (FSR) has raised concerns about rating shopping among companies.

This comes against the backdrop of instances of indicative ratings given by agencies, for which there are no written agreements. The indicative ratings are also not disclosed on the company websites.

"Since such 'indicative ratings' are not disclosed by CRAs (credit rating agencies) on their websites, it becomes difficult to identify instances of possible rating shopping," said the FSR, a bi-annual report released by the RBI on Friday. "The issue of possible rating shopping behaviour on the part of obligors clearly requires serious attention."

Corporate executives do not agree to such an assessment.

"I strongly disagree with this assessment. After the IL&FS (Infrastructure Leasing & Financial Services) crisis, the rating agencies have become very cautious about rating assignments and sometimes the ratings assigned are very unfair and does not go with the fundamentals of the company," said the chief financial officer of a mid-sized company.

According to another corporate executive, the rating committees have people with no experience of corporate business and they insist on a lower rating, being fearful of the regulators. The recent probes on rating agency executives have sapped the moral of the rating committees. Many rating agency executives did not want to comment. One executive said the number of companies considered in the report is too small, and can be explained by risk assessments methodology varying from one rating agency to another.

Some instances of such rating shopping can still be ascertained, according to the FSR, by looking at the dynamics around rating withdrawals where outstanding rating issued by a CRA was withdrawn and a new rating was provided by a different CRA.

The FSR said such new ratings were obtained within three months of each other; and in more than two-thirds of the cases new ratings were provided before the withdrawal of the old ones. This practice has been going on since April 2016, the FSR said.

For long-term bank loan ratings, which is used by banks for credit screening, it was observed that the screening mechanism adopted by investors in short-term instruments had a significant dispersion in the pricing of assets of equivalent tenor after accounting for all relevant factors with the same ratings.

"This implies that these investors must be adopting additional credit screening mechanisms apart from obligor rating during credit selection," the report said.

"Clearly, for ratings that are withdrawn, the new ratings assigned are either the same or an improvement over the earlier ratings. Although replacement of withdrawn ratings by better or similar ratings by a different rating agency is visible across all rating grades, such instances are particularly pronounced at BBB and below ...." the FSR said. There are only nominal cases where withdrawn ratings were better than the assigned ratings.

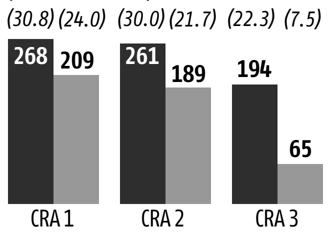
The BBB and below category is where most of the Indian companies reside.

'This is particularly relevant as some of the rating agencies have a much greater share in ratings assigned compared to their share in ratings withdrawn," the FSR pointed out.

However, considering the rated companies number around 40,000, such rating shopping are only a small fraction of the rated universe and "may not make the external ratings based capital adequacy framework infructuous," the FSR said.

REPORT CARD

Share of top three rating agencies in withdrawn and assigned ratings



Movement in withdrawn long-term bank loan ratings

	AAA	AA	A	BBB	BB	B	C	D
Number of ratings withdrawn	1	13	57	241	354	171	6	27
Number of assigned ratings better than withdrawn ratings	-	1	10	69	180	108	5	24
Number of assigned ratings remaining same	1	12	45	170	167	62	1	3
Number of assigned ratings worse than withdrawn ratings	-	-	2	2	7	1	-	-

Source: FSR

Credit portfolio of large borrowers down to 51.8%

GNPAs of this category of loan takers also saw a decline

NIDHI RAI
Mumbai, 28 December

The Reserve Bank of India (RBI), in its financial stability report (FSR) 2019, said the share of large borrowers in scheduled commercial banks' (SCBs') total loan portfolio reduced to 51.8 per cent in September 2019 compared to 53 per cent in March 2019.

Gross non-performing assets (GNPAs) of large borrowers stood at 79.3 per cent in September 2019 against 82.2 per cent in March 2019.

The RBI noted that in the large borrower accounts, the proportion of funded amounts outstanding with signs of stress increased from 20.9 per cent in March 2019 to 21.2 per cent in September 2019.

Special mention account (SMA2) loans went up by around 143 per cent between March 2019 and September 2019. The top 100 borrowers accounted for 16.4 per cent of the SCBs' gross advances and 16.3 per cent of the GNPAs.

India's industrial output declined 3.8 per cent in October on the back of poor performance across all sectors, according to data released by the ministry of statistics and programme implementation.

A major reason for the decrease in the index of industrial production (IIP) is declining performance of eight core industries that comprise 40.27 per cent of the index.

Other than that, coal and cement production also fell 17.6 per cent and 7.7 per cent, respectively, in October.

This economic slowdown can directly be related to the fact that bank lending to sectors like basic metals, chemicals, cement and fertilisers, machinery and equipment, retail and wholesale trade, information technology, oil and gas, food processing, real estate, transport, medical, educational and auto have seen a considerable decline.

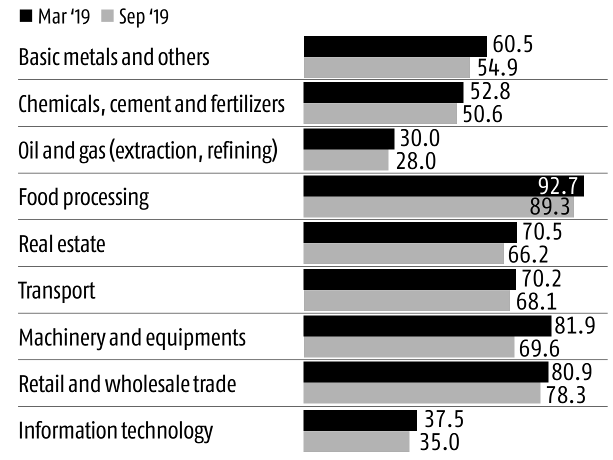
For majority of the sectors, average risk weight (loan exposure of banks) has declined between March and September 2019. This is in line with the declining average risk weight at the aggregated level.

For instance, RBI data shows that banks have reduced lending to basic metals and other sectors to 54.9 per cent in September 2019 from 60.5 per cent in March 2019. Food processing has reduced to 89.3 per cent in September 2019 from 92.7 per cent in March 2019.

Machinery and equipment has also seen a major reduction to 69.9 per cent in September 2019 from 81.9 per cent in March 2019.

SECTORS WITH DECREASING AVERAGE RISK WEIGHT

(%)



Source: PRIME Credit Rating Migration Database, CRILC and Reserve Bank staff calculations

Indian stocks more expensive than EM peers

ASHLEY COUTINHO
Mumbai, 28 December

Emerging markets' (EMs') equities look attractive from a valuation perspective relative to those of developed markets despite the wedge in earnings per share between the two groups, according to the FSR.

That said, the valuation of Indian equities vis-à-vis its EM peers seems to be somewhat expensive. The high valuations of the benchmark indices will be sustainable only if there is a steady rise in corporate earnings, the report observes.

"The quarterly earnings per share growth of the S&P BSE 500 Index went up in the quarter ended September 2019 on a y-o-y basis, although the same for the Nifty 50 scrips declined. Further, future earnings expectations also witnessed a decreasing trend over the six-month period," said the report.

According to experts, the gap between underlying corporate earnings and share prices has widened to a multi-year high.

The Sensex, for instance, may end the year at a price-earnings (P/E) multiple of 29x, the highest in 25 years.

Also, this is the third time in the past five years when index stocks together reported a y-o-y decline in earnings. Index companies had reported earnings contraction in CY15 and CY16, followed by a recovery in CY17 and CY18.

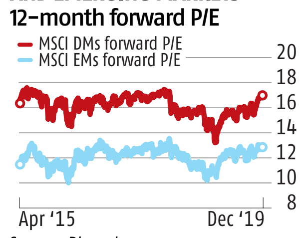
Unlike the trend observed in 2018-19, foreign portfolio investors (FPIs) invested $7.8 billion in the Indian securities market during April-October 2019, the FSR report noted. The first two quarters of FY20 saw inflows in the debt and hybrid segments as well. FPI investments in hybrid instruments saw a sharp increase during the current year with inflows of $744 million up to end-October 2019. However, FPIs offloaded equities worth $3.2 billion in the second quarter of FY20.

"As US monetary easing takes a breather, the exchange rate outlook for EM currencies will be a large determinant of EM local currency bond flows notwithstanding a generally favourable local currency interest rate environment," the FSR observes.

Among BRICS nations (except China), India was the only country to see FPI inflows in both the equity and debt segments during the January-September period while Russia saw the highest liquidation by FPIs in the debt segment during the same period, the report observed.

MSCI FORWARD PRICE EARNINGS (P/E) MULTIPLE - DEVELOPED AND EMERGING MARKETS

12-month forward P/E



Source: *Bloomberg*

Equity prices can indicate signs of stress, says report

JASH KRIPLANI
Mumbai, 28 December

The Reserve Bank of India (RBI) has proposed using the movement in equity prices as part of a larger mechanism that can serve as early warning signals of a potential default in a stressed company.

"Though all equity movements may not be of relevance for bond valuations, since bonds are superior in terms of claim hierarchy, they still present an early sign of distress," the apex bank said in its 20th Financial Stability Report (FSR). "Therefore, it may be useful as an early warning mechanism to convert equity prices to an imputed distance to default measure to which the actual bond prices should be compared."

The FSR argued that an active equity price can serve as the only source of emerging information for all stakeholders

Taking the case of a defaulting subsidiary of a core investment company, the FSR pointed out that equity prices showed resilience even after the subsidiary was classified as 'default'. It attributed the ability of equity prices to withstand the 'default' tag to the fact that the debt was a 'structured obligation', backed by other underlying assets.

The report says equity prices may also be used to determine 'intermediate' rating action, but says one needs to be cautious about the extent they are used for such a purpose. "While the current analysis of using equity prices as an early warning signal only explores the case of a default, it can be useful in determining intermediate rating transitions. Such an approach is not without criticism, since adjusting portfolios based on imputed ratings' migration will entail false signals and over-reactions," the report said.

"Hence, to what extent such prices may be internalised for market valuation of debt instruments or prudential action is a debatable point," it added.

However, given the illiquid nature of debt markets, the report argued that an active equity price can serve as the only source of emerging information for all stakeholders including rating agencies.

"A prudential valuation plan for debt may be useful to take such emerging feedback into consideration," the report noted. According to market participants, rating agencies need to create a system where they can give more leading indicators, so that investors are not caught off-guard with sudden spurt of multiple rating downgrades, as was seen following recent debt market crisis.

Frauds reported in H1 rise to ₹1.13 trn, 97% took place earlier

SUBRATA PANDA
Mumbai, 28 December

Lenders reported frauds of ₹1.13 trillion in the first half of financial year 2019-20 (H1FY20) and 97.3 per cent of these took place in previous years, depicting a significant time lag between the occurrence of fraud and its detection, revealed the FSR. The amount was ₹71,543 crore in FY19.

"The amount involved in frauds that occurred between FY01 and FY18 formed about 90.6 per cent of the frauds reported in 2018-19 in terms of value. Similarly, 97.3 per cent of the frauds reported in H1FY20 by value occurred in previous financial years," said the report, released by the Reserve Bank of India (RBI) on Friday.

The number of frauds reported in H1FY20 was 4,142 and 6,801 in FY19.

Loan-related frauds continued to dominate in aggregate, forming 90 per cent of all frauds reported in FY19 by value and 97 per cent of all frauds reported in H1FY20 by value. As much as ₹70,046 crore worth of loans were reported as fraudulent in H1FY20, while fraudulent deposits was to the tune of ₹417 core and fraudulent foreign exchange transactions was about ₹52 crore.

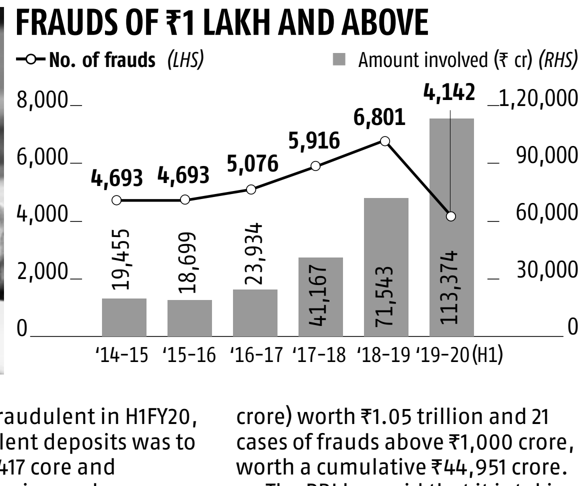
Also, during the first half of FY20, banks reported 398 cases of large-value frauds (above ₹50 crore) worth ₹1.05 trillion and 21 cases of frauds above ₹1,000 crore, worth a cumulative ₹44,951 crore.

The RBI has said that it is taking steps to integrate fraud reporting of NBFCs and urban co-operative banks in its central fraud registry database. "Such interlinking would serve as an invaluable resource in effective fraud detection/monitoring. In addition, a greater thrust has been put on improved governance," it said.

Apart from this, the central bank has sharpened its focus on a fraud response plan that is being sought from banks and for this, stricter timelines and clear guidance with respect to reporting of frauds and declaration and processing of red-flagged accounts will be prescribed.

"Banks are required to set up specialised units to make use of market intelligence and data analytics and also put in place transaction monitoring system. In order to bring clarity, the role and scope of forensic audit along with timelines is also being examined," the RBI said.

FRAUDS OF ₹1 LAKH AND ABOVE



FY20 to set record for most online mineral block auctions

JAYAJIT DASH
Bhubaneswar, 28 December

Auctions of 59 mineral blocks are set to be completed in FY20, making it the most successful year for online auctions since the enactment of the amended Mines and Minerals-Development & Regulation (MMDR) 2015.

In this fiscal year, 16 blocks have already been auctioned. Notice Inviting Tenders (NITs) have been issued for 43 others and auction formalities in respect of these blocks are expected to be completed before the close of FY20. Auctions first took off in 2015-16 after a recast MMDR killed the practice of discretionary allotments and mandated award of mineral resources through a transparent system of auctions. Auctions were slow to start with only six blocks offered in the inaugural year. Between 2015-16 and 2018-19, 54 blocks were put to electronic auctions.

"In this fiscal, the tempo of auctions has accelerated as tenure of all merchant mining leases ends by March 31, 2020. These mines have to be readied for production again before their validity ends. The government is working on environment clearance, forestry clearance and an array of other approvals to ensure seamless transfer of ownership and continuity in operations", said an official with a standalone mining company.

Digital banking initiatives of merging PSBs face delay

According to officials, integration of core banking systems may take 12-18 months

DEBASIS MOHAPATRA
Bengaluru, 28 December

Digital banking initiatives of public sector banks (PSBs), which are in the process of being merged, are likely to be delayed pending integration of core banking platforms.

According to bank officials in the know, though the merging banks operate the same core banking systems (CBS), differences in versions would take around 18 months for complete integration.

"In digital banking, the API (application programming interface) is plugged to the CBS platform for seamless operation since all the customer data is sitting on the platform. When these CBS platforms are going to be merged, there is no point of coming up with a new product before the integration," said a senior official familiar with the digital banking.

"If there is any new API launch, the bank will have to plug it to its own CBS and migrate it later. It will depend on the compatibility of the application," the person said.

Services like instant account opening, internet banking, mobile banking and virtual welcome kit, among others, are part of the digital banking initiatives.

Even some PSBs have started disbursing loans to new clients through these app-based platforms.

"We have to merge multiple APIs working on a similar service segment into a singular application. To achieve this, we are evaluating the features of both banks," said another official of a bank that is in the process of merger.

As part of the consolidation of public sector banks, the central government had in August announced mergers among these lenders. The merger, which will take effect from April 1 next year, will bring down the number of PSBs to 12 from the earlier 27.

While United Bank of India and Oriental Bank of Commerce will be merged with Punjab National Bank, making the proposed entity the second largest PSB, Syndicate Bank merge with Canara Bank as part of this exercise. Similarly, Allahabad Bank will be amalgamated with Indian Bank, while Andhra Bank and Corporation Bank will be merged with Union Bank of India.

Though technology platforms played a major role in deciding the merger plans, bank officials said that the complexity of the process could be higher despite the merged entities using the same core banking platforms.

For instance, though both Canara and Syndicate banks use Oracle's i-Flex (which is now known as OFSS), the versions of the software are different. While Syndicate Bank is currently using the latest version (11.6), Canara Bank is using 10.2 version.

Similarly, though Union Bank, Andhra Bank and Corporation Bank use Infosys' Finance as CBS, the versions are different.

MERGING PLATFORMS

- The delay is because of pending integration of core banking platforms
- Though the merging banks operate the same core banking systems, differences in versions would take around 18 months for complete integration
- Services like instant account opening, internet banking, mobile banking and virtual welcome kit may be affected
- Bank officials said that the complexity of the process could be higher, despite the merged entities using the same core banking platforms