THE IMPACT OF STANDARD & POOR’S CREDIT RATING ON INDIAN ECONOMY

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Abstract

Standard and Poor’s (S&P) has warned that India could lose its investment grade credit rating. In a report titled Will India Be the First BRIC Fallen Angel? the agency said: “Slowing GDP growth and political roadblocks to economic policymaking could put India at risk of losing its investment-grade rating.”

The agency revised its outlook on India’s BBB-long-term sovereign credit rating to negative from stable. What this means is that India runs the risk of losing its investment grade credit rating and being rated as speculative or junk. Let us try and understand what this really means for India.

One clear impact will be foreign investors who are not allowed to invest in non-investment grade securities will stay away from India. This would mean that pension funds and other long-term funds will stay away from India. It could also mean that if foreign investors with positions in India start exiting, the stock market might go down in the days to come.

The present paper discusses the following objectives:

- The Conceptual underpinnings of Standard & Poor’s credit rating.
- The Impact of Credit Rating on World Economy.
- The Impact of S&P’s credit rating on Indian Economy.

Keywords: Standard & Poor’s, Credit Rating, BBB- and Indian Economy.

INTRODUCTION

Standard and Poor’s (S&P) has warned that India could lose its investment grade credit rating. In a report titled Will India Be the First BRIC Fallen Angel? the agency said: “Slowing GDP growth and political roadblocks to economic policymaking could put India at risk of losing its investment-grade rating.”

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What is investment grade?

In 1970, the Penn Railroad, the largest railroad in the United States, went bankrupt. This was something that the rating agencies did not foresee. One of the repercussions of this bankruptcy was that the Securities and Exchange Commission (SEC, the American equivalent of the Indian Sebi) decided to penalize brokers who held bonds of companies that were less than investment grade. But who would decide what investment grade was? As Roger Lowenstein writes in an article titled Triple-A Failure, “This prompted a question: investment grade, according to whom? The SEC opted to create a new category of officially designated rating agencies, and grandfathered the big three – S&P, Moody’s and Fitch. Bank regulators issued similar rules for banks. Pension funds, mutual funds, insurance regulators followed. Many classes of investors were now forbidden to buy non-investment-grade bonds at all”.

Every rating agency follows different rating techniques. The rating agency Moody’s has 21 different types of ratings of which the top 10 are deemed to be investment grade. The remaining 11 are deemed to be speculative by the rating agency and “junk” by the market. S&P has 12 different levels of ratings of which the top five are deemed to be investment grade. India’s rating is BBB-, which is the last rating in the ratings which are deemed to be investment grade. If India’s rating is downgraded, then the next rating is BB+. S&P defines it as a rating which is “considered highest speculative grade by market participants”. Hence BB+ is the first rating at the junk level. The ratings are essentially meant to be an estimate of probabilities. Hence, the bonds of a country which has a BB+ rating are expected to default more than the bonds of a country which has a BBB-rating, thus making them more risky.

CREDIT RATING

As a credit-rating agency (CRA), the company issues credit ratings for the debt of public and private corporations. It is one of several CRAs that have been designated a nationally recognized statistical rating organization by the U.S. Securities and Exchange Commission.

Long-term credit ratings

![Map of World countries by Standard & Poor's Foreign Rating](image)

World countries by Standard & Poor's Foreign Rating:

The company rates borrowers on a scale from AAA to D. Intermediate ratings are offered at each level between AA and CCC (e.g., BBB+, BBB and BBB-). For some borrowers, the company
may also offer guidance (termed a "credit watch") as to whether it is likely to be upgraded (positive), downgraded (negative) or uncertain (neutral).

**Investment Grade**

- **AAA**: An obligor rated 'AAA' has extremely strong capacity to meet its financial commitments. 'AAA' is the highest issuer credit rating assigned by Standard & Poor's.
- **AA**: An obligor rated 'AA' has very strong capacity to meet its financial commitments. It differs from the highest-rated obligors only to a small degree. Includes:
  - **AA+**: equivalent to Moody's Aa1 (high quality, with very low credit risk, but susceptibility to long-term risks appears somewhat greater)
  - **AA**: equivalent to Aa2
  - **AA-**: equivalent to Aa3
- **A**: An obligor rated 'A' has strong capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in higher-rated categories.
  - **A+**: equivalent to A1
  - **A**: equivalent to A2
- **BBB**: An obligor rated 'BBB' has adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments.

**Non-Investment Grade** (also known as junk bonds)

- **BB**: An obligor rated 'BB' is less vulnerable in the near term than other lower-rated obligors. However, it faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions, which could lead to the obligor's inadequate capacity to meet its financial commitments.
- **B**: An obligor rated 'B' is more vulnerable than the obligors rated 'BB', but the obligor currently has the capacity to meet its financial commitments. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments.
- **CCC**: An obligor rated 'CCC' is currently vulnerable, and is dependent upon favorable business, financial, and economic conditions to meet its financial commitments.
- **CC**: An obligor rated 'CC' is currently highly vulnerable.
- **C**: highly vulnerable, perhaps in bankruptcy or in arrears but still continuing to pay out on obligations
- **CI**: past due on interest
- **R**: An obligor rated 'R' is under regulatory supervision owing to its financial condition. During the pendency of the regulatory supervision, the regulators may have the power to favor one class of obligations over others or pay some obligations and not others.
- **SD**: has selectively defaulted on some obligations
• **D**: has defaulted on obligations and S&P believes that it will generally default on most or all obligations
• **NR**: not rated

**Short-term issue credit ratings**
The company rates specific issues on a scale from A-1 to D. Within the A-1 category it can be designated with a plus sign (+). This indicates that the issuer's commitment to meet its obligation is very strong. Country risk and currency of repayment of the obligor to meet the issue obligation are factored into the credit analysis and reflected in the issue rating.

• **A-1**: obligor's capacity to meet its financial commitment on the obligation is strong
• **A-2**: is susceptible to adverse economic conditions however the obligor's capacity to meet its financial commitment on the obligation is satisfactory
• **A-3**: adverse economic conditions are likely to weaken the obligor's capacity to meet its financial commitment on the obligation
• **B**: has a significant speculative characteristic. The obligor currently has the capacity to meet its financial obligation but faces major ongoing uncertainties that could impact its financial commitment on the obligation
• **C**: currently vulnerable to nonpayment and is dependent upon favorable business, financial and economic conditions for the obligor to meet its financial commitment on the obligation
• **D**: is in payment default. Obligation not made on due date and grace period may not have expired. The rating is also used upon the filing of a bankruptcy petition.

**The impact, if India gets downgraded?**

One clear impact will be foreign investors who are not allowed to invest in non-investment grade securities will stay away from India. This would mean that pension funds and other long-term funds will stay away from India. It could also mean that if foreign investors with positions in India start exiting, the stock market might go down in the days to come. This comes after the brief rally we have seen recently in expectation of an interest rate cut by the Reserve Bank of India.

The way foreign investors think about India is very important in deciding how well the Indian stock market performs. Since the beginning of the year foreign institutional investors have been net buyers (the difference between what they have bought and what they have sold) of stocks to the extent of Rs 34,551.33 crore. During the same period, domestic institutional investors have been net sellers of stocks to the extent of Rs 18,666.06 crore.

This buying by the foreign investors is the major reason behind the BSE Sensex, India’s premier stock market index, giving a return of 7.85 percent since the beginning of the year. The threat of downgrade to junk status obviously does not put India in a good light in the eyes of foreign investors. Given this, the stock market is likely to go down, and bring down the overall economic
confidence in the country as well. It would also mean that Indian corporates looking to raise money from abroad would have to pay a higher rate of interest. The bond market in India will largely remain unaffected because it doesn’t have much foreign presence.

The Azhar Syndrome

But the threat of a downgrade by S&P is a smaller worry than the Azhar syndrome. So what is the Azhar syndrome? The term was first used in a report of the name brought out by First Global more than three years back in March 2009. As the report pointed out: “The Azhar Syndrome is all about Azhar… the kid from the slums in Slumdog Millionaire. He flew to LA for the Oscars, slept on clean sheets in an air-conditioned hotel room, for the first time (and possibly the last time)…came to his Bombay slum home…and moaned to the press “It is so hot here, and the mosquitos… I can’t sleep”. He is finished. A few nights in a clean hotel room, and the guy can’t adjust back to the reality of his slum existence.”

Like Azhar assumed that the “five-day” party that he had in Los Angeles would continue forever, so has the Congress Party-led United Progressive Alliance (UPA) assumed that all is well and the economic growth that India saw for the last few years will continue forever on its own. India enjoyed a GDP growth averaging 8.7 percent during 2004-2008 and 7.8 percent during 2009-2011.

The solutions to the economic problems currently facing India are simple and largely agreed upon by everyone who has an informed opinion on the issue. Reuters Pranab Mukherjee, the finance minister, rejected the threat of the S&P downgrade. In a press release, he said that the government is fully seized of the current situation and is confident that there will be a turnaround in our growth prospects in the coming months. Mukherjee expects the Indian economy to grow by 7 percent in this financial year. “A reversal of the interest rate cycle, weak crude prices and a normal monsoon were likely to improve the economic conditions and the slowdown would not be as sharp as widely feared, and that the economy would grow closer to 7 percent this fiscal,” Mukherjee told a conference of the chief commissioners and directors general of income tax on 11 June 2012.

The things that Mukherjee expects will help India grow at 7 percent are things he has no control over. This is the Azhar syndrome, which has plagued the UPA for a while now at work. Mukherjee and the UPA seem to be big believers in what Paulo Coelho wrote in his bestselling The Alchemist – A Fable About Following Your Dream: “Here is one great truth on this planet: whoever you are, or whatever it is that you do, when you really want something, it’s because that desire originated in the soul of the universe. It’s your mission on earth… And, when you want something, all the universe conspires in helping you to achieve it.”

The world might conspire to give India its economic growth. Interest rates might fall. Oil prices might fall. And the country might have a normal monsoon. But this is no way to run a country.

The assumption that economic growth will happen because Mukherjee and his ilk say that it will happen is clearly worrying. As Ruchir Sharma writes in his recent book Breakout Nations – In
Pursuit of the Next Economic Miracles: “India is already showing some of the warning signs of failed growth stories, including early-onset of confidence.”

The Experts Opinion - S&P downgrades

SBI & UBI

If growth peters out further and fiscal deficit overshoots by way of rising subsidy bills. Standard & Poor’s, on Wednesday, downgraded credit ratings of State Bank of India (SBI) and Union Bank of India by a notch, but the banks said it would have no impact on them as the agency had only brought the rating on a par with the sovereign rating.

“We revised the standalone credit profile (SACP) of SBI to ‘BBB—’ from ‘BBB’, and that of UBI (Union Bank of India) to 'BB+’ from ‘BBB-' based on our anticipation of the banks’ weak asset quality performance,” S&P said in a statement.

SBI said the downgrading will have no impact on it as the rating agency has only brought the rating on par with the sovereign rating. “This is not a downgrade per se, but only an equalisation of our ratings with that of the sovereign,” SBI chairman Pratip Chaudhuri said, implying that the announcement by the world’s largest rating agency will have little impact on the bank’s ability to raise overseas funds.

Union Bank of India said it will have no impact on the bank’s fund—raising as it has no plan to mop up overseas funds in the immediate future.

Chidambaram (Indian Finance Minister)

Dismissing fears of a rating downgrade, Indian Finance Minister P Chidambaram on Thursday said the government will take a host of reform initiatives in the next two years to spur growth momentum. "I don't think there is a serious threat of a downgrade but we take the talk of a downgrade seriously. We will engage with rating agency and convince them that India does not deserve a downgrade," the Minister said at a press conference on the sidelines of the IMF-World Bank annual meetings. said this while replying to a question on the possibility of downgrade of India’s credit rating to junk grade by global agency Standard and Poor's in 24 months if more reforms measures were not implemented.

"They (S&P) said there is one-in-three chance over 24 months. I think 24 months is a long time. You will see lot of reforms and lot of change, and lot of strengthening of the Indian economy", he said, adding in terms of growth and potential for growth, India was way above most countries of the world.

S&P in its report on Wednesday said that there was one-in-three likelihood of rating downgrade for India within 24 months if the economic growth prospects dim, its external position deteriorate, or fiscal reforms slow. Replying to questions on impact of easy money policy being followed by the developed world, he said it would not only bring more money into emerging nations but also fuel commodity prices. "There are pluses and minuses. The immediate concern is that if so much liquidity is injected into the system, it might lead to elevated prices, especially in commodities."
It might lead to increased speculation in commodities, crude oil, wheat, cotton and metals," Chidambaram said. As regards the quota reforms at the International Monetary Fund (IMF), the Minister expressed hope that it would be completed by January 2013.

Conclusion

Hardly any constructive steps have been taken to revive economic growth which is falling. Just talking about growth does not create economic growth. The solutions to the economic problems currently facing India are simple and largely agreed upon by everyone who has an informed opinion on the issue.

“The remedies agreed on not just by foreign investors and liberal newspapers but also by Manmohan Singh’s government, are blindingly obvious. A combined budget deficit of nearly a tenth of GDP must be tamed, particularly by cutting wasteful fuel subsidies. India must reform tax and foreign-investment rules. It must speed up big industrial and infrastructure projects. It must confront corruption. None of these tasks is insurmountable. Most are supposedly government policy.”

But there isn’t much hope going around. As the S&P report explains: “The crux of the current political problem for economic liberalization is, in our view, the nature of leadership within the central government, not obstreperous allies or an unhelpful opposition. The Congress party is divided on economic policies. There is substantial opposition within the party to any serious liberalization of the economy. Moreover, paramount political power rests with the leader of the Congress party, Sonia Gandhi, who holds no Cabinet position, while the government is led by an unelected prime minister, Manmohan Singh, who lacks a political base of his own.”

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