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Ratings review

Rules for credit rating agencies need an overhaul

Along with the news about the slowdown in various parts of the economy, reports about alleged corporate governance problems in companies are also increasing. As businesses grapple with this phase of slowing consumption, they are likely to find it increasingly difficult to service the debt on their balance sheets. In these conditions, credit rating agencies (CRAs) have a critical role to play in alerting the external stakeholders about the true state of affairs at a business and give early warnings about possible deterioration in debt servicing capability. The recent exits of the chiefs of few CRAs show that there is much that is amiss in the functioning of these companies. The regulations governing them need to undergo a revamp.

The sharp slowdown in consumption and capital expenditure in the first half of 2019 is likely to exert further pressure on corporate India that has relied excessively on debt to fund growth. A recent report by McKinsey and Company indicates that the share of long-term debt of companies with interest cover of less than 1.5 per cent was 43 per cent in 2017; the highest among emerging economies. With the economy decelerating in the recent quarters, the numbers could have deteriorated further, increasing the instances of creative accounting. CRAs have been found wanting in detecting cases of misrepresentation in recent instances such as the IL&FS issue. Market regulator SEBI has been bringing about changes to the regulations governing CRAs including mandating the disclosure of one-year forward probability of default and asking these agencies to grade the liquidity position of the issuer. SEBI has also asked for an independent audit of the processes employed and the data used in default analysis. Also, it was recently mandated that CRAs could obtain information about the issuer directly from FIs. While these measure are welcome, they are not sufficient. The crux of the issue lies in the manner in which rating agencies earn their income. With the issuer having to pay the raters, questions are being raised, and rightly so, about the independ-

Banks must gear up for disruption

Bankers must develop skills to read early signals of events likely to have a big impact on businesses, and adapt accordingly

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The Indian banking sector has witnessed rapidly increasing stress in the last couple of years with NPAs (non-performing assets) leapfrogging from 3 per cent to 14 per cent of total assets. The resultant erosion in capital base, after providing for NPAs, has crippled banks from processing new advances.

Analysts believe the Indian banking sector poses the biggest challenge for the economy when the government is trying hard to boost employment, investment and growth. Analysts also argue that the government should either privatise public sector banks or give them full independence. But the point they miss is that by doing do, banks will only become less competitive than before. Loans and NPAs are only one part of the problem. If they don't take cognisance of events that are predictors of the future, they would end up seeking bailouts.

No one can precisely predict the future, but preparing for eventual disruption is something everyone should do. Ability to detect early warning signals is a skill that even public sector bankers can acquire. There are a few time-zero events — ones that will have high impact on a business — taking place globally. Bankers must develop the skill to read the warning signals from these events and decide on what to do next.

Time-zero events

More than 50 per cent consumers find traditional consumer banking irrelevant: Imagine an autonomous, financial life — a money-enabled life — with your personal financial advisor accessible wherever and whenever you want through screen-based (mobiles/tablets) and voice-enabled (Amazon Echo/ Google Home) technologies.

As a result, banks will no longer be needed for traditional consumer banking. There will hardly be any bank branches because mobile-phone apps and online account management will take their place.

New fintech solutions to consumer banking services (a combination of bank and financial advisor applications) with the convergence of technology will allow companies such as Amazon to be able to access bank accounts and buy products for you without your having to think about it (frequently-bought items for daily consumption), or buying other products through voice-enabled technology.

Meanwhile, crowd-lending platforms and fintechs will become so powerful in credit-default prediction that they will become the cheapest and easiest platform for lending. Add to that the new developments in blockchain.

Artificial Intelligence (AI) creates transparency across 50 per cent of business: AI-enabled financial advisors can help you manage your money. Such systems will tell you it's time to move your utility provider based on your usage and expenditure patterns. It could tell you that it is time to change your credit card to save on interest, and what the least expensive way is to send money overseas. While customers trust banks to hold their money and personal data, they are sceptical about banks cross-selling products and services without keeping customers' interest in mind.

AI in banking can help build customer trust by providing contextual and timely advice that keeps customers' interests in mind. It may cannibalise their existing revenue streams but will bring in radical transparency hitherto unknown. If banks fail to use digital technology to replicate the banking intimacy in remote villages, then a disruptor will do it and make banks irrelevant. Will we see any bank using AI to literally put customers first, at the risk of short-term losses?

Technology companies capture 25 per cent of traditional banking revenue: Non-bank tech giants (Google, Apple, Alibaba) and fintech companies compete with banks in payments, lending, and foreign exchange services. These new competitors will open up entirely new kinds of services and enjoy substantial growth, while revenue pools will be constantly shrinking for traditional banks.

Open banking can create a massive shift of power to consumers ISTOCK

An Amazon bank account offering lending and deposit services as well as easy payment solutions when ordering from its site could attract lots of customers from incumbent banks.

Fintechs are mushrooming, fulfilling customers' needs of simplicity, convenience, availability, speed, transparency, and reliability, by offering banking products such as online-only bank accounts. Some of these challengers have already obtained banking licences and are also able to run business models with free bank accounts and payments globally. Customers will opt for better experiences.

Open banking arrives and more than 50 per cent of customers give their permission to share their data with third parties: Whether customers like it or not, the government has made it mandatory to provide Aadhaar to even relatively new players who don't have good privacy policies; neither has the government prescribed any privacy norms. In 2018, the UK put into place PSD2 (Second Payment Services Directive), requiring its nine largest banks to share information outside their walls in a secure, standardised format.

This initiative was motivated by several perceptions among regulators: that there was insufficient competition, that customers were overpaying for services like overdraft, and that money was just sitting in accounts failing to reward the consumer with interest on savings.

While it is not clear yet what services will be developed as a result of the move towards open banking, the potential to completely rewire the banking sector is significant. As an analogy, who could have predicted that Google's mapping project would facilitate the founding and growth of geo-location-dependent services such as Uber and its copycats elsewhere?

Open banking has the potential to create a massive shift of power to consumers, as their data is no longer locked away in legacy transaction systems. Data that would support giving loans to people with "thin files" of conventional information could potentially open up entirely new customer segments for related services. (Open banking is a collaborative model in which data is shared through APIs between two or more unaffiliated parties to deliver enhanced capabilities to the marketplace). Among the practices that open banking is likely to change is the current model employed by many fintech firms of "screen scraping," in which users provide their actual log-on credentials to a third party, which gives them far broader access to user information than is necessary, and creates a major security risk.

Once such time-zero events are identified, bankers can start to work backward: What would have to be true six months before time-zero for that to occur? Twelve months before? Eighteen months? Bankers can thus gather relevant data and create a bigger picture.

If you're right about these time-zero events and you're able to see around corners before others, you will have an edge to take your business to the next level.

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