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How is it that no one spotted IL&FS' coming doom? There's an angle few are probing

BY ET CONTRIBUTORS | UPDATED: OCT 05, 2018, 01.13 PM IST

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By Milind Deora

Infrastructure Leasing & Financial Services (IL&FS) is in hot water. On August 7, credit-rating agency Icra downgraded IL&FS' long-term loans and debentures for the first time from AAA to AA+, citing mounting debt, slow asset monetisation and deteriorating credit profiles of hundreds of its subsidiaries. It all came unravelling a month later.

On September 4, it was revealed that IL&FS defaulted on a short-term loan worth Rs 1,000 crore from the [Small Industries Development Bank of India](#) (Sidbi), and subsequently defaulted on various debt obligations on September 14, 17 and 18.

Seven fresh defaults on payment obligations worth Rs 395 crore were declared on September 27.

Waiting for Disaster

While IL&FS is receiving adequate scrutiny for their blunders, our credit [rating agencies](#) (CRAs) are not. [RBI](#) had reportedly warned three years ago in an inspection report of trouble brewing in IL&FS Financial Services (IFIN), saying that its net-owned funds had been wiped out and that it was overleveraged. And, yet, it was only while the crisis was unfolding in September — after it was too late — did Indian CRAs downgrade thousands of crores of IL&FS' debt securities to junk status.

In a March 2018 report, ICRA gave an A1+ rating to the company's commercial paper programme, and AAA rating to its non-convertible

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IL&FS

-3.35 (-9.94%)

Crisil

3.95 (0.24%)

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debentures as well as its long-term loans with a stable outlook, which remained as such till its first downgrade in August. The inability of rating agencies to forecast the IL&FS liquidity crisis brings into question their credibility. It warrants an exploration into their functioning, motivations and regulation.



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Globally, three CRAs oligopolistically dominate 95% of this market: Standard & Poor's (S&P), Moody's and Fitch Ratings. In India, [Crisil](#) dominates the market with 60%-plus share, and the majority shareholder in Crisil is S&P.

Similarly, the largest shareholder in Icra is Moody's. CRAs rate a gamut of long-term and short-term debt securities, such as government, corporate and municipal bonds, and collateralised securities. These instruments may be issued by any entity (not an individual) looking to raise capital, ranging from private companies to local, state or national governments.

CRAs play a critical role in financial markets, and their integrity, therefore, must be airtight. In their infancy in the early 20th century, these agencies forged credibility because they provided disinterested analyses of creditworthiness and risk to those investing in debt, and were paid to do so by these investors themselves.

Because their revenues flowed from investors, the agencies' primary allegiance was to these customers. Their reputations, along with the future of their business, was at stake if they provided faulty predictions or ratings.

Since the 1970s, however, with a restructuring of the payment model, their credibility has been called into question because of an inherent conflict of interest. Since then, revenues for rating agencies flow from the issuers of debt, not from investors, which can be a breeding ground for manipulation and collusion.

It would logically follow that CRAs would need much heavier regulation to accommodate this payment reconfiguration. However, these agencies were not comprehensively regulated or held accountable till the financial world was on its knees during the US subprime mortgage crisis beginning in 2007.

Arguably, the CRAs' role in engendering the global financial crisis was tremendous. The housing bubble was inflated and financed by the creation of new, extremely complex and highly leveraged financial instruments called 'securitised mortgages', in the form of mortgage-backed securities and collateralised debt obligations.

It was impossible for these securities to flourish without the triple-A ratings designated to thousands of them by the Big Three CRAs, which encouraged capital inflow to subprime securities and allowed financial institutions to take unprecedented risk.

Accountability for Accounts

Billions of dollars worth of these CRA-backed securities were junked, resulting in losses of half a trillion dollars. It was only then that stringent regulation of CRAs first became a part of governmental agenda.

The US legislated the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, and the EU created the European Securities and Markets Authority (Esma) in 2011 to protect investors and increase CRA liability. S&P and Moody's had to pay out \$1.37 billion and \$864 million, respectively, as settlements with US federal and state authorities. But they still dominate most of the market.

Rating agencies in India date back to 1987, and have one of the most extensive regulatory frameworks under the Securities and Exchange Board of India (Sebi). However, this is no cause for complacency. In 2015, Indian CRAs came under the Sebi scanner for abruptly downgrading, and subsequently suspending, the ratings for Amtek Auto, and in 2017 for downgrading Reliance Communications' debt to default status, two full months after its default on non-convertible debentures.

They must now be pulled up for failing to identify the IL&FS crisis. CRAs must assume utmost responsibility and be held accountable for any manipulation, inflated ratings, or even slacking in their analysis. Investors must have faith that the information being provided to them is accurate, because thousands of retail investors like myself rely on these ratings to make investment decisions.

It is unfortunate that IL&FS' business decisions have rendered it unable to fulfil its debt obligations. But, perhaps, we also need to look beyond another company on the verge of a bailout, and scrutinise the institutions whose primary obligation is to alert investors and the market of the risk associated with these companies.

The writer is former minister of state, communications & information technology.

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IL&FS crisis

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