

# Govt and regulators must plug loopholes to stop more IL&FS-type frauds

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Limit number of layers of step-down subsidiaries, insist on group-level financials for all firms, disclose defaults immediately



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Just how little IL&FS's much-vaunted board—with some of India's top professionals on it—did is best seen from the “progress and way forward” report put out by its new board led by banker Uday Kotak in less than a month of taking over. Within just a few days of taking over, Kotak informed the country

that while most thought IL&FS had 250 or so entities, the actual number was 347. The new report now classifies the IL&FS Group's debt in terms of whom it is owed to—so, of the Rs 130,602 crore of debt (the earlier estimate was Rs 116,647 crore for FY18), for instance, Rs31,247 crore is owed to group firms and so, ideally, should be paid off last; indeed, it will be important to see how much of this is even genuine. The report talks of one transaction where an asset was transferred from one group entity to another last year in June at Rs 31 crore; a year later it was sold to a third party for `1 crore—since this means that either the first or the second leg of the transaction was fraudulent, a proper estimate of the authenticity of debt will have to await the detailed forensic audits.

Also, as IL&FS's annual report brings out, the picture you see depends upon what level you are looking at—the IL&FS holding company had debt of Rs 17,757 crore in FY18 while the group had a debt of Rs 116,447 crore. The immediate lesson for regulators has to be to insist that any subsidiary has to also make public certain group-level details like debt and leverage for instance. Indeed, one of the reasons why rating agencies got it so wrong was because they were often not looking at the group but just rating step-down subsidiaries. A stand-alone road project may look AAA because of its annual toll collections, but if the group financials look shaky, a rating agency may rate it quite differently. IL&FS also found it easier to hide the truth since its 347 entities were held via four levels of step-down subsidiaries; there were 142 entities at Level 4! Once again, the lesson for regulators is to relook the number of levels of subsidiarisation since this is clearly a large part of the problem.

The sheer number of entities also makes unravelling the mess more complicated. ITNL, the roads transportation arm, has 12,065 lane km of road

networks but another table in the report tells us the transportation business comprises 72 subsidiaries, nine joint ventures, nine associates and 113 joint control operations, taking the total to 203. While the report tells us that total defaults, as of October 8, totalled Rs 4,776 crore, both Sebi and RBI need to act upon this urgently. Sebi needs to revive its proposal, put on hold last year after corporate opposition to it, that makes it mandatory for all listed companies to disclose any default within a day of it taking place. Equally, RBI needs to ensure—once again, this is critical if rating agencies are to be able to see the complete picture—that bankers disclose defaults the minute they take place. Indeed, making such data available instantly will also allow rating agencies to fine tune their rating models with more real-time data.

Interestingly, while government sources spoke of possible infusion of funds by public sector owners of IL&FS like LIC and SBI, as the report points out, IL&FS's rights issue fetched just Rs 5.5 lakh, and that too from retail investors. That none of the PSU owners of IL&FS put in money means they either don't have the cash or didn't feel it made sense to throw more good money after bad. At some point, sooner rather than later, they will have to be forced to part with more money to make good IL&FS's debt. Given the complex web of entities, it is not clear whether the process of resolution can be completed in the 6-9 month time frame indicated by the new board; and since it is unlikely any single firm will touch the group, the best chance is to look at selling various vertical businesses like roads or thermal power. Also, given that IL&FS accounts for around 16% of all bank loans to NBFCs, it is not surprising that the government pressure on RBI to open lines of credit for NBFCs increased after the IL&FS defaults started skyrocketing.

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