Credit downgrade – IL & FS Episode

Why in news?

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Infrastructure Leasing & Financial Services (IL&FS) and its subsidiary received credit downgrade from rating agencies ICRA, India Ratings and CARE recently.

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What led to the downgrade?

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- IL&FS, including its subsidiaries, has under its belt around 90 entities and Special Purpose Vehicles (SPVs).
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- IL&FS and its subsidiary IL&FS Financial Services enjoyed high credit ratings in the recent period.
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- But concentrated exposure to infrastructure and real estate projects led to an overstretched balance sheet and deteriorating asset quality scenario.
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- Also, fragile financial condition of state distribution companies buying power from IL&FS Wind Energy Limited led to the deteriorating credit profile.
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- This, along with other such causes, made IL&FS along with its subsidiaries to have around Rs 1 lakh crore worth public debt on its books.
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- It recently sought immediate loan assistance of Rs 3,000 crore from two of its shareholders, the SBI and LIC.
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- Recently, reports started leaking that the subsidiary had missed due dates on commercial paper, while the parent had defaulted on deposit dues to SIDBI.
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- Several credit rating agencies thus abruptly downgraded its credit rating, from high investment grade (AA+ and A1+) to junk status (BB and A4).
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- In the Indian context, any bond rated 'BB' and below is classified as speculative grade category.

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- This has a significantly higher risk of default of interest and principal.
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What does it imply?

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- **Rating agencies** - The stretched liquidity position of the group was known before.
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- But it took an actual default for the rating agencies to revisit their investment grade ratings.
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- The rating agencies repeatedly flagged loan book concentration, high debt levels and the dire financial straits of the group's firms in their reviews.
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- But they seem to have pinned their hopes on IL&FS' big-name promoters to bail it out of its troubles.
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- This exposes the fragility of the 'structured obligation' in the ratings, to actually weak entities but hailing from large industrial groups, on the faith of a possible rebound in future.
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- **Mutual Funds** - The mutual funds failed to restrict their exposures to the high-risk paper to their 'credit risk' funds.
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- Fund managers instead parked it with their liquid and low duration funds.
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- They also marketed them as low-risk alternatives to savings bank accounts.
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- **Banks** - The episode again shows the risks of banks in funding long-gestation projects with short-term money.
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What is the way forward?

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- The episode has underlined the need for institutional investors to build their own capabilities.
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- They have to strengthen the independent credit appraisal instead of over-relying on rating agencies for their investment calls.
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- Also, SEBI should revisit its recent fund categorisation rules to ring-fence certain categories of debt funds from credit risks and address the shortcomings of fund mangers.
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- Also, rating agencies need to be proactive rather than reactive with their rating actions.
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Source: Business Line

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Quick Facts

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Credit-risk Funds

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- Credit-risk funds are debt funds which have at least 65% of their investments in less than AA-rated paper.
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- They generate high returns by taking higher credit risk and by investing in lower-rated papers.
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- Such companies offer higher interest rates, and as and when their ratings move up, they offer a benefit of capital gains.
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