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Corporate governance failure at IL&FS: The role of internal and external mechanisms

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Abstract
This paper explores the origins of the Infrastructure Leasing & Financial Services (IL&FS) crisis which threatened to become a domestic credit crisis by its mere size and extent had it not been for the timely intervention by the government. In most of the scams post liberalisation, the most high profile being Satyam, there was a failure of both internal and external mechanisms of corporate governance, that is there was a failure on the part of the board of directors (internal) and failure on the part of auditors and credit rating agencies (external). This paper argues that in most cases, and especially in case of a non-banking finance company like IL&FS the external mechanisms are as important if not more so, than the internal ones and if they function properly they can play a pivotal role in regulating and supervising the management thus making overall corporate governance effective.

Keywords: Crisis, corporate governance, board, auditors, credit rating agencies

Introduction

Infrastructure Leasing & Financial Services Limited (IL&FS) was brought into existence in 1987 with a view to looking after the funding needs of the prime infrastructure projects all over India. While HDFC, Central Bank of India and UTI initiated it, ORIX, LIC and Abu Dhabi Investment Authority also joined in later as major stakeholders. IL&FS had in its fold a large number of subsidiaries to dispense financial, infrastructure, and, technology services to sectors such as roads and transportation, power, education, sports, tourism and the like.

Crisis at IL& FS

Trouble surfaced for IL&FS in July 2018 when two of its subsidiaries (out of the 250 odd ones) defaulted on payment of loans to banks and inter corporate deposits to their lenders. Come September, it was being reported that IL&FS was having problems repaying huge amounts (to the tune of Rs. 1,000 crores) to Small Industries Development Bank of India (SIDBI). A similar story was unfolding with Il&FS Financial Services Limited (IFIN), the nonbanking financial company (NBFC) arm of II&FS, that they had been backtracking on commercial paper (CP) payment. The month of September proved disastrous for IL&FS in meeting their commitments and the Reserve Bank of India (RBI) stepped in to take stock of the situation and look at the effectiveness of management.

Soon it blew up into a contingency situation with default one after the other, so the government intervened and took quick action. They dismissed the senior management and replaced them with a new board with Uday Kotak at its helm. The very grim situation where it would have become a Lehman moment (Lehman Brothers was the leading global financial services firm in USA which became the largest bankruptcy due to its erroneous policies of excessively high debt equity ratio and exposure to high risk subprime clients) was prevented from getting out of control. Nevertheless, some damage in terms of liquidity crunch did take place and took a toll on the mutual funds which relied on commercial paper (CP) of large corporations.

The paper is organised as follows: First, some facts which were unveiled during investigations following the crisis are discussed. An analytical review is then made, classifying the mechanisms of corporate governance (CG) into internal and external and how these mechanisms failed at IL&FS. Some conclusions and recommendations follow.

Some Facts and Observations

1. The newly setup board declared the existence of 348 entities, much higher than the disclosure made previously. The amount of debt was stated to be ₹91,000 crores at the end of the financial year 2017-18. Such an enormous amount of debt could not have piled up in a year unless there was serious misgovernance and an attempt to cover up the messy financial position.
2. There was a huge asset-liability mismatch due to short term funds being used for long term projects. With less procurement of funds from banks, than its ever burgeoning needs considering it's huge spread & voluminous size (complex and multi layered), it started relying excessively on CP for long term requirements also (CPs are promissory notes having a short maturity period, not more than 270 days).
3. The rating agency ICRA, gave the highest rating AAA rating to non-convertible debentures which continued till August 2018, just a month before it downgraded it by several notches, due to a series of defaults in not meeting commitments.
4. The RBI with which IL&FS was registered also had no clue of the impending catastrophe till as late as September 2018, so there was a supervisory failure on the part of RBI and the mismanaged state of affairs at IL&FS continued, unabated.
5. The auditors also did not report anything untoward which would warrant immediate attention. In the case of IL&FS, there was a major neglect of duty by the auditors which was put by ministry of corporate affairs (MCA) secretary Injeti Srinivas in the following words: "We are not expecting an auditor to detect a needle in a haystack, but if an elephant is in a room, they ought to find it."
6. The remuneration of the chairman (managing director), vice-chairman and CEO increased significantly during 2015-2018, the period when the company was in doldrums and earnings were depleting. The nomination & remuneration committee (NRC) consisting of nominee and independent directors, instead of replacing them for their poor performance, rewarded them by paying high amounts as compensation.
7. IL&FS had on its board five independent directors (IDs) of repute namely R C Bhargava (chairman of Maruti), Michael Pinto, (a former secretary for Shipping), another was a former LIC chairman and the other two also were well known professionals. But at the end of the day, they were all bureaucrats dealing with the government, who did not have the competency and creativity to deal with fraud and mismanagement. Even though they possessed a high stature they were not suitable for IL&FS since none of them had the experience in infrastructure financing. Though there is a data pool of independent directors prepared by agencies authorised by the ministry of Corporate Affairs (MCA) yet, which of them will be suitable for their particular industry has to be decided by the Board. The independent directors in case of IL&FS did not have the requisite experience and hence not appropriate to the business of finance and lending which was apparent in their being unable to handle the crisis. (Independent directors were kept more to meet the mandatory legal requirement than to really be vigilant towards improper situations).
8. Grant Thornton was commissioned to undertake special audit by the name of project 'Icarus' and pointed out in his report submitted in February 2019, on several irregularities. Some of these were 'ever-greening'(a practice where loans are used to repay previous loans, which is prohibited by RBI), 'round-tripping'(by first borrowing and then lending to own subsidiaries either directly or through third parties even after being fully aware of their financial status), loans being advanced to 'stressed companies' not approved by the 'risk management team', lending at abysmally low cost, even 'less than the borrowing rate', loans granted 'without collaterals', 'loans transferred to promoters' etc.(source- Grant Thornton forensic analysis)

Analytical Review

Corporate governance mechanisms consist of both internal and external sources. Mechanisms which originate from within the firm, namely 'board of directors, ownership and managerial incentives' have been given an exceeding amount of importance in research on corporate governance. Examples of external CG mechanisms which exercise control from outside are the legal system, external auditors, and rating agencies to name a few (Aguilera, R.V, *et al.* 2015) [1].

In the IL&FS case there was a failure of internal mechanisms and the 'agency problem' did take place in that the directors acted in their own self interest which was to receive high amounts of compensation. They neglected their fiduciary duty to act in the interest of the corporation. Agency costs are reflected in:

The account statements of IL&FS showing profits from 2015-2018 whereas if consolidated group accounts were to be seen, they were showing continuous losses; the directors carrying away huge amount of remuneration by showing good performance whereas there was a huge asset- liability mismatch, short term funds like CPs were used to finance long term projects and ever greening of loans took place.

The risk management committee which is of primary importance in finance and investment businesses and to ascertain which clients were creditworthy enough, did not meet after 2015 till the time the crisis surfaced. Even where the risk management committee identified a borrower as subprime, loans were given which would then be paid back by group companies to whom money was advanced for this purpose.

The external mechanisms at IL&FS which could have saved the situation like the supervisory role of the RBI (with whom IL&FS was registered), the external auditors, Deloitte and KPMG and the credit rating agencies ICRA also did not do much.

Though RBI had in 2015 raised red flags in connection with IFIN lending to group companies for ever greening and wrong calculations of 'net owned funds' it did not take any action when IFIN did not conform and take steps in accordance with RBIs inspection report. Had RBI intervened on time the situation would not have assumed such alarming proportions.

The company's auditors Deloitte Haskins & Sells LLP should have highlighted the observation of RBI in its inspection report about IFIN being over-leveraged. They also failed to disclose in their report 'negative cash flows' and 'unfavourable key financial ratios'. IFIN provided loans to businesses who were not in a position to pay their debt.

Further, it granted loans to the defaulters' group companies in order to repay the previous loans, so as to not classify them as bad loans. The auditors also did not disclose the end use of funds that were raised by debentures of IFIN, which they are supposed to according to norms. They did not use analytical tools which auditors typically use during their audit and no attention was given to the statements made by RBI during inspection.

The rating agency ICRA, gave A+ and AAA rating to its commercial paper and non- convertible debentures in as late as March 2018, just about a few months before it reached an impasse, caused by a series of non- payments and not meeting commitments at a stretch. The share of IL&FS in the funds disbursed by banks to the total NBFC sector was quite high. The rating agencies should have considered this huge 'public interest' involved while going so casual in their ratings. The rating agencies are expected to make an independent professional assessment on the expertise they possess. They failed to fulfil their duty and relied instead on their impressive 'institutional parentage'.

Along with this, it was a well known fact that the risk management committee of ILFS did not meet after 2015, risk management committee being a crucial committee in a business involving lending funds. The rating agency chose to show a blind eye to all these facts and kept on rewarding them with high ratings.

Conclusions and Recommendations

For regulation of NBFCs which are now of formidable size and have a huge amount of business, a separate specialised department or agency can be created working under RBI. RBIs hands are too full, and it needs to delegate so that proper monitoring of NBFCs can be done.

The suitability of independent directors for the company should be assessed and the board while recommending their names should justify their relevance to the business of the company so that the IDs can give their best contribution to the affairs of the company and not just be ceremonial showpieces simply to fulfil mandatory obligations.

The auditors and rating agencies have a major role to play as far as investors are concerned. An audit gives reasonable assurance though not absolute that the financial statements do not contain any material misstatement due to error or fraud. Thus, audit of great importance to the owners and other users of financial statements be it creditors, regulators or analysts. An auditor needs to work with professional skepticism in the performance of his duties. Where auditors fail in their duties, they should be subject to stringent supervision and penalties so that they perform their audits in a trustworthy manner which can be relied upon. Similarly, the rating agencies failed the investors who relied on their ratings while putting in their hard earned money in IL&FS. A rating by an independent agency which is a specialised opinion about the corporation's ability to meet its financial obligations as and when they become due guides the investors and creditors about their creditworthiness. Severe penalties should be imposed for such lapses so that the innocent investors do not suffer.

The paper supports the view, 'Internal governance mechanisms such as the board of directors do not operate in isolation, and external factors play an essential role in determining directly and indirectly the effectiveness of a firm's governance' (Aguilera, R. V. *et al*, 2015) [1]. Hence, an enhanced role should be assigned to the external auditors and rating agencies i.e., the external mechanisms of corporate governance instead of placing too much reliance on the internal mechanisms. These outside channels will strengthen the effectiveness of internal channels and hence improve overall corporate governance.

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