# INVISIBLE BALANCE SHEET IN INFRASTRUCTURE FINANCE: LEGAL AND ECONOMIC PERSPECTIVES

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**ABSTRACT**

India's infrastructure financing ecosystem is increasingly shaped by legally non-enforceable but economically significant instruments such as comfort letters, off-budget borrowings, and quasi-sovereign guarantees that escape disclosure and accountability. These practices, while enabled by corporate actors, are further entrenched by state institutions that exploit legal and constitutional gaps to obscure fiscal risk. The "invisible balance sheet," a shadow layer of governmental and corporate responsibilities that elude official financial statements, regulatory supervision, and parliamentary examination, is the result of this phenomenon, according to this research. The paper uses Indian case studies like Telangana's PSU debt, KIIFB, and IL&FS to place this phenomenon within larger doctrinal failures, such as the Companies Act's statutory silences, contract law's stringent enforceability requirements, and the absence of constitutional protections against off-budget state borrowing. Despite recent regulatory efforts to improve fiscal transparency, such interventions have been largely ad hoc and insufficient in addressing the underlying structural issues. This paper undertakes a detailed legal and policy analysis to argue for the formal codification of quasi-fiscal instruments, the imposition of mandatory disclosure obligations for all contingent liabilities, and the introduction of constitutional safeguards to ensure legislative and public oversight. By prioritizing the economic substance of fiscal commitments over their legal form, the paper proposes a comprehensive reform agenda aimed at strengthening the transparency, accountability, and legal integrity of India's infrastructure financing framework.

## I. INTRODUCTION

India's infrastructure financing architecture increasingly relies on a shadow layer of fiscal instruments that obscure the true magnitude of public and corporate liabilities. These instruments ranging from comfort letters and support undertakings to off-budget borrowings and quasi-sovereign guarantees accumulate into what may be termed an "invisible balance sheet". It is a collection of financial obligations that, while economically significant, often escape formal recognition in financial statements, government accounts, or statutory disclosures. These contingent liabilities remain invisible to regulators, auditors, investors, and even legislatures however, they are routinely realized in times of financial distress, defaults, or policy intervention.

At the core of this invisible balance sheet lies a form of deliberate legal engineering that displaces risk from balance sheets without triggering legal enforceability. Letters of comfort issued by parent corporations or state departments offer moral assurance of financial support but do not qualify as "guarantees" under Section 126 of the Indian Contract Act, 1872. This allows companies and public bodies to avoid the disclosure requirements mandated by the Companies Act, 2013, and SEBI's Listing Obligations and Disclosure Requirements (LODR) Regulations[1]. Similarly, Special Purpose Vehicles (SPVs) are frequently used to ring-fence liabilities from corporate or state-level accounts, while still allowing debt to accrue at the project level, thereby misrepresenting credit risk. At the sub-sovereign level, State Governments increasingly resort to off-budget borrowings through public sector undertakings (PSUs) and urban development authorities, circumventing Article 293(3) of the Constitution and evading legislative oversight.[2]

The legal system's fragmented treatment of these practices has enabled their proliferation. While the Companies Act requires disclosure of formal guarantees and inter-corporate loans, it is silent on non-binding financial undertakings, letters of support, and informal fiscal backstops. Similarly, the LODR framework, despite post-IL&FS tightening, allows listed companies to structure risk through unconsolidated subsidiaries and off-balance-sheet SPVs. The Constitution of India, while prescribing borrowing limits and fiscal responsibility through Article 293(3) has no implementing framework to prevent states from accumulating contingent

[1] The SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.
[2] The Constitution of India, 1950, Art. 293(3).

liabilities through state-run entities that do not formally require consent from the Union government.

The consequences of this regulatory blind spot have already begun to materialize. The collapse of Infrastructure Leasing & Financial Services (IL&FS) in 2018 exposed over ₹99,000 crore in hidden liabilities across 348 group entities, many backed by informal letters of comfort and corporate cross-holdings.[3] The Government of Telangana's ₹1.18 lakh crore (₹118,000 crore) in off-budget liabilities, routed through entities like the Telangana State Finance Corporation and urban bodies, bypassed legislative approval and FRBM targets.[4] Similarly, the Kerala Infrastructure Investment Fund Board (KIIFB) has raised thousands of crores through masala bonds and state guarantees embedded within complex SPV structures, without reflecting them in consolidated state accounts.[5] In the Zee Essel vs Yes Bank case, a comfort letter backed by ₹200 crore in fixed deposits was never disclosed to the board or public shareholders, raising serious questions about auditor responsibility and governance failures.[6]

Despite such high-profile episodes, Indian legal scholarship remains largely silent on the problem. Existing regulatory responses focus on accounting disclosures or ad hoc post-crisis interventions rather than a systemic legal framework. This paper argues that the problem extends beyond fiscal opacity to fundamental legal design flaws. India lacks a codified framework to define, classify, and regulate contingent liabilities generated through informal instruments by both public and private actors in infrastructure finance. The law currently recognizes enforceable guarantees but offers no treatment of "near-guarantees" instruments that are not legally binding but economically relied upon.

Accordingly, this paper proposes the development of a comprehensive legal-economic framework to address the "invisible balance sheet" in infrastructure finance. It argues for: (i) a statutory taxonomy of contingent liabilities based on economic substance and systemic risk; (ii) mandatory disclosure of comfort instruments and quasi-guarantees under corporate and

[3] FORTUNE INDIA, IL&FS: Solving the puzzle, available at https://www.fortuneindia.com/enterprise/ilfs-solving-the-puzzle/102980 (Last visited on June 20, 2025).
[4] VV Balakrishna, CAG report shows BRS government's reliance on off-Budget borrowings, THE NEW INDIAN EXPRESS, August 03, 2024, available at https://www.newindianexpress.com/states/telangana/2024/Aug/03/cag-report-shows-brs-governments-reliance-on-off-budget-borrowings#:~:text=The%20CAG%20report%20said%20that,as%20per%20the%20TSFRBM%20Act (Last visited on June 20, 2025).
[5] Rajesh Abraham, KIIFB to repay Rs 2,150-crore masala bonds on schedule, THE NEW INDIAN EXPRESS, January 30, 2024, available at KIIFB to repay Rs 2,150-crore masala bonds on schedule (Last visited on June 20, 2025).
[6] Yes Bank Limited v. Zee Entertainment Enterprises Limited and Others, (2020) SCC OnLine Bom 11763.

securities law; (iii) constitutional enforcement of Article 293(3) to prevent off-budget fiscal risk accumulation; and (iv) creation of a national public "Contingent Liability and Fiscal Risk Register," modeled on the UK's Whole-of-Government Accounts.

Through doctrinal analysis, comparative legal frameworks, and grounded Indian case studies, this paper seeks to answer a foundational question: How can Indian law reconcile the economic reality of invisible liabilities with the legal fiction of their non-existence? In answering this, it aims not merely to critique the current system but to offer a blueprint for reform restoring fiscal transparency, legal accountability, and democratic legitimacy to India's infrastructure financing landscape.

## II. CONCEPTUAL FOUNDATIONS: EXPLORING OFF-BALANCE-SHEET LIABILITIES

Off-balance-sheet (OBS) liabilities are debts that aren't officially listed on the company's balance sheet but may pose financial risks in the future. Identifying off-balance-sheet liabilities is challenging and when these liabilities appear, investors and the general public are impacted since they are held responsible for them.[7] These include contingent obligations in public finance, such as annuity commitments made through extra-budgetary institutions, comfort letters from ministries or public sector undertakings (PSUs), and guarantees for public–private partnerships (PPPs). To make the deficit appear lower, the government moves a portion of its borrowings or guarantees outside the budget, but the risk to the general public remains the same. The government takes this action in order to keep its dominant market position and to borrow easily.[8]

According to Goa's CAG report, a bank loan of Rs 800cr that was backed by a state comfort letter was not recorded in official accounting books and bypassed the debt ceiling.[9] In corporate finance, OBS liabilities are usually the result of moral commitments or letters of support that

[7] MAINSHARES, Off-balance sheet liabilities in a small business**,** available at https://mainshares.com/learn/off-balance-sheet-liabilities-in-a-small-business (Last visited on June 20, 2025).
[8] Ashutosh Kumar, Congress hid deficits via off-budget borrowings, oil bonds: Sitharaman, FORTUNE INDIA, MAY 27, 2024, available at https://www.fortuneindia.com/macro/congress-hid-deficits-via-off-budget-borrowings-oil-bonds-sitharaman/116935?utm ((Last visited on June 20, 2025).
[9] Newton Sequeira, Goa Off-Budgeting Loans to Mask Outstanding Debt, Says CAG Report, TIMES OF INDIA, Aug. 8, 2024,available at https://timesofindia.indiatimes.com/city/goa/goa-off-budgeting-loans-to-mask-outstanding-debt-says-cag-report/articleshow/112355886.cms (last visited June 22 2025).

parent companies give to subsidiaries' creditors or lenders. These commitments indicate financial assistance but do not amount to legally binding guarantees.

The International Monetary Fund (IMF) defines contingent liabilities as obligations that may arise depending on the outcome of a future event, such as defaults on loans or revenue shortfalls in infrastructure concessions.[10] While these liabilities do not affect financial statements directly at the time of issuance, they often materialize during economic distress, creating a mismatch between legal visibility and economic exposure. As a result, the traditional balance sheet framework fails to capture the full spectrum of fiscal risk, especially in jurisdictions like India where legal classification often dictates disclosure and enforcement.

**A. Taxonomy of Common Off-Balance-Sheet Instruments in Infrastructure Finance**

In India's infrastructure finance ecosystem, several instruments routinely generate OBS liabilities. These include:

i. Contingent Guarantees: It is a promise by one party to pay a debt if another party fails to discharge it but this guarantee came into effect only on happening of certain events.[11] For instance, state governments or central ministries may provide guarantees to cover termination payments in infrastructure concessions or backstop payments to financial institutions. These guarantees may be invoked only upon the occurrence of specific events, and if the likelihood is remote, they are not recorded or disclosed.[12] These guarantees may be invoked only upon the occurrence of specific events, and if the likelihood is remote, they are not recorded or disclosed.

ii. Comfort Letters and Letters of Support: Comfort letters and letters of support are usually issued by parent companies to the creditors of their subsidiaries or by state government departments to assure them that the subsidiary or special-purpose vehicle would remain solvent and, in any default, it will be backed by us.[13] The Comfort Letter or Letter of Support is

[10] International Monetary Fund, Public Sector Debt Statistics: Guide for Compilers and Users, IMF ELIBRARY, Dec. 8, 2011, available at https://www.elibrary.imf.org/display/book/9781616351564/9781616351564.xml (last visited June 22 2025).
[11] LSDATA, What Is Contingent Guaranty?, LSDATA, available at https://www.lsd.law/define/contingent-guaranty (last visited June 22 2025).
[12] Caroline Banton, Contingent Liability: What Is It, and What Are Some Examples?, INVESTOPEDIA, June 14, 2024, available at https://www.investopedia.com/terms/c/contingentliability.asp (last visited June 22 2025).
[13] Will Kenton, Letter of Comfort: Definition, Uses, Vs. Guarantee, INVESTOPEDIA, Dec. 26, 2022, available at https://www.investopedia.com/terms/l/letterofcomfort.asp (last visited June 22 2025).

drafted in such a way that it expresses the drawer's intention but does not make an outright promise to complete its obligations. As a result, they are contingent liabilities that are not shown on the balance sheet and are not legally enforceable. In recent judgments, courts have held that comfort letters are legally binding only if they meet the guarantee requirements under Section 126 of the Indian Contract Act.[14]

iii. Moral Obligation Undertakings: Moral obligation refers to a duty based on ethical considerations rather than legal enforceability.[15] These undertakings involve non-binding commitments made by a public authority to honor debts or shortfalls incurred by an SPV or subsidiary. Although unenforceable under contract law, lenders and rating agencies often rely on them in evaluating credit risk, creating implicit liabilities but they are not present in the Balance Sheet.

iv. Annuity Payment Guarantees in PPPs: An annuity-payment guarantee is a promise by a government entity to the private entity who enter in a PPP, to pay a fixed amount semi-annually if private revenue shortfalls in infrastructure projects. These payments, though not always guaranteed by law, are contractually structured to be made from budgetary allocations and often treated by lenders as quasi-sovereign guarantees. The APG are often issued in highways project, ports and power project to incentivize private participation despite uncertain returns. APGs are considered contingent liabilities and are excluded from balance sheet recognition due to their uncertain occurrence. This off-balance sheet treatment creates a fiscal illusion, masking true liabilities.

**B. Legal vs. Economic Obligations: The Enforcement–Disclosure Divide**

A central characteristic of off-balance-sheet liabilities is the divergence between legal enforceability and economic expectation. The systematic non-disclosure of legally non-enforceable instruments like comfort letters and moral undertakings facilitates the creation of high-risk off-balance-sheet liabilities in India, directly contradicting the "substance over form" principle enshrined in corporate law.

[14] Supra note 6.
[15] LSDATA, What Is Moral Obligation?, LSDATA, available at https://www.lsd.law/define/moral-obligation (last visited June 22 2025).

Under Section 126 of the Indian Contract Act, 1872, a "contract of guarantee" must involve a legally binding promise to discharge another's obligation.[16] But the Comfort letters and moral undertakings fall outside this definition of guarantee due to their lack of binding tripartite commitments and are thus excluded from the purview of enforceable guarantees.

However, under corporate law, such instruments still create economic consequences. Sections 129 of the Companies Act, 2013 require directors to present a "true and fair view" of a company's financial position[17] and section 133 of the Companies Act requires the company to comply with the accounting standards prescribed by the government.[18] Similarly, SEBI's LODR Regulations, 2015, Rule 30(8) require all listed companies to disclose all relevant information on their website as per the requirements of the stock exchange regulations[19]. However, companies exploit the Contract Act's narrow thresholds to omit these instruments from financial statements, artificially excluding them from Schedule III's liability recognition criteria. This transforms informal support into off-balance-sheet liabilities: undisclosed parental letters of comfort, for instance, enable subsidiaries to secure loans at preferential rates by signalling implicit group backing, even when consolidated financial statements (mandated under Companies Act Section 129(3)) omit these arrangements.

This asymmetry between what is legally recognized and what is economically relied upon creates systemic vulnerability. Credit rating agencies, institutional lenders, and investors often price risk based on implicit state or group support, even when there is no legal obligation. In effect, economic expectations are built on legal ambiguity, and when defaults occur, these "soft commitments" crystallize into hard fiscal costs borne by the public exchequer or corporate balance sheets.

### C. The "Invisible Balance Sheet" as a Doctrinal Concept

The doctrine of the invisible balance sheet is a framework primarily used by non-profit organizations to manage the assets and liabilities that do not appear on the Official or Final Balance Sheet of the organization. Invisible assets refer to those assets that add value to the organization after certain events but are not recorded on the official balance sheet, for example, Customer loyalty, brand recognition enabling premium pricing, Community trust, etc. The

[16] The Indian Contract Act, 1872, §126.
[17] The Companies Act, 2013, §129.
[18] The Companies Act, 2013, §133.
[19] The SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, Reg. 30(8).

invisible liability refers to the obligations that a company has to do on the occurrence or happening of the event which are not recognized in the balance sheet.

The invisible balance sheet captures the disjunction between legal invisibility and economic reality. It refers to consisting of comfort instruments, off-budget guarantees, and informal undertakings that is not captured by statutory accounting frameworks but is structurally embedded in India's infrastructure financing ecosystem.

Courts have occasionally recognized economic substance over legal form in interpreting such instruments. In the case of State Bank of India v. Mula Sahakari Sakhar Karkhana Ltd., the Supreme Court drew a thin line between an indemnity and an unconditional bank guarantee.[20] The instrument issued by the bank lacks the requirement to become a binging guarantee. An indemnity is contingent until occurred, the issuing bank need not show the full amount as a funded liability on its balance sheet, and instead, it is disclosed in the notes as a contingent or "off-balance-sheet" exposure that attracts neither loan-loss provisions nor risk-weighted capital until the loss materializes. The case demonstrates how careful drafting can shift large credit-risk positions off the face of the balance sheet. Similarly, judicial treatment of government support letters in arbitration and insolvency proceedings has blurred the lines between moral and legal obligations, particularly when public funds are ultimately used to rescue failing infrastructure projects.

In this context, the invisible balance sheet operates as a legally ambiguous yet fiscally consequential construct. It enables governments and corporations to shift liabilities off the books while maintaining project-level creditworthiness. However, the lack of enforceability standards, disclosure mandates, or constitutional checks makes these instruments vulnerable to misuse transforming risk management into risk obfuscation.

## III. THE LEGAL-INSTITUTIONAL ARCHITECTURE IN INDIA: FRAGMENTED AND INCOMPLETE

### A. Companies Act, 2013: Statutory Silences and Disclosure Gaps

The Companies Act, 2013 forms the cornerstone of corporate financial regulation in India, prescribing standards for financial reporting, disclosure, and governance. While the Act

[20] State Bank of India v. Mula Sahakari Sakhar Karkhana Ltd., (2006) 6 SCC 293.

mandates the disclosure of formal guarantees, loans, and advances (Sections 129, 133, 186, and 134), it remains largely silent on non-binding instruments such as comfort letters, moral undertakings, and informal support agreements. As a result, these instruments are typically omitted from formal financial statements, enabling companies to obscure significant contingent liabilities from shareholders, auditors, and regulators. This statutory silence creates a loophole that is routinely exploited, undermining the transparency and reliability of corporate financial disclosures. Where a company has a subsidiary or associate company, they must file a consolidated balance sheet according to the prescribed manner to the shareholders in the annual general meeting.[21] If any person such as the managing Director, whole Time Director or any person fails to perform their duties, they shall be punished by imprisonment for the term not less than 1 year or a fine not less than 50000 but not more than 500000, or both.[22] However, in real practice, companies often sidestep disclosure obligations for informal financial instruments, such as letters of comfort or non-binding undertakings by classifying them as non-enforceable and, therefore, non-material.

Section 186 of the Companies Act, 2013 deals with inter-corporate loans, investments, guarantees, and securities.[23] The section states that no company shall give loans and guarantees in connection with loans to any person or body corporate and if they purchase the securities of other companies shall not exceed the limits mentioned. If they want to go beyond then the special resolutions must be passed by the Shareholders.[24]. Yet, this provision too sticks to the legal definition of a "guarantee" according to the Indian Contract Act, 1972. Comfort letters and undertakings that do not meet the threshold of enforceability under the Indian Contract Act are excluded from the compliance net, even when they are economically equivalent to guarantees.

Further, Ind-AS 110, which governs the consolidation of financial statements, its objective is to ensure that financial statement of the subsidiary is accurately presented.[25] But there are many shortcomings or loopholes to exploit. Ind-AS 110 mainly focuses on the control over the entity and consolidation only when an entity exercises "control" over another legally and de facto.[26]

[21] The Companies Act, 2013, §129(3).
[22] The Companies Act, 2013, §129(7).
[23] The Companies Act, 2013, §186.
[24] The Companies Act, 2013, §186(2).
[25] MINISTRY OF CORPORATE AFFAIRS, Indian Accounting Standard (Ind AS) 110: Consolidated Financial Statements, available at https://www.mca.gov.in/mca/html/mcav2_en/home/home/Stand.html (Last visited on June 20, 2025).
[26] Id.

In India, this has led to the proliferation of joint ventures (JVs) and unconsolidated SPVs. The SPV are created for the specific purpose or operations where the company asset is separate from the asset of the SPV which leads to no risk to the originating activity.[27] Therefore, the debt and assets of the SPV do not appear on the balance sheet of the company which led to avoid statutory scrutiny. These SPVs accumulate liabilities backed by implicit support from promoters or group companies, but remain off the consolidated balance sheet, leaving stakeholders including investors and regulators blind to the real fiscal liabilities.

### B. SEBI (LODR) Regulations: Disclosure without Transparency

The SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, require listed companies to disclose material events and information to investors. However, the focus remains on legally enforceable obligations, allowing companies to avoid disclosure of comfort letters, moral undertakings, and other informal support mechanisms unless they are deemed "material" by management. This selective approach to disclosure undermines investor protection and impairs the ability of stakeholders to accurately assess the risk profile of listed entities. The regulatory framework, therefore, fails to capture the full spectrum of fiscal risk posed by off-balance-sheet instruments.

The Zee Essel vs Yes Bank case highlights this gap. A ₹200 crore comfort letter supported by fixed deposits was not disclosed to the board or stock exchanges and only surfaced during legal proceedings and regulatory investigations. Even after SEBI's circulars tightening rules on related party transactions (RPTs) and loan disbursal from subsidiaries, enforcement remains weak. Credit rating agencies have also long depended on such undisclosed assurances when issuing investment-grade ratings, exposing systemic risks built on informal, hidden support.

Post-2020, SEBI and the RBI have moved to restrict the use of promoter guarantees and comfort letters as credit enhancement tools. In 2021, SEBI directed that any financial support extended to group companies must be disclosed in compliance with the RPT framework[28], and

[27] VINOD KOTHARI CONSULTANTS, Special Purpose Vehicle, available at https://vinodkothari.com/spv/#:~:text=More%20on%20SPEs%20and%20QSPEs&text=For%20detailed%20compendium%20on%20what,of%20recent%20additions%20over%20time.&text=We%20have%20carried%20brief%20excerpts,on%20our%20news%20page%20here (last visited June 22 2025).

[28] RESERVE BANK OF INDIA, Master Direction: Liquidity Risk Management Framework, ¶ 4.3.1 (Direction No. DNBR.PD.134/03.10.001/2023-24), April 1, 2024,available at https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=12568 (last visited June 22 2025).

RBI imposed restrictions on NBFCs using credit enhancements from non-banking promoters.[29] Yet, such reforms stop short of addressing the foundational problem: the legal non-recognition of quasi-guarantees, which remain economically material but formally invisible.

### C. Indian Contract Act, 1872: The Doctrinal Straitjacket

The legal enforceability of the comfort letter depends on the wording of the letter issued by the company or government. The wordings play a major role to become a comfort letter to a binding guarantee under section 126 of the Indian Contract Act, 1872. The section defines a contract of guarantee as *"*a contract to perform the promise, or discharge the liability, of a third person in case of his default."[30] For such a contract to be enforceable, three essential elements must be present: (i) a clear intention to guarantee, (ii) an identifiable principal debt, and (iii) lawful consideration for the surety's promise.[31] However, comfort letters are commonly issued by parent companies or government departments which often fall short of these criteria. They are typically written in vague, promissory, or non-binding language, thereby evading legal classification as guarantees while nevertheless creating economic reliance.

Indian courts have increasingly been called upon to adjudicate disputes involving such quasi-guarantees. In IL&FS Infrastructure Debt Fund vs. *McLeod Russel India Ltd.,* the NCLT examined whether the LOC or shortfall undertaking can be considered as a guarantee under the Indian Contract Act and the court held that it all depends on the intention of the party in issuing the instrument and held the corporate debtor liable for not performing his duty.[32]

In the case of *Yes Bank Ltd. v. Zee Entertainment Enterprises Ltd.,* the Bombay High Court emphasized that a letter of comfort amounts to a contract of guarantee only if the conditions laid down in Section 126 are met, particularly a definitive promise to repay in case of default, rather than a mere expression of support or intent.[33] These cases illustrate the blurred boundary between moral assurances and enforceable obligations, prompting a growing body of litigation wherein creditors seek to treat comfort letters as de facto guarantees.

[29] Reserve Bank of India, Press Release No. 2023-2024/1126 (Issued on October 17,2023).
[30] Supra note 17.
[31] The Indian Contract Act, 1872, §127.
[32] IL&FS Infrastructure Debt Fund vs. *McLeod Russel India Ltd, (2023) SCC OnLine NCLT 11005.*
[33] Supra note 6.

Yet, Indian contract law continues to privilege form over substance. The judiciary's insistence on traditional formalities such as clear consideration and explicit assumption of liability renders many comfort instruments non-enforceable, even when they perform an economically equivalent function to formal guarantees. This doctrinal conservatism fosters opacity in infrastructure finance by permitting actors to shift credit risk without legal accountability. As such, the legal framework not only fails to capture the systemic risk posed by these instruments but also enables strategic ambiguity in their deployment.

**D. Fiscal Responsibility Laws and Constitutional Gaps**

The Fiscal Responsibility and Budget Management (FRBM) Act, 2003 at the Union level and its state counterparts aim to ensure fiscal discipline by capping budget deficits and limiting guarantees.[34] Yet these laws only apply to explicit liabilities, and exclude off-budget borrowings and contingent liabilities unless expressly disclosed.

Article 293(3) of the Constitution restricts state governments from raising loans without the Centre's consent when the loan is given by the government of India or a guarantee given by the government of India[35]

The Telangana and Kerala cases illustrate this institutional lacuna. Telangana's ₹1.18 lakh crore in off-budget borrowings were routed through entities like the Telangana State Finance Corporation, bypassing both legislative scrutiny and FRBM ceilings[36]. In Kerala, the Kerala Infrastructure Investment Fund Board (KIIFB) issued offshore masala bonds with the backing of a state government support undertaking listed on the London stock exchange. KIIFB borrowed ₹5036 crore for various infrastructure projects which are not disclosed in the financial accounts of the state.[37] The KIIFB has no revenue of its own and the interest or liabilities are paid from the revenue of the state government, even though the bonds were technically issued by a separate entity.

Despite growing reliance on such instruments, there is no judicial or statutory mechanism to regulate "moral obligation borrowing" or to bring quasi-fiscal activities of state-sponsored

[34]The Fiscal Responsibility and Budget Management Act, 2003.
[35] Supra note 2.
[36] Supra note 4.
[37] GOVERNMENT OF KERALA, State Finances Audit Report of the Comptroller and Auditor General of India for the Year Ended 31 March 2020, Report No. 5 of 2021, 77.

bodies under the purview of Article 293.

### E. IBC and the Shadow of Personal Guarantees

The Insolvency and Bankruptcy Code (IBC), 2016 has reconfigured India's credit-risk profile by incorporating personal guarantees (PGs) a standard security in project finance into the machinery of the Code. Since a PG meets the tripartite "surety" test of section 126 of the Indian Contract Act, lenders can now trigger it under Part III (ss 95-100), subjecting promoters to NCLT scrutiny the very moment a corporate debtor is admitted to CIRP. Conversely, comfort letters that are considered only "moral-obligation" commitments by courts are not enforceable under the Code and may not support an insolvency petition.

The Anil Ambani insolvency case is a good example of this. When Reliance Communications defaulted, the State Bank of India proceeded under a personal guarantee provided by Ambani and initiated insolvency proceedings under Section 95 of the IBC.[38] Despite litigation on issues of constitutional validity and procedural fairness, the case illustrated how individual promoters take on institutional risk frequently with no disclosure to the shareholders or regulators.

This trend is cause for concern in the infrastructure space, where personal guarantees are being employed as backstops in PPPs or concession debt-laden concessions. They mask systemic risk and place a burden on individuals even as group companies sidestep formal liability once again validating the invisible balance sheet rationale.

## IV. ANATOMY OF THE INVISIBLE BALANCE SHEET: CASE STUDY EVIDENCE

This section analyzes key case studies where India’s invisible balance sheet architecture has materially shaped financial outcomes through default, regulatory arbitrage, or fiscal risk realization. Each example illustrates a different mode of liability creation: through special-purpose structuring, regulatory circumvention, constitutional evasion, quasi-sovereign signaling, and judicially facilitated bailouts. Together, they reveal the legal and economic mechanics of India’s shadow fiscal layer.

[38] Mayur Shetty, SBI Moves NCLT to Recover Anil Ambani’s Personal Guarantee, TIMES OF INDIA, Jun. 12, 2020, available at https://timesofindia.indiatimes.com/business/india-business/sbi-moves-nclt-to-recover-anils-personal-guarantee/articleshow/76329633.cms (last visited June 23 2025).

### A. IL&FS Group Collapse: Systemic Risk through Structured Disaggregation

Invisible Leasing &Financial Stability (IL&FS) is one of the most complex invisible balance sheets in India's corporate history. The IL &FS is a financial institution which involve in infrastructure project by lending or financing in the infra. Projects. The majority shareholder are Life Insurance Corporation of India and ORIX Corporation of Japan and others.[39] It functioned through a vertically and horizontally layered more than 300 subsidiaries, including SPVs, trusts and Joint Ventures.[40] This structure allowed liabilities to be distributed across multiple projects inside SPV backed by a comfort letter or shortfall undertaking which led to avoiding mandatory consolidation under Ind-AS 110 and masking the true debt leverage of the parent. The total debt reached to ₹91,000 crore.[41]

In June 2018, IL&FS Transportation Networks failed to repay the Inter Corporate Deposit due to SIDBI of ₹450 crore. This led to rating downgrades and defaults on commercial paper by the rating agencies and exposing asset liability mismatch. By September the group was in outright default on multiple bank loans, prompting the Union Government to petition the NCLT under sections 241-242 of the Companies Act. On 1 October 2018 the tribunal suspended the board and installed an emergency team led by Uday Kotak, while the NCLAT soon imposed a moratorium to forestall piecemeal creditor action.[42]

Because of this auditor did not consolidate them in the financial statement due to a lack of control, yet the parent company had issued back-to-back comfort letters assuring lenders of timely debt service as they are not legally binding but were often accepted as sufficient assurance. When the underlying toll-road and power projects stalled, those letters crystallized into real claims, inflating the group's liabilities overnight and transmitting contagion to mutual-fund CP portfolios and bank balance sheets.

[39] Shashank Pandey, Explainer: The IL&FS Insolvency Case, BAR & BENCH, July 21, 2019, available at https://www.barandbench.com/columns/litigation-columns/ilfs-insolvency-the-journey-so-far (last visited June 23 2025).
[40] INFRASTRUCTURE LEASING & FINANCIAL SERVICE LIMITED, Annual Report 2018, 18
[41] Supra note 42.
[42] PRESS INFORMATION BUREAU, Government in Public Interest Moved NCLT to Supersede Management of IL&FS on Grounds of Mismanagement, Oct. 1, 2018, available at https://www.pib.gov.in/newsite/PrintRelease.aspx?relid=183864 (last visited June 23 2025).

This case study shows how comfort letters can migrate liabilities off the face of the balance sheet and how Ind AS loopholes around "control" obscure economic reality and lead to economic crisis.

**B. Zee Essel Yes Bank: Shadow Guarantees and Auditor Complicity**

In 2016, Yes Bank Ltd. extended a USD 50 million credit facility to Living Entertainment Ltd. (LELM), a Mauritius subsidiary within the Essel-Zee conglomerate, to finance the acquisition of Veria International Ltd. shares and refinance prior inter-corporate deposits.[43] The transaction architecture comprised (i) a facility agreement secured by a pledge of Veria shares, (ii) a put-option agreement obligating ATL Media Ltd. (ATL) another group entity to repurchase those shares on demand, and (iii) a two-page "Letter of Comfort" issued by the Zee Entertainment Enterprises Ltd. (ZEEL) to maintain at least a 51 percent shareholding in ATL and to "support ATL by infusing equity or debt" sufficient to honor the put option, it expressly disavowed creating any binding guarantee or financial liability in favour of Yes Bank. In the year 2019, ZEE promoters diluted their ZEEL stake below 30%. The Yes Bank declared an event of default, enforced the security package, and exercised the put option, which ATL ignored. The bank's subsequent demand letters culminated on 31 March 2020 in a recharacterization of the comfort letter as an "absolute, irrevocable, and unconditional guarantee," prompting Zee's refusal. The Yes Bank filed a suit LD-VC-120/2020 in the Bombay High Court seeking a money decree and asset-freezing injunction.

The High court denied interim relief, stating that the comfort letter lacked the essential ingredient to become a guarantee under section 126 of the Indian Contract Act, 1972. The court said that ZEE issued LOC only to infuse funds in ATL not to repay debt.[44] Therefore, court's LOC would amount to a guarantee if he fulfills the essential ingredient under section 126 of the Indian Contract Act, 1872, and thus the instrument issued by ZEE could not be construed as a contract of guarantee.

[43] MAJMUDAR & PARTNERS, Yes Bank vs Zee: A Curious Case of Comfort & Guarantee, Sep. 2, 2020, available at https://www.majmudarindia.com/yes-bank-v-zee-a-curious-case-of-comfort-and-guarantee/ (last visited June 23 2025)
[44] Id.

This case demonstrates the second layer of the invisible balance sheet: non-enforceable but economically material undertakings created unilaterally, without corporate authorization or legal backing, but which result in financial exposure and reputational harm when uncovered.

### C. KIIFB and Kerala's Masala Bonds: Institutionalized Fiscal Ambiguity

The Kerala Infrastructure Investment Fund Board (KIIFB), established by Act 4 of 1999 and relaunched in 2016, was designed to finance critical infrastructure like roads, hospitals, and schools without burdening the State's regular budget or breaching the 3% Fiscal Responsibility and Budget Management (FRBM) Act deficit cap.[45] KIIFB generated revenue through market borrowings, a fixed share of Motor Vehicle Tax and petroleum cess, and loans from banks and Alternative Investment Funds (AIFs).[46] By May 2024, it had approved 1,103 projects worth ₹86,170 crore. [47]A significant early achievement was issuing India's first sub-sovereign masala bond (₹2,150 crore) on the London Stock Exchange in May 2019 at 9.72%, which was successfully repaid in 2024, bolstering its market reputation.[48]

Kerala kept KIIFB's substantial debt off its budget by classifying it as a contingent liability. This accounting relied on the rationale that repayment was secured by earmarked Motor Vehicle Tax flows, with the State Treasury only liable in case of default. This "below the line" treatment allowed Kerala to technically comply with the 3% Gross State Domestic Product (GSDP) deficit ceiling under the FRBM Act and borrowing limits under Article 293(3) of the Constitution. Crucially, this exclusion artificially reduced the State's headline debt-to-GSDP ratio, trimming it from roughly 38% to around 35% in FY 2023. However, this approach was controversial. The Comptroller & Auditor General (CAG) declared the borrowings constituted "public debt" requiring State Legislative Assembly approval and Union Government consent under Article 293(1). The Assembly rejected the CAG's finding and blocked a detailed audit.

A pivotal shift occurred in 2022-23 when the Union Finance Ministry ruled that all off-budget borrowing (OBB) raised by state entities, including KIIFB, would be counted against the State's

[45]KERALA INFRASTRUCTURE INVESTMENT FUND BOARD, KIIFB: Kerala Infrastructure Investment Fund Board, available at https://www.kiifb.org/ (last visited June 23 2025).
[46] Supra note 40.
[47] Aneesa P.A., How the Kerala Infrastructure Investment Fund Board Went from Being State's Strength to a 'Liability', THE PRINT, Feb. 19, 2025, available at https://theprint.in/india/how-the-kerala-infrastructure-investment-fund-board-went-from-being-states-strength-to-a-liability/2500447/ (last visited June 23 2025).
[48] Rajesh Abraham, KIIFB to Repay Rs 2,150-Crore Masala Bonds on Schedule, THE NEW INDIAN EXPRESS, Jan. 30, 2024, available at https://www.newindianexpress.com/states/kerala/2024/Jan/30/kiifb-to-repay-rs-2150-crore-masala-bonds-on-schedule (last visited June 23 2025).

own Net Borrowing Ceiling. This reclassification slashed Kerala's annual market-borrowing headroom by approximately ₹3,000–4,000 crore through FY 2026. Concurrently, KIIFB faced a severe liquidity strain as its own cash flows proved insufficient. In FY 2024, it earned ₹5,629 crore but spent ₹6,600 crore, resulting in a deficit covered almost entirely by a state grant. This shortfall was exacerbated because roughly 80% of KIIFB projects (primarily schools and hospitals) generated no user charges, shifting the repayment burden directly onto the State Treasury.[49] The combined effect of the Union's reclassification and KIIFB's structural revenue deficit forced the State government to divert 8-12% of its annual Own-Tax Revenue to service KIIFB dues, risking delays in salaries and pensions. This fiscal stress contributed to CRISIL revising Kerala's credit outlook to 'A+/Negative' in May 2024, citing total debt plus guarantees edging up to approximately 40.5% of GSDP.[50] Despite measures like hiking land tax and vehicle levies in the 2025-26 budget to contain the deficit, the State still warned of potentially breaching FRBM limits in 2024-25, highlighting KIIFB's transformation from a flagship financier into a significant fiscal albatross.

The case demonstrates that off-balance-sheet devices may solve the optics of fiscal prudence only to re-impose the burden on budgets and citizens later, underscoring the need for consolidation rules that recognize economic substance over legal form.

**D. Telangana's PSU Debt: Off-Budget Fiscal Expansion without Consent**

Telangana represents an example of off-budget borrowing executed entirely outside the framework of legislative or constitutional accountability. According to the 2023 CAG audit, the state's off-budget liabilities stood at ₹1.18 lakh crore, incurred through borrowing by state-level PSUs and corporations.[51] These entities, including the Telangana State Finance Corporation and Mission Bhagiratha Corporation, borrowed from public sector banks and institutional lenders for state-approved projects[52], without requiring legislative approval or consent under Article 293(3).

[49] Supra note 40.
[50] CRISIL RATINGS, Kerala Infrastructure Investment Fund Board – Rating Rationale, Sep. 10, 2024, available at https://www.crisil.com/mnt/winshare/Ratings/RatingList/RatingDocs/KeralaInfrastructureInvestmentFundBoard_September%2010_%202024_RR_350132.html (last visited June 23 2025).
[51] GOVERNMENT OF TELANGANA, State Finances Audit Report of the Comptroller and Auditor General of India for the Year Ended 31 March 2021, Report No. 1 of 2022, 65.
[52] Id.

These borrowings were routinely supported by departmental comfort letters and government endorsement documents, which were not registered as guarantees or included in fiscal deficit calculations. This structure enabled the state to artificially compress its reported debt to GSDP ratio, thereby meeting FRBM targets while continuing large-scale borrowing through proxy entities.

The Telangana case reveals the third dimension of the invisible balance sheet: the circumvention of constitutional fiscal controls via para-statal actors. It shows how state governments externalize debt, manufacture moral obligation instruments, and evade Union scrutiny, without any recourse for the Legislature or public audit systems to restrain them ex ante.

## V. COMPARATIVE ANALYSIS: GLOBAL REGULATORY RESPONSES TO CONTINGENT LIABILITIES

The challenges posed by invisible balance sheets are not unique to India. Across jurisdictions, governments and regulatory bodies have grappled with the fiscal risks embedded in off balancesheet instruments particularly those arising from public-private partnerships, moral undertakings, and quasi-fiscal guarantees. What distinguishes high-capacity regulatory regimes is not the absence of contingent liabilities but their transparent classification, disclosure, and institutional accountability. This section analyses four international models United Kingdom, China and United States, to extract regulatory and doctrinal lessons for India's fragmented framework.

### United Kingdom

In the United Kingdom, both public and corporate sectors exhibit a robust regulatory and disclosure framework regarding off balance sheet liabilities and comfort letters. The government consolidates public sector liabilities through the publication of Whole-of-Government Accounts (WGA), prepared in accordance with International Financial Reporting Standards (IFRS). [53]This ensures that liabilities such as Private Finance Initiative (PFI) or Public-Private Partnership (PPP) commitments, guarantees, and long-term leases are either

[53] HM TREASURY, The Balance Sheet Review Report: Improving Public Sector Balance Sheet Management, Nov. 25, 2020, available at https://www.gov.uk/government/publications/the-balance-sheet-review-report-improving-public-sector-balance-sheet-management (Last visited on 23 June 2025).

recorded on the balance sheet or disclosed in the accompanying notes. Since 2021, the HM Treasury has operated a Contingent Liability Central Capability, which oversees a portfolio of contingent liabilities estimated at approximately £250 billion by 2025.[54]

From a corporate law perspective, comfort letters in the UK are typically not legally enforceable. English courts, as established in the landmark case Kleinwort Benson Ltd v Malaysian Mining Corp., distinguish between binding guarantees and non-binding statements of intent. Comfort letters usually represent moral commitments and lack enforceability unless they unequivocally demonstrate an intent to be legally bound. Consequently, such letters do not meet the definition of a financial guarantee and are generally excluded from formal financial statements. Nevertheless, under IFRS, companies may be required to disclose support arrangements if, in substance, they imply a potential financial obligation.[55]

In the public sector, although comfort letters are used, significant transparency mechanisms limit their potential misuse. For example, any material letter of comfort issued by a department must be reported to Parliament and may require Treasury approval.[56] A notable instance illustrating the UK's approach is the London Underground PPP (Metronet) case, where a government issued comfort letter supported Transport for London's obligations without constituting a legal guarantee.[57] Though the letter avoided liability recognition at inception, the government's eventual financial intervention demonstrated the economic substance of the obligation, prompting critical scrutiny by the Public Accounts Committee.

Overall, the UK approach to comfort letters and SPV liabilities reflects a balance between legal non-enforceability and institutional transparency, in contrast to jurisdictions like India where similar instruments often remain undisclosed and unregulated until a crisis materializes.

[54] UK GOVERNMENT INVESTMENTS, Annual Report on the UK Government's Contingent Liabilities 2025, March 26, 2025), available at https://www.ukgi.org.uk/2025/03/26/annual-report-on-the-uk-governments-contingent-liabilities-2025/ (Last visited on 23 June 2025).

[55] Institute of Chartered Accountant in England and Wales, FRS 101: Reduced Disclosure Framework, available at https://www.icaew.com/technical/corporate-reporting/uk-gaap/frs-101-reduced-disclosure-framework (Last visited on 23 June 2025).

[56] HM Treasury, Managing Public Money, June, 2025, available at: https://assets.publishing.service.gov.uk/media/684ae4c6f7c9feb9b0413804/Managing_Public_Money.pdf (Last visited on 23 June 2025).

[57] HM Treasury, Supplementary Accounting Guidance: Financial Reporting Manual, July 10, 2010, HC103, available at https://assets.publishing.service.gov.uk/media/5a7cbb3ce5274a2f304efbd0/0103.pdf (Last visited on 23 June 2025).

**United States**

In the United States, both the corporate and public finance sectors have evolved comprehensive mechanisms to manage and disclose off-balance sheet liabilities and comfort letters. Following the corporate scandals of the early 2000s, particularly the collapse of Enron, significant regulatory reforms were introduced. The Sarbanes Oxley Act mandated that registrants provide detailed disclosures in their Management Discussion and Analysis (MD&A) sections about the nature, risk, and extent of off-balance sheet arrangements.[58] Accounting standards such as FIN 46 (now codified as ASC 810) require consolidation of variable interest entities (VIEs) when the primary beneficiary bears the majority of risk, thereby ensuring greater transparency of SPV-related liabilities.[59] Similarly, ASC 842 mandates capitalization of operating leases, reducing opportunities to obscure financial obligations.[60]

In terms of legal enforceability, comfort letters in the U.S. corporate context generally do not constitute binding obligations unless they meet the requirements of a legal guarantee or induce significant reliance by creditors. Courts may enforce such letters under doctrines like promissory estoppel or fraudulent misrepresentation, but only in cases where there is clear intent and creditor reliance.[61] Nonetheless, most comfort letters are carefully drafted to avoid creating enforceable duties.

At the state level, moral obligation bonds have historically served as a mechanism to bypass constitutional debt limitations. These instruments, which rely on a non-binding assurance from the state legislature to appropriate funds in case of default, mirror the function of comfort letters in public finance. For instance, New York State extensively employed moral obligation bonds during the 1960s and 1970s to fund infrastructure without voter approval. The resultant buildup of contingent liabilities contributed to fiscal distress, culminating in statutory reforms that banned such bonds in 1976.

Today, public sector accounting standards, particularly GASB 94, mandate that state and local governments recognize most PPP related obligations on the balance sheet and disclose

[58] The Sarbanes-Oxley Act, 2002, § 401(a) (U.S.A.).
[59] FINANCIAL ACCOUNTING STANDARDS BOARDS, Accounting Standards Codification, Topic 810: Consolidation, § 810-10-25-38 (2009).
[60] FINANCIAL ACCOUNTING STANDARDS BOARDS ('FASB'), Accounting Standards Update No. 2016-02: Leases (Topic 842) (2016).
[61] Chemtex, LLC v. St. Anthony Enterprises, Inc., [2007] 490 F. Supp. 2d 536 (United States District Court for the Southern District of New York).

contingent liabilities.[62] Additionally, rating agencies incorporate the fiscal implications of moral obligations into their credit assessments, creating an external discipline mechanism[63]. Compared to India, the United States has a more mature legal and regulatory framework for both recognizing and disclosing quasi-fiscal obligations, although similar issues of implicit liabilities persist.

**China**

China presents a compelling comparative example due to its widespread use of off-balance-sheet entities, particularly Local Government Financing Vehicles (LGFVs), to fund infrastructure while circumventing statutory borrowing restrictions. Historically, Chinese local governments were prohibited from directly issuing debt, leading to the proliferation of LGFVs that borrowed on behalf of local authorities without formal guarantees.[64] Although legislation enacted since 2014 bans explicit guarantees to LGFVs, it is widely assumed in the market that local governments will intervene to prevent defaults, thereby constituting an implicit, non-enforceable guarantee.[65]

Despite regulatory crackdowns and efforts to consolidate some LGFV liabilities onto local government balance sheets through debt swaps, hidden debts continue to pose significant fiscal risks. Estimates suggest that trillions of yuan remain off the official books, mirroring India's "invisible balance sheet" problem. The persistence of moral hazard in China underscores the limitations of formal legal restrictions in the absence of rigorous enforcement and transparent disclosure. The Chinese case illustrates the systemic consequences of relying on informal assurances in lieu of institutional accountability and legal clarity.

Across all jurisdictions, the overarching trend is toward greater recognition, disclosure, and accountability for quasi-fiscal obligations. While comfort letters remain largely unenforceable legal instruments, their economic substance often necessitates disclosure. Countries such as the

[62] GOVERNMENTAL ACCOUNTING STANDARDS BOARD, Statement No. 94: Public-Private and Public-Public Partnerships,2020.
[63] MOODY'S INVESTORS SERVICE, Higher Education Methodology, Aug. 4, 2021, available at https://ratings.moodys.com/api/rmc-documents/72158 (last visited June 23 2025).
[64] Patrick Hendy, Elena Ryan & Grace Taylor, The ABCs of LGFVs: China's Local Government Financing Vehicles, RESERVE BANK OF AUSTRALIA BULLETIN, Oct. 17, 2024, available at https://www.rba.gov.au/publications/bulletin/2024/oct/the-abcs-of-lgfvs-chinas-local-government-financing-vehicles.html (last visited June 23 2025).
[65] Donald C. Clarke, The Law of China's Local Government Debt Crisis: Local Government Financing Vehicles and Their Bonds, GW LAW SCHOLARLY COMMONS, Jun. 5, 2016, available at https://scholarship.law.gwu.edu/faculty_publications/1218/ (last visited June 23 2025).

UK, US, and EU Member States have developed legal and institutional mechanisms to curb the misuse of such instruments and to bring hidden liabilities into the purview of fiscal oversight. India and China, by contrast, still face systemic challenges in managing and disclosing off-balance sheet commitments. These international experiences offer valuable models for reform, emphasizing the importance of transparency, enforceability, and fiscal prudence in infrastructure finance.

## VI. LEGAL-POLICY ANALYSIS: SYSTEMIC RISKS AND DOCTRINAL GAPS

Despite the sophistication of India's financial architecture, the legal and regulatory framework governing fiscal obligations remains structurally incapable of capturing contingent liabilities that do not meet rigid doctrinal thresholds. There are four key fault lines under-classification in law, the disjuncture between accounting and legal recognition, doctrinal arbitrage in quasi-guarantees, and the constitutional vacuum surrounding off-budget borrowing which collectively enable the proliferation of India's invisible balance sheet.

### A. Legal Under-Classification of Fiscal Exposure

India's statutory instruments for financial disclosure such as the Companies Act, SEBI's LODR Regulations, and the FRBM Act predominantly rely on legal enforceability as the threshold for classifying liabilities. As a result, comfort letters, support undertakings, and non-binding resolutions are systematically excluded from the definition of "contingent liabilities" unless they are deemed legally binding. Under Section 129 and Schedule III of the Companies Act, 2013, contingent liabilities must be disclosed only if they are probable and measurable. Similarly, SEBI's LODR Regulation 30 requires disclosure of only "material" events, leaving listed entities to interpret materiality through narrow legal definitions.[66] In practice, this means companies can avoid disclosing quasi-obligations that lack the form of a binding contract. This enables selective disclosure companies often avoid reporting obligations arising from letters of support or promoter comfort, even when these instruments have clear economic implications. SEBI only in year 2021 moved to tighten this by requiring that even promoter letters of comfort which impose obligations on a listed company now be disclosed highlighting how such

[66] The SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, Sch. III.

liabilities were previously kept off the books.[67]

In public finance, the Fiscal Responsibility and Budget Management (FRBM) framework mandates the disclosure of explicit guarantees by governments but excludes informal liabilities created through off-budget special purpose vehicles or departmental endorsements, unless the state voluntarily discloses them. This means that letters of comfort or "support" issued by a government (which stop short of a legally enforceable guarantee) typically do not show up in official liability statements. A striking example is the Union government's use of off-budget financing for subsidies: the Comptroller and Auditor General (CAG) reported that by 2018 the Food Corporation of India had borrowed about ₹1.21 lakh crore from the National Small Savings Fund to cover food subsidy arrears a liability not reflected in the Centre's budget or debt figures.[68] The CAG warned that such off-budget expenditures allow the Centre to under-report its fiscal deficit and debt). This under-classification is not merely a technical gap it structurally erases risk from the formal fiscal narrative, misleading investors, citizens, and oversight bodies about the true extent of obligations.

**B. Accounting Law Disjuncture in Recognizing Contingent Liabilities**

A second, more subtle layer of systemic risk arises from the mismatch between accounting standards and legal thresholds for quasi-fiscal commitments. Indian accounting standards particularly Ind AS 37 (Provisions, Contingent Liabilities and Contingent Assets) call for recognizing liabilities that are not yet enforceable but have a probable outflow of resources in notes.[69] Yet, in practice, enforcement of this standard is weak, especially in the absence of binding contractual terms. Legal compliance often defers to whether an obligation is contractually enforceable, while accounting might consider economic substance – this gap widens when neither side takes responsibility for grey-area commitments.

Moreover, auditors routinely rely on management declarations for identifying contingent

[67] PTI, Sebi Asks Cos to Disclose Loans and Guarantees Given by Them, ECONOMIC TIMES, June 1, 2021, available at https://economictimes.indiatimes.com/markets/stocks/news/listed-cos-to-reveal-loans-given-to-promoters-in-compliance-report-on-corporate-governance/articleshow/83120370.cms (last visited June 23 2025).
[68] MINISTRY OF FINANCE, Report of the Comptroller and Auditor General of India on Compliance of the Fiscal Responsibility and Budget Management Act, 2003 for the Years 2017-18 and 2018-19, July 5, 2021, Report No. 6 of 2021, 25.
[69] MINISTRY OF CORPORATE AFFAIRS, Indian Accounting Standard (Ind AS) 37: Consolidated Financial Statements, available at https://www.mca.gov.in/mca/html/mcav2_en/home/home/Stand.html (Last visited on June 23, 2025).

liabilities. In cases like the Zee Entertainment–Yes Bank[70], the omission of a ₹200 crore fixed deposit-backed comfort letter from Zee's financial statements was not initially challenged by the auditors. The arrangement in that case involved the promoter of Zee Entertainment providing a letter of comfort to Yes Bank, effectively pledging ₹200 crore of the company's fixed deposits as a guarantee for loans given to the promoter's private entities. Yes Bank went on to prematurely appropriate the ₹200 crore deposit in July 2019 to settle the dues of those group entities when they defaulted. Despite this clear economic exposure, the auditor did not report it as a contingent liability or qualify the accounts. The National Financial Reporting Authority (NFRA) later observed that the auditor had failed to apply professional skepticism and did not adequately assess the economic impact of the comfort instrument.[71] NFRA's investigation concluded that the auditors were "grossly negligent*"* and did not challenge management's assertions regarding the arrangement. This creates a dangerous gap: the legal system defers to accounting for disclosure thresholds, while accounting practitioners defer to legal enforceability resulting in a mutual abdication of responsibility. Economically significant liabilities can thus remain neither recorded nor disclosed until a default or loss materializes (as it eventually did in the Zee–Yes Bank case when the funds were seized).

### C. Doctrinal Arbitrage between Legal and Moral Instruments

The third systemic weakness is the deliberate use of doctrinal arbitrage by corporate promoters, state authorities, and even lenders to blur the boundary between enforceable guarantees and merely "moral" undertakings. In a legal environment where Section 126 of the Indian Contract Act defines guarantees narrowly, actors have strong incentives to issue comfort letters that signal assurance but evade legal liability. This gap has increasingly become the subject of litigation. For instance, in the IL&FS Infrastructure Debt Fund vs. *McLeod Russel India Ltd.* dispute, courts scrutinized whether a promoter's letter of comfort could be treated as a guarantee. The promoters contended that a letter of comfort (along with a shortfall undertaking) "cannot be treated to be any corporate guarantee," since it lacked the explicit enforceable language of a contract of guarantee. The creditor, on the other hand, argued that the comfort letter and undertakings should be treated as guarantees given their intent and economic effect. The NCLT examined whether the LOC or shortfall undertaking can be considered as a guarantee under the Indian Contract Act and the court held that it all depends on the intention

[70] Supra note 6.
[71] National Financial Reporting Authority, Order No. 27/2024 (December 23, 2024).

of the party in issuing the instrument and held corporate debtor liable for not performing his duty. The very fact that a major lender attempted to initiate insolvency proceedings based on a comfort letter (and associated undertakings) underscores how blurred the line between formal and informal obligations has become.

Outside the courtroom, credit rating agencies have also played a complicating role in this arbitrage. For years, rating agencies tacitly accepted letters of support or implied group backing as justification for elevated credit ratings of corporate group entities, even in the absence of formal guarantees. This led to a distortion in credit-risk pricing, enabling over leveraged entities to access cheaper capital than their standalone financials would warrant. A prime example is the IL&FS fiasco of 2018. Infrastructure Leasing & Financial Services (IL&FS) and its web of subsidiaries enjoyed high credit ratings (even AAA in some cases) largely due to the implied support of the parent company and government stakeholders, rather than the subsidiaries' own merit. In fact, regulatory inquiries later found that rating agencies placed "excessive reliance" on IL&FS management's assertions and were "getting comfort from the parentage" of IL&FS, instead of performing independent assessments of the firms' health. This complacency persisted even as warning signs grew one IL&FS subsidiary had defaulted in June 2018, yet group entities still held top ratings until the crisis broke. When IL&FS suddenly defaulted on over ₹99,000 crore of obligations in September 2018, those non-binding assurances proved illusory, and the rating agencies had to abruptly downgrade dozens of bonds from investment grade to junk status. A whistleblower later revealed that "nobody is aware of the extent of contingent liabilities of IL&FS through comfort letters and [debt-service reserve account] support issued which will soon convert to actual liability" highlighting how extensive these hidden guarantees were.[72] Thus, the law's failure to codify quasi guarantees instruments that are not legally enforceable but are relied upon in practice creates a regulatory arbitrage. Actors can benefit from the appearance of a backing or guarantee (to appease lenders, investors, or rating agencies) without incurring the accountability of a formal guarantee. This gap incentivizes the proliferation of such off-the-record assurances, to the detriment of market transparency and stability.

[72] Sucheta Dalal, Explosive: RBI Governor, IL&FS Board, Rating Agencies and Vigilance Commission Ignored Repeated Whistleblower Letters Since 2017, MONEYLIFE, December 5, 2018, available at https://www.moneylife.in/article/explosive-rbi-governor-ilfs-board-rating-agencies-and-vigilance-commission-ignored-repeated-whistleblower-letters-since-2017/55868.html (last visited June 23 2025).

### D. Constitutional Vacuum in Regulating State-Level Off-Budget Liabilities

Perhaps the most structurally entrenched doctrinal gap lies in the Constitution's treatment of state-level borrowing, particularly under Article 293(3). This provision prohibits states from raising new loans without Union government consent if the state is indebted to the Centre.[73] However, the restriction applies only to direct government borrowings and not to debt incurred by state owned public sector undertakings (PSUs), statutory boards, or other parastatal entities. Consequently, state governments have exploited this lacuna by channeling debt through such off-budget entities, often accompanied by comfort letters or unofficial "government support" resolutions that stop short of explicit guarantees. Because these borrowings are undertaken by separate legal entities, they are not brought to the state legislature for approval, nor do they appear in the state's budget documents even though, economically, they may be backed by government revenues. In effect, this is a constitutional grey area that allows states to take on substantial liabilities outside the framework of democratic authorization or federal oversight.

In Telangana, for instance, the state accumulated approximately ₹1.2 lakh crore of debt via off-budget mechanisms (loans taken by state-owned companies and SPVs) that were not accounted for in its official debt numbers.[74] These borrowings did not trigger Article 293(3) scrutiny because legally they were not state loans yet the state government implicitly supported them, and they are ultimately serviced through the state's resources. By FY2023-24, Telangana's off-budget liabilities had grown so large that if one adds them to the state's official debt, the debt to GSDP ratio shoots up from about 26% to 34.5%, breaching the 33% debt ceiling set by its Medium-Term Fiscal Policy.[75]. Similarly, Kerala pursued an off-budget borrowing strategy through the Kerala Infrastructure Investment Fund Board (KIIFB), a statutory entity. By 2019, KIIFB had raised about ₹3,106.57 crore via bonds, including ₹2,150 crore through masala bonds sold to overseas investors marking the first instance of a state agency tapping international markets.[76] These borrowings were explicitly designed to finance state infrastructure outside the normal budget. The constitutional issue, however, is that KIIFB's debt effectively enjoys a state government guarantee and is to be serviced via state fiscal

[73] The Constitution of India, 1950, Art. 293.
[74] Srinivasa Rao Apparasu, Telangana Government Spent over ₹ 1.11 Lakh-crore Beyond Budget Last Year, Says CAG, HINDUSTAN TIMES**,** March 28, 2025, available at https://www.hindustantimes.com/india-news/telangana-government-spent-over-1-11-lakh-crore-beyond-budget-last-year-says-cag-101743103453981.html (last visited June 23 2025).
[75] Id.
[76]Supra note 50.

resources (such as dedicated cesses), yet it was never approved by the state legislature as part of government borrowing. The CAG sharply criticized this arrangement, deeming the KIIFB off-budget borrowings "not in accordance with the Constitution." The CAG report noted that Kerala, through KIIFB, bypassed the limits on government borrowings under Article 293 debt that would normally require central consent and legislative sanction and that such borrowings "do not have legislative approval." In essence, KIIFB functioned as a surrogate borrowing vehicle for the state. Since KIIFB itself has no independent revenue stream, any failure to meet its obligations would fall back on the state's exchequer, meaning these liabilities are de facto sovereign liabilities of the state. Yet, because of the constitutional gap, they remained off the state's balance sheet and away from public scrutiny at the time of borrowing.

There is no judicial precedent that squarely addresses this issue of off-budget state borrowing. Courts have so far largely treated these transactions as commercial contracts of the entities involved, declining to extend the interpretation of Article 293 to cover such moral obligation borrowings by states. In other words, as long as the debt is in the name of a PSU or board, the constitutional debt limits and consent requirements have not been enforced by the judiciary. This leaves a constitutional accountability vacuum: state-level fiscal risk is being created outside the traditional framework of democratic authorization, legal regulation, and federal control. Only after the fact when repayment crises or defaults occur due to these invisible debts surface, by which point they pose a threat to fiscal sustainability. The combination of the above fault lines means that significant liabilities can lurk in the shadows of India's public finance system, requiring urgent reforms in law, accounting practice, and constitutional doctrine to bring these risks into the light.

## VII. PROPOSED DOCTRINAL AND REGULATORY REFORMS

The persistence of India's invisible balance sheet is not merely a failure of enforcement but of legal imagination. The current regime regulates formal guarantees while leaving quasi-fiscal instruments comfort letters, support undertakings, off-budget borrowings outside the bounds of enforceability and disclosure. To prevent this a comprehensive set of reforms aim to recast India's fragmented approach into a cohesive legal-economic framework capable of addressing systemic fiscal opacity.

### A. Codified Legal Taxonomy of Contingent Liabilities

The first step toward systemic reform is the codification of contingent liabilities under Indian law not merely in accounting standards or audit guidance, but within statutory frameworks such as the Companies Act, SEBI regulations, and FRBM statutes. Current classifications distinguish between "provisions," "contingent liabilities," and "commitments," but fail to capture the economic substance of non-enforceable yet relied-upon instruments.

India must legally recognize a new category of instruments "quasi-guarantees" which include letters of comfort, support resolutions, moral obligation undertakings, and any instrument that induces third-party reliance without formal liability. These should be statutorily distinguished from enforceable guarantees (under Section 126 of the Contract Act) and discretionary policy promises. Additionally, a new concept of "contingent fiscal undertaking" should be introduced to encompass any off-budget support, annuity commitment, or loss backstop that is not recognized in financial accounts but may affect future government cash flows.

By institutionalizing this taxonomy, India can end the legal fiction that separates legal form from economic exposure a prerequisite for any serious fiscal accountability.

### B. Mandatory Disclosure and Consolidation Reforms

Legal recognition must be complemented by mandatory disclosure across corporate, regulatory, and governmental domains.

For listed companies, SEBI must amend the LODR Regulations to explicitly include comfort letters, intra-group guarantees, support undertakings, and letters of intent as material events under Regulation 30. The Related Party Transaction (RPT) framework should be extended to cover all financial risk transfers within promoter-controlled groups, regardless of enforceability.

For unlisted entities, the Companies Act should be amended to require mandatory disclosure under Schedule III of all parent-subsidiary, group level, or promoter derived contingent liabilities, even if they do not meet enforceability thresholds. Section 129A, which empowers the Central Government to prescribe additional financial disclosures, should be invoked to mandate such reporting in the Board's Report and Financial Statement Notes.

For states, the Union and State FRBM Acts must be amended to require publication of an "Extended Debt Statement", which includes not only direct debt and guarantees, but also moral undertakings, annuity commitments, off-budget SPV liabilities, and project level risk transfers. This can be modeled on existing disclosures in South Africa and New Zealand, where governments publish granular contingent liability annexures to budget documents.

**C. Creation of a Public Risk Register**

Transparency must move beyond closed financial statements toward public, searchable, institutional disclosure. India should establish a national "Contingent Liability and Fiscal Risk Register" under the Ministry of Finance, integrated with CAG audits, SEBI disclosures, and State Budget records.

This Register should consolidate:

- All sovereign and sub sovereign guarantees (central, state, and municipal),
- Comfort instruments issued by public and quasi-public entities,
- Off-budget liabilities of statecontrolled PSUs and SPVs,
- Annuity and revenue shortfall commitments in PPPs,
- Contingent project guarantees, whether enforceable or not.

It should mirror the UK's Whole-of-Government Accounts model, which aggregates and audits the complete fiscal footprint of the public sector, and New Zealand's Fiscal Risk Statements, which disclose unrecognized liabilities and legal exposures that may affect fiscal sustainability.

Such a database would enable Parliament, investors, credit agencies, and citizens to assess the total systemic fiscal exposure bridging the information gap that currently allows invisible liabilities to accumulate unchecked.

**D. Legislative Approval and Constitutional Controls**

The final and most foundational reform must address the democratic deficit in off-budget borrowing and contingent fiscal commitments. Article 293(3) of the Constitution, while

restricting state borrowing, lacks operative rules to regulate moral obligation borrowing via state run PSUs and statutory bodies.

Two measures are needed:

1. Judicial reinterpretation or legislative clarification of Article 293(3) to include borrowing undertaken on behalf of the state or with its fiscal support, regardless of the formal issuer. This would empower the Union to monitor and veto excessive off-budget fiscal activity at the state level, in line with cooperative federalism principles.

2. A statutory mandate under both central and state laws that requires legislative approval for:

- Comfort letters issued by ministries, departments, or public sector boards,
- Off-budget debt incurred by state entities or urban bodies above a defined threshold,
- Any quasi-fiscal undertaking that is not a budgetary appropriation but affects future public cash flows.

Such provisions would bring fiscal decisions under democratic scrutiny, reversing the present trend of informal executive discretion in creating long-term public liabilities.

## VIII. STEPS TAKEN BY THE GOVERNMENT TO CURB THE OFF-BALANCE SHEET LIABILITY

1. Fiscal Consolidation through On-Budgeting of Fully-Serviced Bonds (Union Budget 2025-26): The 2025-26 Union Budget represents a significant institutional shift by reclassifying all Government-fully-serviced bonds as explicit Central Government liabilities.[77] Statement 27 integrates these obligations (quantified at ₹1.38 lakh crore) directly into the primary Fiscal Responsibility and Budget Management (FRBM) Act disclosure tables. This policy change terminates the erstwhile practice of recording these liabilities solely on the balance sheets of Central Public Sector Enterprises (CPSEs) while servicing interest payments from the Consolidated Fund of India, thereby enhancing fiscal transparency.

[77] MINISTRY OF FINANCE, Borrowings by Union Government and its Instrumentalities, March 25, 2025, available at https://sansad.in/getFile/annex/267/AU2783_3lYamJ.pdf?source=pqars (last visited June 23 2025).

2. Conditional State Borrowing Limits and Guarantee Redemption Funds (Finance Ministry Order, March 2025): To enforce subnational fiscal discipline, a March 2025 directive from the Ministry links state borrowing capacity to the establishment of prefunded Guarantee Redemption Funds (GRFs).[78] Off-budget borrowing undertaken via State Public Sector Undertakings (SPSUs) will now be deducted from the permissible 3%-of-Gross State Domestic Product (GSDP) borrowing ceiling for states lacking an operational GRF.[79] This mechanism is exemplified by Kerala's FY 2025-26 borrowing limit reduction of ₹3,300 crore due to its non-operational GRF.[80]

3. Enhanced Audit Trail for Contingent Bank Exposures (RBI Master Circular, 1 April 2025): The Reserve Bank of India's revised Master Circular on "Disclosure in Financial Statements – Notes to Accounts" (effective 1 April 2025) imposes stricter disclosure requirements on banks.[81] It mandates the explicit quantification (in Rupee terms) of the financial impact of all Letters of Comfort (LOCs) issued during the reporting period. Additionally, banks sponsoring off-balance-sheet SPVs must now provide a dedicated disclosure table within the audited financial statements, thereby incorporating previously implicit "moral" support obligations into formal, audited disclosures.[82]

4. Harmonization and Risk-Weighting of Non-Fund-Based Credit (Draft RBI Directions, 9 April 2025): The draft RBI "Non-Fund-Based Credit Facilities Directions 2025" proposes a unified regulatory framework for guarantees, Letters of Credit (LCs), co-acceptances, and default-loss guarantees issued by both banks and Non-Banking Financial Companies (NBFCs). [83]

5. Comprehensive Capital Treatment for Contingent Exposures (Basel III Master Circular, 1 April 2025): The consolidated Basel III Master Circular (effective 1 April 2025) mandates the

[78] Vision IAS, State Government Guarantees, March 15, 2024, available at https://visionias.in/current-affairs/monthly-magazine/2024-03-15/economics-(indian-economy)/state-government-guarantees (last visited June 23 2025).
[79] Prasanta Sahu, Tougher Borrowing Norms for States to Instil Discipline, FINANCIAL EXPRESS, June 11, 2025, available at https://www.financialexpress.com/policy/economy-tougher-borrowing-norms-for-states-to-instil-discipline-3876533/ (last visited June 23 2025).
[80] V. R. Prathap, Centre Slashes Kerala's Borrowing Limit by ₹3,300 cr Citing Failure to Constitute Guarantee Redemption Fund, ONMANORAMA, May 17 2025,available at https://www.onmanorama.com/news/kerala/2025/05/17/setback-for-kerala-as-centre-cuts-borrowing-limit.html (last visited June 23 2025).
[81] Reserve Bank of India, Master Circular, Disclosure in Financial Statements – Notes to Accounts, RBI/2012-13/41 (Issued on July 2, 2012)
[82] Id
[83] VINOD KOTHARI CONSULTANTS , Unified Framework for Non-Fund Based Facilities, by Banks and NBFCs, April 9, 2025, available at https://vinodkothari.com/2025/04/unified-framework-for-non-fund-based-facilities-by-banks-and-nbfcs/ (last visited June 23 2025).

application of prescribed Credit Conversion Factors (CCFs) to *all* off-balance sheet items, as detailed in Table 9.[84] This regulation ensures consistent capital allocation against the full spectrum of derivative contracts and contingent liabilities, including instruments with extended tenors such as long-dated guarantees and swaps, thereby mitigating regulatory arbitrage based on instrument type or maturity.

## IX. CONCLUSION

India today stands at the cusp of an infrastructure revolution, but it is financing that revolution on the back of fiscal illusions and legal evasions. A silent architecture of contingent liabilities comfort letters, support undertakings, SPV debt, and moral obligation bonds has emerged alongside, and often beneath, the formal system of law and finance. These instruments are neither fully enforceable nor fully invisible; they operate in a twilight zone where accountability is deferred, disclosure is discretionary, and risk is ultimately socialized.

This paper has argued that such practices are not aberrations they are systemic. The legal framework's over-reliance on enforceability as the sole test of obligation, its failure to codify quasi-guarantees, and its fragmented constitutional control over sub-sovereign borrowing have created a dual fiscal regime. In this regime, economic obligations persist without legal form, and governments and corporations routinely escape the burdens of transparency while retaining the benefits of credit access.

But this comes at a cost. Invisible liabilities, by definition, resist scrutiny but when they crystallize, they erode market confidence, distort investor risk assessment, and ultimately shift the burden onto taxpayers without their consent. They corrode the very premise of democratic public finance: that obligations undertaken in the name of the people must be authorized, disclosed, and legally accountable.

India cannot afford to repeat the cycle of quiet accumulation followed by fiscal reckoning. What is needed is a new generation of fiscal governance reforms ones that acknowledge that risk transfer is not merely a financial device, but a legal and constitutional act. Making the

[84] Reserve Bank of India, Master Circular, Basel III Capital Regulations, RBI/2025-26/08 (Issued on April 1, 2025).

invisible visible in law, in accounts, and in public discourse is not just a technical correction; it is a foundational act of democratic renewal.

The task ahead is difficult but urgent: to reimagine fiscal regulation for a future where infrastructure is robust, but so is the law that supports it.