
CREDIT RATING AS A DETERMINANT OF CORPORATE CONTROL

Rizwi Mishra, NALSAR University of Law, Hyderabad, Telangana.

ABSTRACT

A credit rating not only provides a quantified score based on a detailed issuer analysis but also a qualitative opinion on an organization's financial health, and hence it is the primary diagnostic tool used for default prediction and signals an upcoming financial crisis¹. This paper discusses the development of credit ratings in the Indian financial system from a risk market signal to the issuer in the theory of credit scoring to a product with significant legal and regulatory effects.² Through varying agency structures such as CRISIL, ICRA and care operating under SEBI control the following is demonstrated that a once-in-straight away rating reduction immediately leads to action from the lenders including debt acceleration and an immediate transfer of control from shareholders to lenders.³

This paper also demonstrates the role that credit ratings can play in determining the volume and composition of current debt, one of the precursors to formal insolvency. The key contention is that credit ratings have become de facto regulatory triggers, in the contemporary financial environment, determining the mechanisms of debt recovery and the nature of restructurings.⁴ In this sense, the credit rating has come to be a powerful visà-vis instrument far beyond being just an information input relative to debt and financial stability.

Existing literature linkage among credit rating and asset price, trade off practice of regulation on financial innovations, governance and reputation incentive scheme, relation between regulator and a financial institution, geographic proximity and bank loan, bank effects on market price of bonds, triggers behind bank bankruptcy in Asian countries and Indian scenario, inception of decision of bankruptcy, the effectiveness of different regulatory tools, prediction of insolvency using quantitative approach and role of SEBI on Indian market.⁵

Keywords: credit rating, quasi-regulatory trigger, credit risk, Indian banking sector, insolvency, SEBI.

¹ Frank J. Fabozzi, *Bond Markets, Analysis And Strategies* (9th Ed. 2019).

² John C. Coffee, Jr., *Gatekeepers: The Professions And Corporate Governance*, 84 B.U. L. Rev. 308 (2004).

³ Securities And Exchange Board Of India (Sebi), *Credit Rating Agencies Regulations*, 1999.

⁴ Steven L. Schwarcz, *Private Ordering Of Public Markets: The Rating Agency Paradox*, 2002 U. Ill. L. Rev. 1 (2002).

⁵ Financial Stability Board, *Credit Rating Agencies: Reducing Reliance* (2014).

INTRODUCTION

The most profound structural change in the history of modern finance is the developing world credit rating industry, transitioning from a constricted, localised personal trust network to a global, quasi-regulatory system.⁶ Credit, in the premodern world, was fundamentally an issue of personalities and proximity, until the passage of the industrial revolution and the consequent westward expansion forced traders to travel beyond the reach of their personal, local information networks. Over-measurement, and the consequent under-extension of credit to unmeasured strangers, was a natural outgrowth of the "handshake" world of commerce, and the loss of capital associated with unforeseen defaults based on a lack of information would prove a salient concern for producers, as not all of the 1837 recession's effects had been eradicated by the end of the decade.⁷ It was this need for information which gave rise to the credit reporting industry, and the origins of the world industry can be traced to the establishment of the mercantile credit rating agency in New York, under Lewis Tappan in 1841, following the economic crisis of 1837.⁸ Tappan pioneered the consolidation of personal histories, into published ledgers of world credit behaviour, in effect creating the world's first global credit register. Robert Dun acquired Tappan's agency by 1857, which cohered with the 1933 merger, to eventual birth of Dun & Bradstreet.⁹

These "reports" were then given by John Moody, pioneer of Moody's investors service, the "authoritative" standard in credit rating.¹⁰ By 1900 Moody realised that investors needed more than "punchy" data and were in need of an opinion on the relative risk and value of individual securities. This led to Moody's innovative publication in 1909, the analysis of railroad investments, which introduced the now-ubiquitous letter-rating system (aaa through c) to the bond market.¹¹ The use of such an effective micro-comparison system of the relative risk between individual debt issues and issuers was such that it was widely adopted in other markets across the world by the early 20th century; Poor's Publishing Company (1916), Standard Statistics Company (1922) and Fitch Publishing Company (1924). The massive dominance by these "big three" agencies to become the all-encompassing "rating authorities" in global credit since a

⁶ Richard Sylla, A Historical Primer on the Business of Credit Ratings, in *RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM* (2002).

⁷ Richard Sylla, A Historical Primer on the Business of Credit Ratings, in *RATINGS, RATING AGENCIES AND THE GLOBAL FINANCIAL SYSTEM* (2002).

⁸ Id.

⁹ Id.

¹⁰ John Moody, *THE ANALYSIS OF RAILROAD INVESTMENTS* (1909).

¹¹ John Moody, *THE ANALYSIS OF RAILROAD INVESTMENTS* (1909).

merger between standard and poor's in 1941 to create standard & poor's (s& p) is unprecedented to date, with little opposition for nearly 50 years in this cartel.¹² The 1970s, however, did bring about a global trend of world's markets building up their own agencies in Canada, Japan and South East Asia as the business came to realise the essentiality of these agencies to modern credit markets.

India has had a relatively young history of credit rating (not more than 3 decades in total so far) but has grown rapidly.¹³ Until the late 1980s there was neither a standardised way to assess corporate credit-worthiness nor a reliable and objective process of doing the same. Investors and banks were limited to subjective or fixed-rate "discounts" from observed market value. The Srisil start-up period officially kicked off with the establishment of the credit rating information services of India limited (CRISIL) in 1987¹⁴, and was led by ICICI Ltd. When CRISIL crossed the start-line on 1 January 1988 there was no credit derivatives market or even much awareness of "paying for an opinion" in most Indian companies. But when the Indian economy has begun its transformation to freer markets in the 1990s and had expressed its prioritisation of perceived transparency and analytical rigor,¹⁵ the Indian pioneer achieved critical mass and market acceptance with a successful IPO in 1993 and a strategic alliance with S&P in 1996. By 2005, S&P had gained majority ownership; the Indian risk battler had become part of the global financial architecture, already referencing the international best practice.¹⁶

The 1990s also heralded the presence of other large participants who contributed toward creating a varied and stable Indian market. The investment information and credit rating agency (ICRA) was formed in 1991 followed by credit analysis and research limited (care) in 1993.¹⁷ These institutions helped intensify the competition in the market which worked to the advantage of investors as they offered dedicated research and varying views. The status of these agencies gradually shifted over time from that of mere providers of "optional" information into some of the strongest indicators of economic stability and disciplined operation. However, this transition was brought about officially by SEBI when the industry came under its umbrella and the securities and exchange board of India (credit rating agencies)

¹² Frank Partnoy, *The Siskel and Ebert of Financial Markets*, 77 WASH. U. L.Q. 619 (1999).

¹³ Reserve Bank of India, *Report on Trend and Progress of Banking in India* (latest ed.).

¹⁴ CRISIL Ltd., *History and Evolution of Credit Rating in India*.

¹⁵ Government of India, *Economic Reforms and Liberalisation Policy* (1991).

¹⁶ Standard & Poor's, *CRISIL Acquisition Reports* (2005).

¹⁷ ICRA Ltd. & CARE Ratings Ltd., *Corporate History Reports*.

regulations, 1999 were enacted.¹⁸ Although out of necessity, its introduction rendered credit ratings obligatory for many debt instruments thereby transforming it into a predefined requirement in the process of raising capital instead of simply a signal operating within the market. The new rules also imposed on these agencies certain measures such as mandatory disclosure norms and restraints on conflicts of interest which increased both domestic and foreign investor faith in the Indian market.¹⁹

Modern credit rating in India can be best understood as a "quasi-regulatory trigger" which coordinates the entire credit lifecycle.²⁰ As the Indian rating industry matured, the ratings were incorporated into the "institutionalized" bis-CRISIL model (originally the CRISIL risk assessment model (ram)) in 1999 as an integral part of the Indian banking industry and the emergence of basel-ii focused bank loan ratings in 2007. Today the rating is much more than a number; it is the expression of the expected probability of default of principal and interest flows; it classifies the rating candidate as either "investment grade" (which presumes good borrowing policies, repayment capacity and prudent conduct) or "speculative grade" (which conspicuously warns the market of high risk of default, unavailability of amortisation payments or distress factors).²¹ Together with the mark-to-market implications, which in fact depend on the rating itself, the low and high credit quality of the borrowing entity can have either (or both) of the following associated financial effects. The borrowership can access a relatively lower interest rate (or rate as less as index-linked) or it attains access to the widest pool of credit whether through other insurers or issuers (or an extended investor base) which otherwise would be unable to easily determine the relative default likelihood vis-à-vis other issuers, and therefore establish the price at where the trade is fair and sustainable; while a rating downgrade can constitute the beginning of "early warning" or incipient default processes by triggering the most aggressive practices of lenders, i.e. debt acceleration, or the most rapid transfer of control of the corporate estate from shareholders to creditors.²² The impact of the rating downgrade on investor psychology is often so immediate, tracking runs, or the decision to begin distressed sales in the market is so sharp that the rating has the unarguable co-ordinating power to conflate the filing of an application for insolvency proceedings or restructuring of the business as a

¹⁸ Securities and Exchange Board of India (Credit Rating Agencies) Regulations, 1999.

¹⁹ Id.

²⁰ Steven L. Schwarcz, Private Ordering of Public Markets: The Rating Agency Paradox, 2002 U. ILL. L. REV. 1 (2002).

²¹ Steven L. Schwarcz, Private Ordering of Public Markets: The Rating Agency Paradox, 2002 U. ILL. L. REV. 1 (2002).

²² Michael R. Roberts & Amir Sufi, Control Rights and Capital Structure, 64 J. FIN. 1657 (2009).

"reality".²³

As we have seen, this history of the credit rating agencies can be understood as part of a long story of economic globalisation and risk management.²⁴ In India, as global agencies have rapidly expanded and created reference points, the associated industries-be it the SME sector or the infrastructure bond market-have benefited from consistent, standardised credit information.²⁵ The industry is continuing to evolve to keep pace with the speed of modern capitalism-be it through the launch of live financial news, the release of SME sentiment indices (such as crisidex), or the development of powerful, AI-infused research tools. True, the industry has faced criticism about conflicts of interests and missing the warning signs of systemic shocks. But the course of a couple of centuries shows that credit ratings will continue to be a public good, in the pursuit of market transparency, objective decision-making, and systemic stability-even in India.²⁶

THE "QUASI-REGULATORY WIRE": FRAMING THE RESEARCH GAP AND PROBLEM STATEMENT

The research gap: from "market signal" to "contractual executioner"

Comprehensively, existing academics have chronologically recorded the historical development of CRAS, statistical aggregation and accuracy the default models; yet an empirical void remains on the contractual independence offered by ratings in the contemporary scenario in India.-primarily they have classified the credit rating as a passive "market signal" transition designed to accomplish the information symmetry gap between borrow and lender.²⁷ Yet, virtually absent is any research on the evolution of the rating into a "quasi-regulatory wire".

Nowadays in Indian debt markets, a rating is no longer an opinion but a high-voltage contractual tripwire hard-wired into each loan agreement. Once a downgrade "hits" this tripwire, contractual clauses are triggered to shove us past judicial contemplation and right ahead towards forced acceleration of outstanding debt and "Government of Indian corporate

²³ Ben S. Bernanke & Mark Gertler, Agency Costs and Business Fluctuations, 79 AM. ECON. REV. 14 (1989).

²⁴ Timothy J. Sinclair, *supra* note 1.

²⁵ Reserve Bank of India, *supra* note 7.

²⁶ Financial Stability Board, *Credit Rating Agencies: Reducing Reliance* (2014).

²⁷ George A. Akerlof, The Market for "Lemons", 84 Q.J. ECON. 488 (1970).

control si-cono.²⁸

In addition, there remains a crucial pro-cyclical feedback gap. Few have explored whether these "tripwires" in Indian loan contracts truly trigger the predicted defaults.²⁹ When a lagging company is induced to payout its entire principal balance at once when the rating drops, the wire induces a liquidity freeze, precluding any operational buffer. Moreover, a post-IBC recovery gap persists: even after the IBC, researchers have not yet established whether high pre-default ratings yield a lower loss given default (lgd) or more favorable "haircut" results for banks presiding over NCLT.³⁰

In order to close the empirical and theoretical gaps, this paper attempts to answer the following (primary and secondary) research questions:

Within the given task, the main aim of my research is to explore the motives behind the advertising of the erotic bakery. I intend to examine the various motivations for the advertising of this product by carrying out two primary research methods.

How far are credit ratings used as quasi-regulatory triggers in the State Bank Of India's. Indian banking industry and to what degree does this "tripwire" effect impact the address of financial stress towards legitimate insolvency?

Secondary research questions:

1. Contractual impact: In what ways do "rating-trigger" provisions in Indian loan documents radically shift the legal relationship and balance of power between a lender and its borrower in a downgrade?
- 2 Pro-cyclicality problem: Does the built-in perpetuation of debt pressure resulting from automatic acceleration lead to a self-fulfilling prophecy of Indian corporate default, in which the rating itself reverses direction and becomes the active trigger of the very demise of which it was intended to act as a deterrent?
3. Governance transition: At what exact rating level (e.g. The investment grade cut-off

²⁸ Michael R. Roberts & Amir Sufi, *supra* note 16.

²⁹ Ben S. Bernanke & Mark Gertler, *supra* note 17.

³⁰ INSOLVENCY AND BANKRUPTCY CODE, 2016, No. 31 of 2016, India.

point) does "corporate control" transition from being with the shareholders to being with the creditors in the Indian context and what are the legal consequences of this?

4. Recovery correlation: Is there a statistically significant correlation between an entity's credit rating on the date of the issuance of debt and the company's final recovery rate (minimisation of "haircuts") during NCLT proceedings under the IBC?

The fundamental finding of this paper is that the Indian financial system has outsourced its "early warning" to private rating agencies.³¹ When hard-coded in legal contracts as quasi-regulatory wires, these ratings become death-dealing executioners, rather than mere subjective opinions, upon a downgrade.³²

This "automated" insolvency introduces systemic risk. Any technical problem or delay on the part of a single agency would trigger the tripwire immediately, without recovery opportunity for the corporate debtor.³³ This paper examines the risks of contract autonomy and experiments with a new understanding of ratings-not passive signals but an active piece in upholding corporate viability through the new style of insolvency.

THE CONTRACTUAL MECHANICS OF CREDIT RATINGS: COVENANTS, ACCELERATION AND CONTROL

In the modern financial world, credit ratings are not merely market indicators, but evolve to become mighty "quasi-regulatory" devices, as they are incorporated into private debt contracts.³⁴ This is achieved through three arrangements: rating-dependent performance pricing, acceleration clauses, and cross-default provisions, all of which make up the instruments that reconcile the problem of risk management that lenders are always "timid of being short changed".

The covenants linked to rating and performance pricing (performance pricing or performance related pricing):

³¹ John C. Coffee, Jr., Gatekeepers: The Professions and Corporate Governance, 84 B.U. L. REV. 308 (2004).

³² Steven L. Schwarcz, Private Ordering of Public Markets: The Rating Agency Paradox, 2002 U. ILL. L. REV. 1 (2002).

³³ FINANCIAL STABILITY BOARD, *Credit Rating Agencies: Reducing Reliance* (2014). ³⁴

³⁴ Timothy J. Sinclair, *THE NEW MASTERS OF CAPITAL* (2005).

1. Performance pricing.

The most widespread use of rating-linked triggers in loan agreements has been in the form of performance pricing covenants, which automatically vary the spread(interest paid) according to the borrower's credit rating.³⁵ Thus price, and consequently the risk-adjusted pricing, is incorporated explicitly into the contract over the course of the loan from research conducted on North American markets, it appears that these triggers can also have a 'downside bias': the potential narrowing of spreads following an upgrade³⁶ for investment-grade borrowers tends to be smaller than the potential widening following a downgrade.

2. Accelerating debt and the "insolvency tripwire"

In addition to the price changes, credit ratings also serve as the worst-possible "tripwire" via acceleration clauses, which allow a lender to immediately exercise the legal right to declare the entire principal loan amount due and payable upon the borrower falling below a certain rating threshold³⁷-most importantly-at the investment grade/ speculative grade boundary line (i.e., {it bbb-} / {it bb+}), whereas older style loan contracts focused on financial maintenance tests (debt-to-ratios, etc.), upside early warning systems are increasingly being outsourced to rating agencies in the case of covenant-lite loans. The net result is that an obvious blank rating "opinion" becomes an instantaneous legal date for a firm's vanishing liquidity.

3. Implication of cross-defaults/ systemic fragility?

Cross-default clauses amplify the severity of a rating-triggered event. They state that a breach or rating-triggered breach in one debt instrument defaults the whole firm's capital structure.³⁸ Thus, one rating downgrade does more than simply raising the cost of a specific debt issue; it can also trigger a systemic liquidity crisis, where every creditor has the right to call a claim or enforce collateral all at once. This processes credit monitoring out of the bank's own research team and into the realm of the credit rating agency: an aggregate, static, but more-or-less arbitrage-free determinant for corporate control transfers.

³⁵ Michael R. Roberts & Amir Sufi, Control Rights and Capital Structure: An Empirical Investigation, 64 J. FIN. 1657 (2009).

³⁶ Steven L. Schwarcz, *supra* note 2.

³⁷ Viral V. Acharya et al., Covenant-Lite Loans and Financial Stability, RBI Working Paper (2019).

³⁸ Douglas W. Diamond, Financial Intermediation and Delegated Monitoring, 51 REV. ECON. STUD. 393 (1984)

4. Responses from the lenders and borrowers: the shift of corporate control.

The reaction to a rating downgrade is a tense situation of high stakes. For lenders, the effect of a downgrade act as a "clear signal in the corporate sector to clench down," possibly kicking in "step-in rights" which enable the banks to require more collateral, limit future borrowing or even intervene in management decisions.³⁹ Research on the banker borrower relationships in Germany show that riskier borrowers pay higher premiums, but banks in "house bank" relationships may at the margin extend "more finance than the borrower's balance sheet justifies" while requesting more collateral as a consequence.

However, for borrowers, the effect is often a desperate scramble for liquidity. Rating triggers propel a pro-cyclicality spiral. The very mechanism that ostensibly offers protection to the lender-accelerated term debt can actually jeopardize the firm, pushing it into insolvency by accelerating cash-asset depletion at precisely the time the firm is most financially ailing.⁴⁰ In the Indian case, even this pro-cyclicality is exacerbated by the IBC, in which a rating-triggered default may be the primary threshold indicating to the lenders that it is time to begin recovery procedures (or to demand a change in control).⁴¹ As a result, the credit rating has adopted the trappings of a corporate destructor.

BATTERED-DOWN MERGERS & ACQUISITIONS AND MARKET SIGNALLING:

Credit rating downgrade, in the world of corporate finance, is a very high fidelity "market signal" that changes the equilibrium between a distressed firm and the prospective acquirors by a revolution⁴². Unlike traditional mergers and acquisitions that revolves around synergy and growth, distressed mergers and acquisitions especially in the Indian context under IBC is in-between informational and liquidity rights ,When the CRA pushes a firm near to the gray (speculative grade) zone, he essentially sends out a "distress signal" which signals a, potential change in corporate control.

Changes in ratings can therefore be used as a coordination devices between the market players. From the investors point of view the downgrade implies a "market correction" of the firm value

³⁹ Raghuram G. Rajan & Luigi Zingales, Power in a Theory of the Firm, 113 Q.J. ECON. 387 (1998).

⁴⁰ Ben S. Bernanke & Mark Gertler, Agency Costs, Net Worth, and Business Fluctuations, 79 AM. ECON. REV. 14 (1989).

⁴¹ Insolvency And Bankruptcy Code, 2016, No. 31 of 2016, India.

⁴² Timothy J. Sinclair, *supra* note 4.

that induces "bargain-hunting" incentives; acquirers of distressed and bankrupt targets typically report positive announcement abnormal returns, because the event elicits a redistribution of value from the target firm creditors and shareholders wealth to the acquirer, but the signal also discourages strategic behaviour by the lenders.⁴³ As the ratings decline, the banks have incentive to use "step-in rights" or impose hostile covenants in order to prevent exhausted collateral, thereby producing a "fire sale" environment that favors fast-acting acquirers with high levels of liquidity

Value suppression & information asymmetries

A key feature of distressed signalling is the "value suppression" that occurs in advance of an acquisition. The firm's external financial signals (ex. A voluntary downgrade or pressure by creditors to do so) causes the firm's cost of capital to increase, and causes its trade credit to fall away - the firm finds itself in a "death spiral" or "pro-cyclicality"⁴⁴ where the firm's internal value becomes depressed by its external signals of financial distress. Strategic acquirers who interpret a firm's distressed signals do not acquire immediately, but seek to wait for the "liquidity squeeze" to get worse before acquiring at a much steeper discount - a so called "haircut" for the existing creditors. This process has been institutionalized in India under the IBC where a rating triggered breach constitutes a formal signal by bidders to start a "distressed mergers and acquisitions" process under the CIRP.⁴⁵

Market participants' strategic behaviour

The signalling of distress alters the strategic interaction between these three actors:

1. Lenders upon receiving the signal, lenders move from "relationship banking" into "recovery mode," which usually involves a short-term exit strategy through a distressed sale rather than an operational turnaround.⁴⁶
2. Acquiring firms trading partners on the buy side analyze the rating signal as a leading indicator of their entry point. The target encroaching on the class "speculative grade"

⁴³ Edith S. Hotchkiss & Robert M. Mooradian, Acquisitions as a Means of Restructuring Firms in Chapter 11, 7 J. FIN. INTERMEDIATION 240 (1998).

⁴⁴ George A. Akerlof, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, 84 Q.J. ECON. 488 (1970).

⁴⁵ Insolvency And Bankruptcy Code, 2016, No. 31 of 2016, India.

⁴⁶ Raghuram G. Rajan & Luigi Zingales, Power in a Theory of the Firm, 113 Q.J. ECON. 387 (1998).

may be the signal to private equity and 'vulture' funds to commence due diligence as the target's principals trample the firm's umbilical cord.⁴⁷

3. Target management: management may resort to frantic "window dressing" or sell assets aggressively to prevent another downgrade, which can sometimes backfire by signalling even severe distress to knowledgeable investors.⁴⁸

In the final analysis, when credit ratings are used in distressed mergers & acquisitions, it is to serve as a 'quasi-regulatory wire'. Signals transform the view of a company as a viable proposition to a 'distressed asset'; signals set the time, price and outcome of the corporate rescue. It is the incorporation of these signals into the IBC system that it has ensured that in India, the credit-rating is the trigger that will bring a unglamorous firm from boardroom to auction room.⁴⁹

CASE STUDY

Case study: Credit rating failures during the Infrastructure Leasing & Financial Services Limited Crisis.

The fall of Infrastructure Leasing & Financial Services Limited (IL& FS) in 2018 stands as the worst financial crisis in the Indian NBFC sector till date.⁵⁰ The company was founded in 1987 by the central bank of India, housing development finance corporation, and the unit trust of India. Its founding purpose was to help develop India's infrastructure projects.⁵¹ Life insurance corporation of India became the largest shareholder of IL& FS, meanwhile, investors outside India such as Orix corporation and Abu Dhabi investment authority held a significant number of shares in the company.

As of 2018, IL& FS had grown to become one of India's largest infrastructure conglomerate with over 256 group companies, including majority-owned subsidiaries, special purpose vehicles (SPV), joint venture and associate companies.⁵² The entity spread across diverse sectors including transportation, power, ports, urban infrastructure and finance. Though the

⁴⁷ Andrei Shleifer & Robert W. Vishny, Liquidation Values and Debt Capacity, 47 J. FIN. 1343 (1992).

⁴⁸ Stewart C. Myers, Determinants of Corporate Borrowing, 5 J. FIN. ECON. 147 (1977).

⁴⁹ Steven L. Schwarcz, *supra* note 2.

⁵⁰ Reserve Bank of India, *Report on Trend and Progress of Banking in India 2018-19* (2019).

⁵¹ Infrastructure Leasing & Financial Services Ltd., *Annual Report* (2018).

⁵² Infrastructure Leasing & Financial Services Ltd., *Annual Report* (2018).

entity seemed financially healthy, the corporate nature as diverse sectors with a complex corporate structure and heavy reliance on debt concealed significant governance and liquidity issues.⁵³

The first signs of an impending crisis emerged in mid-2018 when a number of IL& FS subsidiaries started defaulting on their debt payments.⁵⁴ This was initially signalled by the road arm which was IL& FS transportation networks ltd. Subsequent to this, the financial arm namely IL& FS financial services limited defaulted on close to 450 Crores of inter-corporate deposits to the small industries development bank of India. Defaults on smaller short-term deposits and commercial paper obligations that followed, put investors and creditors in a complete state of panic.

One of the significant problems revealed by the crisis was the failure of credit rating institutions and rating agencies. Only a few months before the defaults, rating agencies such as ICRA limited, India ratings & research, and care ratings were still handing out investment grade ratings to IL& FS debt instruments to investors and facilitated the group to keep raising vast amounts of capital from a variety of investors including banks, mutual funds and institutional investors.⁵⁵ Internally, the company was Government of India through a liquidity crunch.

After IL& FS started defaulting at the end of 2018, the rating agencies started to make a series of abrupt downgrades in August- September 2018. Much to the vitrol of critics, the agency had not considered IL& FS's mounting debt burden sufficiently and responded far too late through abandon-sive rating downgrades, despite sufficient warning signs. IL& FS' excessively leveraged balance sheet; complex group structure; and dependence on short-term borrowing to finance preponderance of long-term infrastructure projects were risk factors that the agencies failed to capture in the rankings.

Due to the systemic significance of IL& FS to the financial markets in India, the Government of India intervened to address the unfolding crisis in IL& FS on 1 October 2018 by superseding the managing committee and naming a new one led by Uday Kotak.⁵⁶ The goal of the intervention was to restore stability in the financial system and stem contagion to banks, mutual

⁵³ Infrastructure Leasing & Financial Services Ltd., *Annual Report* (2018).

⁵⁴ Reserve Bank of India, *supra* note 1.

⁵⁵ Securities and Exchange Board of India, *Report of the Committee on Credit Rating Agencies* (2019).

⁵⁶ Press Information Bureau, Government of India, *Supersession of IL&FS Board* (Oct. 1, 2018).

funds and the non-banking financial sector more broadly.⁵⁷

As a reaction to the crisis, the securities and exchange board of India implemented tighter disclosure standards for credit rating agencies.⁵⁸ One of these reforms mandated that agencies be more open about liquidity risks and stress indicators of the companies whose securities they rated.⁵⁹

The IL& FS had revealed the impact of unduly delayed or improper assessment of the credit risk as they worsened the financial glitch.⁶⁰ It could have acted as a cautionary warning or a wakeup call for India's financial sector wherein reforming the architecture of large financial conglomerates, strengthening the regulator and assignment of credit risk of company to rating agencies, and demonstrating transparency becomes quintessential.

POLICY MEASURES TO TACKLE SYSTEMIC DANGERS DUE TO DOWNGRADE IN CREDIT RATINGS

Financial stability is threatened when credit rating downgrades induce liquidity crises, capital flight, and suddenly elevate the costs of borrowing with respect to an issuer.⁶¹ If a market is highly rating-dependent, a swift downgrade can lead to a wave of insolvency proceedings,⁶² and deprive market stakeholders of confidence. Regulatory reforms should therefore ensure greater disclosure requirements, greater supervision of CRAs, reduction in conflicts of interest and increased transparency of insolvency proceedings.

An important area for reform is enhanced disclosure requirements. Credit rating agencies should be mandated to disclose more about their rating processes including their key assumptions, models and risk management strategies. This increased transparency regarding the models used by CRAs would allow market participants and regulators to better understand the CRAs ratings, and thus better identify potential sources of bias or inaccuracy.⁶³ Currently, CRAs often have very opaque models that are difficult to scrutinize. It is also important that CRAs be required to disclose their rating process, and any material changes in a borrowers

⁵⁷ Press Information Bureau, Government of India, *Supersession of IL&FS Board* (Oct. 1, 2018).

⁵⁸ SEBI Circular on Enhanced Disclosure by Credit Rating Agencies (2019).

⁵⁹ SEBI Circular on Enhanced Disclosure by Credit Rating Agencies (2019).

⁶⁰ Financial Stability Board, *Credit Rating Agencies: Reducing Reliance* (2014)

⁶¹ Financial Stability Board, *Supra Note 8*.

⁶² Financial Stability Board, *Supra Note 8*.

⁶³ IOSCO, *Code of Conduct Fundamentals for Credit Rating Agencies* (2015).

financial position in a timely manner so that investors can all the forewarned rather than all the shocked into a perceived hasty action.⁶⁴

A second core reform would be to tighten regulation of CRAs. Financial regulators such as the SEBI must play a more active role through on Government of India regulation and regular sampling of CRAs. Instead of penalizing agencies ex post through enforcement actions like cancellations or fines, regulators could direct CRAs to reveal member-level rating decisions, internal research and review procedures, and procedures for resolving rating conflicts.⁶⁵ Regulators could also establish a panel to oversee ratings that determine substantial credit decisions or invoke the expertise of third-party auditors for high-risk ratings. These review and audit infrastructure can provide a system of checks against delayed rating downgrades and rating inflation that confound the creation of market signals.

Thirdly the key reform proposal is to minimize the conflicts of interest that arise from the issuer-pays business model. As operating today, the crts are paid by the very company as to which they are providing a rating, creating incentives for "rating inflation" in order to win or retain business.⁶⁶ Alternative methods of funding the CRAs could seek to eliminate this inherent structural conflict including (among others) a regulator "fee pool" where issuing firms pay fees to a neutral third agency that then assesses the votes of each CRAs without regard to the issue.⁶⁷ Other modes of funding that might present divestiture solutions would include (among others) investor-pays or regulator-pays models that would loosen the direct reliance of CRAs on issuing firms.

Transparency on insolvency proceedings and restructuring is also of relevance. Reforms should aim at avoiding that a rating downgrade may have unintended consequences of disproportionate magnitude.⁶⁸ Credit history should not be the sole precondition when questioning if a company is weak and an insolvency tribunal or regulator should consider several other indicators of the creditworthiness of a company. Disclosure on those factors would be conducive to better investor confidence and prevent a downgrade from being an own-fulfilling precipitant of financial problems.

⁶⁴ IOSCO, *Code of Conduct Fundamentals for Credit Rating Agencies* (2015).

⁶⁵ SEBI (Credit Rating Agencies) Regulations, 1999.

⁶⁶ Frank Partnoy, *The Siskel and Ebert of Financial Markets*, 77 WASH. U. L.Q. 619 (1999)

⁶⁷ Frank Partnoy, *The Siskel and Ebert of Financial Markets*, 77 WASH. U. L.Q. 619 (1999).

⁶⁸ INSOLVENCY AND BANKRUPTCY CODE, 2016, No. 31 of 2016, India.

In sum, a well-balanced reform proposal involving credible disclosure, robust regulatory oversight, structural adjustments in the CRA compensation scheme and transparency reform of the insolvency system could substantially diminish the systemic risks arising from the downgrade of credit ratings. This reform would restore the reliability of a mainstream source of information and benefit investment market participants and the overall financial system.

CONCLUSION

The transformation of credit ratings from states of insufficient information to “quasiregulatory wires” has radically altered the objects of corporate finance and corporate insolvency.⁶⁹ As this study has argued, ratings now not only narrow informational disequilibrium, but also provide binding contractual machinery that determines the process of default from solvency to formal reorganization. With the loading of rating-dependent covenants and debt acceleration provisions, credit ratings have become the overarching determinant of control rights, systematically depriving shareholders of their nominal monopoly and pressing powers, well ahead of an official default.

In the Indian setting, the interaction of credit signals with the IBC reveals a fragile system.⁷⁰ Ratings are beneficial to the “dissemination of information, market efficiency and guiding risk-taking” but yet their “pro-cyclicality” can quickly cause the death of a temporary liquidity crisis as a terminal insolvency.⁷¹ To forestall this, regulators and financial institutions in the Indian systemic must explore a less “automated” path than what’s currently taken by “automatic” trigger events. As such, we recommend a more differentiated blend of enhanced disclosure, restructuring of compensation in financial intermediation and a wider range of financial metrics to assess the health of a firm at the time of insolvency proceedings to avert the self-fulfilling cash collisions.⁷²

⁶⁹ Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1 (2002).

⁷⁰ INSOLVENCY AND BANKRUPTCY CODE, 2016, No. 31 of 2016, India.

⁷¹ Ben S. Bernanke & Mark Gertler, *Agency Costs and Business Fluctuations*, 79 AM. ECON. REV. 14 (1989).

⁷² IOSCO, *supra* note 10.