Staring at the IL&FS default

Background

We discuss the implication of the default of a 'financing-cum-project executing' giant- Infrastructure Leasing and Financial Services (IL & FS) on the accounting valuation of the embedded interest rate guarantee of exempt provident funds. Pension actuaries in the Indian actuarial profession should take cognizance of the possible measures of provisioning for the IL&FS default while valuing the embedded interest rate guarantee on exempt provident funds. As some regulators have already provided guidance for loss recognition, this could serve as a reference point for exempt provident funds with an exposure to IL&FS bonds. In particular, we focus within the Institute of Actuaries of India's Guidance Note 29.

IL&FS as a borrowing institution defaulted on its loan repayment of ₹400 crs in September 2018. In its wake, the existing regulatory guidance could be relevant for default provisioning for pension actuary whilst valuing the embedded interest rate guarantee on exempt provident funds (PFs).

Exempt PF funds' Context

The Employee provident funds that are self-managed by companies are granted the 'exempt status, if the rules of the PF set up by the establishment are not less favorable than those specified in section 6 of the EPFMP Act. Besides this, the employees should also enjoy other provident fund benefits that are at par with those under the Act. The exempt PFs have to match the interest rate on contributions as declared by the EPFO in order to retain the 'exempt' status.

Most investment of exempt PFs has historically been in debt securities. 'Debt' - now for many years in India - has always been synonymous with 'secure' returns. Moreover, the quasi- government nature of IL&FS with heavy weight investors like LIC, HDFC and SBI translated into the highest 'AAA' rating. Hence, a significant number of exempt PFs have an exposure to the IL&FS securities. However with a ratings downgrade and actual loan default, the IL&FS default needs to be provided for by adjusting the fair value of assets. It does not absolve the PF trusts to meet their obligation toward their employees. On a related note, many finance experts have remarked that the Public Provident Fund, a refuge of numerous small investors scouting for a secure return has sizeable exposure to IL&FS securities.

Given that the default has happened, it becomes important to determine the provision to be made against the exposure. For pension actuaries, it becomes important to view this default in the context of their responsibility under the relevant accounting standard (AS15/Ind AS 19), Guidance Note 29 and the prescribed market practice by the various regulators.

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The Pension Actuary's mandate

In the actuarial valuation report, the actuary certifies the content of the valuation report, along with the disclosures. In doing so, the actuary is also certifying the value of assets in order to arrive at the net provision/ cost of the embedded interest rate guarantee. Therefore, the onus of determining if the provisioning for such a default is commensurate with market

practice (allowing for the client's judgment), partly lies on the actuary. An unusually low provisioning could result in the underestimation of the net obligation in the PF Trust, which would likely amount to professional negligence.

Hence, the actuary may have to sensitize the client about the importance of adequate provisioning. This also represents an opportunity for actuaries to engage more in the asset valuation of exempt PFs by quantifying future credit risk and embedded derivative contracts (as per Ind AS 109 or IFRS 9).

Professional Guidance

The Institute of Actuaries of India's Guidance Note 29 and AS15/Ind AS 19 prescribe the Fair Value of Assets in order to arrive at the net provision to be made in the books. In the strictest sense, the fair value of debt should reflect the current interest rate environment in the measurement of the obligation. However, historically, the assets considered are the ones reflected in the PF Trust's financial statements. Since, the balance sheet is not on a fair value basis, the 'Held-to Maturity' (HTM) approach is often employed in order to arrive at the value of debt securities. Now that a default has happened and the existing IL&FS securities downgraded, even the HTM accounting of debt securities will need to reflect the mark-down.

In this regard, it may be worthwhile to consider the prescribed approach by two regulators in the financial markets viz. the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI). Establishments in industries other than the financial services are also likely to rely on this regulatory guidance in order to make the appropriate provision for FY 2018-19.

RBI View and Guidelines[1]

Banks are exposed to around 60% of the total debt of ₹91,000 crores of the IL&FS group. The RBI has provided guidance that banks must regard IF&LS loans as non-performing assets (NPA) in their books of account and provide according to the RBI norms. Banks will have to make a provision between 15% and 40% on sub-standard non-performing assets whose duration lasts from six months to a year, based on whether it is secured or not. From the second year, the NPA will attract a provisioning of 100% on the unsecured portion and between 25%-40% between second and fourth year on the secured portion.

SEBI Guidelines

Amongst the downgrades by rating agencies of IL&FS debt, of particular note was the downgrade that led to the classification as a “Non-investment” grade security. This resulted in a NAV decline of at least 25 mutual funds that held around ₹2,700 crores of IL&FS debt. This led to a worsening of NAV for mutual funds that invested in IL&FS debt securities which prompted the Association of Mutual Funds in India (AMFI)to propose to SEBI to allow “side-pocketing or segregating”[2] of IL&FS debt.

Despite the latitude given for segregating securities, SEBI states that, the valuation should take into account the credit event and the portfolio shall be valued based on the principles of fair valuation.

As per Master Circular for Mutual Funds dated July 10, 2018[3] paragraph 9.7.4.2, provision is to be maintained for NPAs (debt securities) as follows:

Time since due date of interest	Total provisioning required for NPA’s (debt securities) as % of book value
6 months	10%
9 months	30%
12 months	50%
15 months	75%
18 months	100%

[1]https://www.financialexpress.com/industry/ilfs-classification-rbi-rejects-bankers-plea-for-six-month-moratorium/1438021/

[2]Side pocketing involves a fund segregating illiquid securities in default from other securities that are perfectly liquid, thus creating two funds. The fund may segregate the debt papers of IL&FS into a separate fund, while the rest of the good papers remain in the original fund, thus the good portfolio is almost unaffected by the bad papers.

[3]https://www.sebi.gov.in/legal/master-circulars/jul-2018/master-circular-for-mutual-funds_39491.html

Exempt PF trusts could also consider the nature and duration of their exposure to IL&FS debt and mirror the RBI provisioning norms prescribed for banks. Else a one-time write off regardless of the nature of loans could also be resorted to. The actual write off would also be dependent upon the employer covenant and the proportion of the PF trust's exposure to IL&FS securities.

Ind AS 109 principles

Ind AS 109 is a 'Fair Value' standard and hence is consistent with the fair value requirements for valuing

assets under AS 15/Ind AS 19. Notwithstanding the HTM proxy for fair value of debt securities that an Indian Actuary may consider, Ind AS 109 could be referred for an estimated provision.

Para 5.5.3 of Ind AS 109 requires *'at each reporting date, an entity shall measure the loss allowance for a financial instrument at an amount equal to the lifetime expected credit losses **if the credit risk on that financial instrument has increased significantly since initial recognition'***. Lifetime expected credit losses is defined as 'the expected credit losses that result from all possible default events over the expected life of a financial instrument' i.e. the expected NPV of credit losses on the financial instrument or the total expected credit loss on the instrument. In the context of IL&FS securities, this would entail anticipating the possible losses on such securities.

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Ind AS 109 defines credit loss as *'the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls), discounted at the original effective interest rate(or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets)'* and Expected Credit Loss (ECL) as *'the weighted average of credit losses with the respective risks of a default occurring as the weights'*. These are recognised as a loss allowance as per Ind AS 109 paragraph 5.5.1. Thus, for the IL&FS debt securities, the ECL would need to be evaluated.

ECL can be defined mathematically as ECL = Exposure at Default (EAD) × Probability of Default (PD) × Loss Given Default (LGD) × Effective Interest Rate[4]. Although, this is more relevant in the context of a loan portfolio of a bank, it could possibly be used for loss provisioning for other industries, albeit with reduced rigour.

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Moreover, Ind AS 109 is silent on the methodology to determine PD, LGD or EAD. Hence, the ECL would depend upon factors like the nature of loan (secured, unsecured), the prevalent rating, besides other actors.

For arriving at the ECL of IL&FS securities, one approach could involve the homogeneous grouping of such securities. This grouping could be as per the nature, duration, etc of the debt, each with their own PDs and LGDs. The EAD, PD and the LGD for each group would then be reflective of the group's underlying risk. Example, the LGD for secured debt will be lower than the LGD for unsecured debt, due to the presence of collateral. Also, the PD for NPA could be "1", while for a downgraded security, it could be lesser than 1, depending upon the extent of the downgrade. This method would allow for the relative credit worthiness of each asset and the provision will be reflective of this. Although such an approach would be influenced by considerable management judgment, it could be a tool to gauge the provisioning consistency with the regulatory prescription.

Conclusion

An appropriate allowance for the default in the fair value of plan assets while valuing the Interest Rate guarantee in the Exempt PF funds is necessary. The provision made by the PF Trust in its own books of account may not reflect the true underlying risk. Rather, the mandate for the pension actuary is to arrive at the appropriate provision net of carrying value of assets. Hence, the actuary could approximate the provision that reflects the underlying risk using tested methods. This would ensure that the net obligation in the PF Trust is correctly reflected.

[4]Demystifying Expected Credit Losses, KPMG, July 2017

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