Disclosure of default: the present SEBI disclosure regulation is adequate

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ANALYSIS, ON THE DOT

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There is a much economic sense in achieving rapid disclosure about default. **Volume 1 of the report of the Bankruptcy Legislative Reforms Committee (BLRC)** articulates a clear strategy for disclosure about default (Section 4.3.5). SEBI and RBI are in the early stages of implementing this. Many people who are used to opacity about default are surprised at the new concept of immediate disclosure of default. We argue that economic logic and the existing SEBI regulations about disclosure (the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, or "LODR") are consistent with immediate disclosure about default by listed issuers. LODR does not require modification in order to achieve the desired outcome. The lack of disclosure that is presently prevalent reflects an endemic state of violation of the LODR. Executive action by SEBI, to enforce against a few violations, will deliver the required change in the behavior of listed issuers, on disclosure.

How does the credit market benefit from the disclosure of default?

A firm in distress is a melting ice cube. Every day of delay harms recovery rates. The central idea of the bankruptcy code (and the resolution corporation proposed under the FRDI Bill) is to rapidly resolve the problem. Speed in resolution reduces the bankruptcy cost that is ultimately borne by society.

When a default takes place, if it is rapidly known to the community of bidders, they will gear up to toss bids into the Insolvency Resolution Process (IRP). Reducing delays in disclosure of default thus reduces the delays (or increases the quality of the work done by bidders) in the IRP and improves recovery rates. Thus, the rapid disclosure of default is a tool for obtaining a well-functioning bankruptcy process.

How does micro-prudential regulation benefit from the disclosure of default?

Micro-prudential regulation involves ensuring that financial firms, such as banks or insurance companies, recognize losses and hold adequate equity capital after taking losses into account. Financial firms have an incentive to hide bad news. Disclosure of default helps to block evergreening, and thus works in favor of micro-prudential regulators. RBI and IRDA will thus benefit when there is immediate disclosure of default.

How do capital markets benefit from a disclosure framework?

Speculative trading discovers prices on financial markets. Every market participant combines hard information with a process of analysis and formation of a speculative view about the future. The interests of society are best served if the maximal hard information is made available, on an equal footing, to all speculators.

This guides the regulation of disclosure. Exchanges coerce issuers to disclosure a comprehensive array of information that helps speculators peer into the future and form a view of the fair value of each security.

The push for better disclosure could come from any of these three channels: From a government agency such as IBBI which is tasked with building a healthy credit market, from micro-prudential regulators such as RBI and IRDA and from the financial markets regulator, SEBI. In India today, the natural way forward seems to run through SEBI, which shapes the listing agreement between a firm and the exchange. Through this, listed borrowers and listed lenders can be coerced to disclose defaults. Hence, in the remainder of this article, we focus on securities law and its impact on disclosure of defaults.

The firm, not the security

Corporate finance involves multiple securities that stand at different levels of seniority in the waterfall. Information about all aspects of the corporate financial structure is required for the valuation of any of these securities.

Another way to think about this is through derivatives pricing. All securities issued by a firm (e.g. equity, the debt of various kinds) constitute derivatives that have, as the underlying, the value of the firm. Facts about the firm are thus relevant for pricing all these derivatives.

Hence, while a lot of real-world rules about disclosure flow from each security that is listed, disclosure rules should be a rulebook that kicks in when an issuer has one or more listed security in the public domain.

Materiality of defaults

The LODR governs the disclosure of information by listed issuers, that is, issuers that have a single listed security. The essence of LODR is a principles-based perspective on what should be disclosed: Disclosure obligations under the LODR are triggered for all information that is 'material'. What constitutes material information is left to the judgment of the issuer's board.

The LODR lists the following indicative criteria for determining the materiality of any given piece of information:

- if the event or information is not disclosed, it is likely to result in the discontinuity or alteration of an event or information already available publicly;
- if the event or information is not disclosed, it is likely to result in a significant market reaction if the said omission were to come to light at a later date;
- even where neither of the above-mentioned conditions are satisfied, an event or information may be treated as material, if in the opinion of the board of directors of the issuer, such event or information is material.

This covers all the issues associated with default: A listed company should disclose any default, a listed bank should disclose when a large borrower defaults, etc.

A default on a loan to a bank or financial institution is, by itself, a material event for the valuation of all securities issued by a listed issuer.

As an example, consider a company financed by equity and one bond issue. Default by the company to anyone bondholder is a very important event for the shareholder, for this raises the possibility of large losses for the residual claim (equity). It is also a very important event for every holder of the bond (including to the bondholders who were actually paid on time). Hence, the default by the company to anyone bondholder should be disclosed. The LODR explicitly recognizes this and makes specific provisions for the expected as well as immediate disclosure of default on bonds. For instance, it mandates a listed entity to inform the stock exchange of any action that *will affect* the payment of interest on or the redemption, of debt securities. A listed entity is required to similarly inform the stock exchange of an expected default in the timely payment of interest or redemption amount in respect of debt securities. Notices of board meetings that propose an alteration of the date for payment, or amount, of interest or redemption on bonds, are required to be given to exchanges at least 11 days prior to the date of the meeting.

Suppose the company was, instead, financed by equity and one loan. The same logic holds. Default by the company on the loan is an important event for the shareholder. Suppose the same firm had issued debt securities as well, a default on a loan is equally important for the bondholders. It is also equally material for all other stakeholders, such as the firm's vendors and employees, as it may show signs of impending or ongoing financial stress. Hence, such default should be disclosed as soon as it occurs.

Additionally, the LODR deems certain information to be material, and mandates its disclosure, notwithstanding the judgment of the issuer's board. It lists information "deemed" to be material in Schedule III. However, Regulation 30(12) clarifies that the list is inclusive and where the listed entity has information, which has not been indicated in Schedule III, but which may have a material effect on it, the listed entity is required to make an adequate disclosure of such information. Listed issuers are required to have in place a policy for determining the materiality of information for the purpose of disclosure.

Definitional issues relating to 'default'

In India, the concept of default has often been conflated with the RBI mandated prudential norms on income recognition, asset classification and provisioning for banks and financial institutions. While RBI's prudential norms classify an asset as an NPA only after the expiry of at least 90 days from the due date, the price discovery process in the financial market happens independently of the prudential norms.

The Insolvency and Bankruptcy Code, 2016 (IBC) has dispensed with this conceptual confusion by defining default as the non-payment of the whole or any part of the debt when due and payable. It allows the enforcement of creditor rights on the occurrence of a default. The IBC has, thus, already made a paradigm shift in how we think about default and the timing of enforcement of creditor rights in India. The same standard should be applied for the purpose of default disclosures as well.

Information overload?

It is possible to disclose too much. As an example, suppose an Indian software services company loses one customer. Should this be disclosed to the public security-holder? The answer depends on the size of the customer. Material information should be disclosed. As an example, Nielsen has a contract of **$2.25 billion with TCS**: events of contract renewal or contract disruption for this contract are large when compared with the size of TCS which had consolidated revenues of about $19 billion in 2016-17, to merit disclosure.

This takes us to the question: What is material information? It is neither feasible nor sensible for a regulation to pinpoint every fact that must be disclosed. LODR is principles-based and should remain principles-based. These details should evolve through jurisprudence.

A good way to think about what is `material' information is to compare the stock price impact against normal security price fluctuations. As an example, suppose the share price of a company has a daily standard deviation of 3%. Suppose the revelation of default generates a share price impact of 1.5%. This is a pretty big piece of news, by the standards of the ordinary price fluctuations experienced by the security. Hence, this news should be disclosed. *We suggest that what is material to the price of a security is news that is likely to have an impact on the price of above half the standard deviation of daily returns.* This quantifiable construct can be used by practitioners and prosecutors when translating the principles-based LODR into rules for living and acting when faced with events in the real world.

Fixing enforcement

Why do we have poor disclosure of default in India? This is not a failure of regulations: the LODR is quite fine on the principles. Defaults are material events and thus should be disclosed. This is a failure on the executive side. The materiality thresholds under LODR are being pervasively ignored, and SEBI has not punished violators. Sound enforcement of the LODR against firms who have failed to comply with the disclosure of material debt defaults, should get the job done.

Is there a conflict with banking secrecy?

In the past, the fiduciary obligations of banks towards their consumers have been used to avoid disclosing the identity of defaulters. However, contractual obligations of banking secrecy are consistent with disclosures as long as such disclosures are mandated by law. For instance, confidentiality obligations in standard contracts between banks and their clients, commonly exempt disclosure obligations under the law. Similarly, even where the confidentiality obligation is imposed by statute, such as the State Bank of India Act, 1955, specific exemptions are carved out for information that is mandated to be disclosed by law. The LODR is law, and hence disclosures that flow from LODR is consistent with banking secrecy.

Conclusion

A sound credit market requires rapid disclosure of default. A sound capital market requires rapid disclosure of default. Rapid disclosure of default plays in favor of micro-prudential regulation. In India, so far as concerns the capital markets, the principles-based LODR is in place, and the text of LODR is sound. The gap is in enforcement. Enforcement of the existing LODR will deliver sound disclosure of defaults by listed companies and important defaults faced by listed lenders.

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