To Say or Not To Say (A)¹

The Present Moment

Rita replaced the telephone and leaned back on her chair with a sigh. “That hadn’t been easy,” she mused. She had been talking to a client who wanted to invest Rs 10 crores (approximately $1.6 million USD) in a debt instrument that her company was placing. And she was finding herself reluctant to sell the debt to the client, commissions to the company notwithstanding.

The Organization and Their Work

Rita reflected on two busy years at b-school followed by a campus offer from her “dream company” on day one of placements: life had been sweet to her, she thought. Rita’s job was in the Private Placement of the Debt Department, a place that showed promise in terms of bringing even more income to one of India’s largest and very well-known investment banking companies. The team consisted of a senior manager who supervised overall policies and put his signature to the decisions; the “grip on the day-to-day-realities” manager who was her boss and guided decisions; and three MBAs with varying years of work experience.

Their mandate was simple. Some client companies needed to “raise debt,” i.e., borrow money, either in the form of bonds or secured debentures. Other companies, mutual funds, treasuries of banks and other assorted bodies had money to invest or lend. The MBAs helped the client who needed to raise funds to structure a debt instrument and decide on the interest rate (called "coupon rate") and then sell that instrument to clients who wished to invest. They earned their commissions from the first party, i.e., the seller of debt. The buyers were thus to be assiduously wooed.

¹ This case was inspired by interviews and observations of actual experiences, but names and other situational details have been changed for confidentiality and teaching purposes. It was prepared for the Giving Voice to Values program by Piya Mukherjee, corporate trainer, Visiting Faculty and Director, VES Leadership Academy and Research Centre.
Focus: Sell!

Most in-house training focused on the marketing aspect of the work. There were periodic training modules done on various aspects of structuring debt instruments, helping clients “clean up” their balance sheets by giving closure to liabilities that threatened to turn “bad,” and due diligence. The last theme was treated as a “necessary but not exciting” aspect of conducting business. Markets were booming; companies were expected to see the merit of self-regulation.

It didn’t take too long for Rita to spot the wide gap between what her teachers taught in the classroom and what was actually practiced in the financial markets. Interest rates were decided in a rough and ready way of assessing demand and supply. Deals were often decided on the basis of goodwill, sealed with handshakes. Millions of rupees changed coffers, sometimes on the basis of a simple telephone conversation with an old acquaintance. To Rita, the casual way in which money moved seemed exciting, but also seemed to carry the shadow of repercussions, if things went wrong.

Niggling Doubts

“What happens when the company whose debt instrument we are selling can’t redeem the instrument?” Rita asked her boss one day. She had just finished reading the balance sheet of a company that would raise Rs 800 million and didn’t like the large amount under the heading, “Contingent Liabilities.” “If it is a secured debenture, the investor is safe, right?” she added.

Her boss gave a wry grin and said, “Let’s hope we don’t end up selling debt paper of companies who can’t repay their debt in future. We will end up tarred by the same brush. And yes, in theory, the secured debenture is safe. But look at their balance sheet to see if the company has created a Debenture Redemption Reserve (DRR). If that is missing, you know the company is shrugging off this responsibility."

"Just remember to make sure that when you sell debt to any Provident Fund, you sell only safe debt, a 'AAA' rated instrument.”*

“Why?” queried Rita.

“This is mandated by the government. Because this is 'sacred money,' the kind that is deducted from the salary of employees every month, matched by an equal amount contributed by the employer, and deposited in safe investments so that the employee, after retirement, has either a large lump-sum amount to use, or receives a pension for many years. This is a low-risk, low return kind of area. No fancy debt instruments for this category of investors,” her boss patiently explained.

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* A Provident Fund is a pension fund.
An Investor Calls

And now this. The lady who had called up this morning was the manager of the Provident Fund of a well-known Public Sector Organization, one of the investors with sacred money. Rita and she had often chatted face-to-face, discussing the relative merits of various debt instruments. This morning, the fund manager had taken the initiative to call.

“We have an investible surplus of Rs 10 crores. And I know ABC Company is currently selling bonds that are rated AAA. I also know that your company is one of the lead managers for the issue. So I thought of investing in the bonds of ABC company, through your organization. When can I send my cheque? This is my good deed for the day; I have done my homework and am saving you a trip to my office,” she ended with a chuckle.

Silently, Rita groaned. A couple of weeks back, when the offer document for the bonds of ABC company had landed on her desk, Rita had flipped through the pages to check the health of the finances. There was an abridged version of the balance sheet included. She frowned. “Surely 'Other Income' should not be the main contributor to the 'Total Income' category. And they have no DRR for past liabilities. And wait, that is a huge amount under contingent liabilities.” She flipped back to the cover of the offer document. “AAA” stood out in bold letters. “How could this instrument get the highest rating?” She indignantly marched to her boss.

“Because,” he said, “ABC company happens to be one of the largest shareholders of the credit rating company that has given the AAA certificate,” her boss pointed out. Rita was speechless.

“Then the rating is misleading! And there is a conflict of interest. Didn’t we check the balance sheet before accepting the mandate to be their investment managers?” she continued.

Her boss shrugged. “Senior management has told us that this is a prestigious mandate. Can’t say no to ABC company. They are large and reputed. Have you seen the lineup of merchant bankers vying to sell their products? If we say no, it means less commission for our organization. Plus, the soured goodwill. Besides, there are others who will happily step in to push the paper.”

“Won’t the regulators have something to say about this?” asked Rita, hoping to find an answer she liked.

“Unfortunately not. Strictly speaking private placement of debt is not regulated, since the investor is not the common person, i.e., not a retail investor. Our investors are supposed to have the financial savvy to read the offer document and use their discretion,” replied her boss.

“Let me call you back in a few minutes,” Rita brightly answered the investor, before replacing the telephone.
Rita knew that the investor in question had neither the time nor the knowledge to analyse the balance sheet of ABC company. The debentures the company was selling would have received perhaps an AA or even an A rating from an unbiased credit rating agency, meaning they did not qualify as an investment for a Provident Fund.

Didn’t she have to tell the investor the true state of affairs? “No!” she said to herself. “Telling her would mean my company’s credibility might suffer. In the future she and other investors might view financial products being sold by my company with suspicion. It isn’t my company’s fault that the credit rating of the bonds of ABC company is misleading!”

She calculated the commission her company would earn from the deal. Nothing spectacular, but a reasonably attractive amount. “Won’t I be wrong to cause my company to lose out on this income?” she asked herself.

Another factor to consider was her career. Her departmental manager had recently introduced her to new recruits as “our star sales person who is great at building rapport with our investors.” Her quarterly sales could use a boost and she should consider herself lucky: “This investor called me up and is willing to send in a check without my having to work for it. Usually, we visit so many potential investors before successfully placing a debt investment.”

“But would it be right to sell debt at the cost to an investor?”

Rita wondered whether she was exaggerating the risks. “My seniors thought it fit to sell these bonds. Who am I to worry? ABC is a very large company. It’s not like it’s on the verge of bankruptcy or something.”

“Besides, I might be crossing some lines as far as my company’s mandate with ABC company is concerned. We sign some kind of agreement with them that we will work in their best interests, I think. ABC company is our client. I can’t possibly criticize one client to another! Not professional at all.”

With all these thoughts swirling in her head, she decided she needed go to her departmental boss for advice. But she slumped back into her chair when she recalled the words said by the company CEO during her training program. “You have been hand-picked for your intelligence and abilities. Make the best use of them. Don’t come to us with problems but with solutions. In this company, we appreciate those who show a 'can-do' spirit.”

“How do I do the right thing for everybody concerned? Is that even possible or am I being too idealistic?” Rita wondered.
End Note

In India, it is not mandatory for debt instruments (e.g., bonds, debentures, fixed deposits) that are being privately placed to have a credit rating certification at the time of approaching potential investors. However, many well-managed organizations voluntarily choose to have their debt instruments rated in order to help market the financial product. A high rating allows the organization issuing the debt (i.e., the seller of debt) to pay a lower interest on the debt instrument.

In India, a AAA credit rating is the highest possible credit rating that a debt instrument can receive. It signifies a very high level of safety and a high probability that the seller of debt will be able to service the debt (i.e., pay the interest regularly) and will be able to redeem the debt (i.e., repay the principal amount) at the end of the tenure of the instrument. Hence the interest rate that is paid out for such an instrument will be relatively lower than that paid on an instrument with, say, an AA rating.

In descending order of safety, the ratings given by CRISIL (a reputed Indian credit rating agency) for long-term debt instruments are: AAA, AA, A, BBB, BB, B, C, D and NM. Of these, only instrument which receive credit rating of AAA are considered as worthy of investment by Provident Fund Trusts.