Towards a Meltdown*

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India's financial sector is in the midst of a second crisis, even as the first in the form of a humungous mass of non-performing assets on the books of commercial banks remains unresolved. This time the problem is not of non-financial entities, especially corporations, defaulting on loans taken from the financial sector, mainly the banks, but of financial firms, mainly non-bank financial companies (NBFCs), defaulting on debt instruments they sold to banks, insurance companies and mutual funds. The current round of panic began when Dewan Housing Finance Limited (DHFL), an earlier favourite of investors, financial markets analysts and the policy-making establishment 'delayed payment' on a Rs.1,000 crore debt. The company claims it would meet all its interest and capital payments commitments that would fall due within the seven-day 'cure period available to it, to avoid it being in default. But that depends on its ability to sell large volumes of assets it holds, or shrink it business, to garner the resources to make the payment.

The DHFL scare is, of course, not the first sign of a major crisis in the NBFC sector. The NBFC crisis was first revealed in June 2018, when IL&FS defaulted on debt (mobilised through issue of commercial paper and inter-corporate deposits) of a smaller Rs.400 crore. But soon it became clear, when in early September another of the network of firms under its umbrella defaulted on a Rs. 1,000 crore loan from SIDBI, that the IL&FS crisis was large. As of now, the total debt of the more than 150 domestic companies in the IL&FS group is placed at around Rs.100,000 crore, with most of it in default in principle. To ensure orderly resolution of the problem through sale of assets and other means, the National Company Law Appellate Tribunal (NCLAT) has imposed a temporary moratorium on repayment requirements by more than 100 of the domestic companies in the group.

Resolution is taking long and questions as to who would carry how much of the burden of loss are still being answered. News of what caused the crisis and who all are responsible appears periodically in the media. But with the government having stepped in and replaced the incumbent management with a new board mandated to resolve the crisis, the fact that IL&FS signalled a much larger crisis was all but forgotten, except for those involved in or engaged with the problem. To others, IL&FS featured only as a company in which a set of high profile executives and their collaborators, who overborrowed through a complex web of companies they created, to invest in projects and lend to entities who were fed new loans or provided resources when they failed to generate surpluses and were on the verge of defaulting on past borrowing, manipulated the books to show profits that allowed them to pay themselves large bonuses. But the DHFL crisis is a reminder that that is only a small part of the story.

The narrative in circulation simplifies the problem even if it does not provide any easy solution to it. A number of questions remain unanswered. Why for example were these executives, who were celebrated and feted as the best brains in India's modernised and innovative, post-liberalisation financial sector, allowed to continue these activities for as long as they did, and even after a whistle-blower had revealed that all was not well with the firm? How did those who designed and executed these fraudulent activities escape the attention of major shareholders, including the Life Insurance Corporation, leading accounting firms, rating agencies ranking debt, the Reserve Bank of India and the Ministry of Finance? And, how even after the crisis broke did the larger economy-wide ramifications of that crisis remain concealed, leading to its being implicitly categorised as an instance of large scale fraud by a few rogue managers?

What the DHFL crisis indicates is that, however much parts of the public narrative on IL&FS are true, there is more to the issue that is being revealed to the public eye. While DHFL has thus far defaulted (in principle) on some of its loans, the real issue is that the company would be hard put to deliver payments on the rest of what in its case too is an estimated, close to Rs. 1,00,000 crore of debt. DHFL, unlike IL&FS, is not some kind of a government-sponsored entity, set up in the first instance with equity support from public entities such as the Central Bank of India and the Unit Trust of India, among others, and later from the LIC. The government had an important hand in its creation as a market-driven alternative to the development financial institutions (such as IFCI, IDBI and ICICI) that were being done away with as part of the financial liberalisation agenda. Those institutions, being specially funded by the finance ministry and the central bank to pursue specified development objectives and social mandates institutions, were it was argued distorting the playing field and preventing the realisation of the “efficiency” gains to be derived from the free operation of the market mechanism. So the argument that the government’s implicit sanction encouraged corruption and fraud cannot be applied to DHFL, which too is being accused of illegitimate practices in the form of an alleged siphoning out of funds to the benefit of the promoters.

In the post-DHFL default situation, the fraud explanation for the unravelling crisis, is being supplemented with a new theory summarised in the view that the crisis is one of a shortage of “liquidity”. When this rather opaque language is rendered transparent, it appears that the crisis is being attributed to the inability of NBFCs to access new loans from the market. Banks and other financial players are seen as having turned cautious and holding back on new lending, having burnt their fingers in the IL&FS episode and given their own NPA books. This is making it difficult for the likes of DHFL to borrow money to carry on their business. Hence, they are unable to service other loans that they had earlier taken.

To the uninitiated even this need not be too clear. After all, DHFL has exposure to a huge volume of housing and real estate assets, including in tier II and III cities. If those assets, in the form of loans to individuals and developers, are providing their promised returns, why should absence of new loans lead to default? And the emphasis on access to liquidity as the main problem, clearly suggests that large scale defaults on loans it has provided are not being seen as the source of DHFL’s troubles.

To cut the story short, it appears that DHFL has borrowed short term and lent out long term, so that returns on its lending cannot help clear all of its short term loans when they fall due. It needs to keep renewing those loans and obtain new loans, to sustain and expand its business, which if kept going would deliver returns higher than the cost of capital and cost of operations to ensure a profit. Because of the liquidity problem resulting from the banks turning tight-fisted, DHFL is being squeezed out of the market for credit, so that it is not able to secure the funds to meet its payments commitments and keep its business going. It would spell trouble if DHFL was not earning enough to meet its interest payment commitments. But it cannot be expected to earn enough to meet all the capital payment commitments falling due without access to new credit.

Thus, the NBFC crisis stems from two different sources. First, as happened in the case of IL&FS, there is the possibility that projects that were funded with borrowing went bad or did not deliver the returns they were expected to generate. Things worsened when in order to prevent these loans from going bad and affecting the solvency of the institution concerned more loans were advanced, either to the defaulting firm or to others who moved those funds to the potential defaulter in the form of investments or payments, so that the loan can be serviced. The NBFC in turn, in order to remain in business and service the loans which helped finance these projects borrows more. The spiral of debt unwinds. The second source of trouble, which seems to be relevant to DHFL, is that even when the projects financed by the NBFC may not be going bad, the fact that it is using short-term borrowing to provide long term loans to its clients, requires it to roll-over its own debt, or borrow again, to sustain its operations while repaying old loans that fall due. If for some reason the market is unwilling to roll-over loans and advance additional loans for expansion, the NBFC faces a liquidity problem. Being tied into long maturity assets It does not have the money to repay its own loans, leading to default.

The current NBFC crisis is a combination of these two. The first of the problems, epitomised by the IL&FS crisis, occurred partly because huge increases in liquidity in the years after 2003 led to a surge in lending, especially to the infrastructure area. Long term capital of that kind is best mobilised by issue of long maturity bonds, so that there is no maturity mismatch between the source of funds and its use, or through the operations of specialised financial institutions with access to government and central bank financial support and to government guarantees that permit low cost, long-term borrowing. Unfortunately, since the market for corporate bonds is not active in India and the government decided to shut down the development financial institutions as part of the liberalisation programme, neither of these sources of funding were available.

But the need for investments in infrastructure remained, especially because fiscal austerity had substantially reduced public investment in the area. The solution the government found was to get public sector banks and newly created and implicitly government-sponsored entities, like IL&FS, to undertake long-term lending. Being implicitly government-sponsored these latter firms not only received financial support from other public institutions like the LIC, but also were seen as being government guaranteed. Banks not only lent to infrastructure directly, but to these institutions and through them indirectly to infrastructure. Unfortunately, investments in infrastructure have proved to be extremely bad bets for multiple reasons. IL&FS had to crash and it did. That set off the train of events that now threaten the solvency of DHFL.

What about fraud? It cannot be denied that it played a role in IL&FS. But in a financially liberalised world, identifying where bad practices favoured by liberalisation end and fraud begins is difficult. If for example, a financial institution which is heavily exposed, long-term to a group or a project is faced with potential default that can have extremely bad repercussions for its own books of accounts, should it lend more to the entity concerned or let it default? If rules and monitoring do not prevent further lending, many managers may choose the soft alternative of keeping the project alive and prevent default, in the hopes that matters would improve. It is another matter that in a climate like that, some or many managers, looking to illegitimate gains or even their “performance-related” payment prospects, may choose to indulge in fraud. The causes for the crisis run deep, and the use of words and phrases like “fraud”, “liquidity shortage” and “environmental factors” only conceal the fact that deregulation and liberalisation explain India’s own financial meltdown.

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