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A YEAR AFTER IL&FS COLLAPSE

Debt, Destruction and Dithering

When the government superseded the IL&FS board and appointed Uday Kotak to head it, there was hope of a quick resolution. But the complexities and lack of legal framework to handle financial institutions' bankruptcy have clogged the system, say Saloni Shukla & Shilpy Sinha

ANIRBAN BORA

Ganesh Utsav, Mumbai's main festival and forerunner of hope for the business community, didn't bring much cheer to top bosses at India's biggest infrastructure financier last year. On the eve of the 10-day festival on September 12, the then VC and MD of Infrastructure Leasing & Financial Services (IL&FS), Hari Sankaran, was busy in meetings with top investment bankers, including Credit Suisse's India head Mickey Doshi. The meetings came two weeks after IL&FS reported its first default, and predated the sacking of the board, some members of which would later end up in jail.

Unlike in the past, those meetings were not for mandating banks to raise funds, but to sell assets to stay afloat. Items on the block included the IL&FS headquarters, a circular building in the heart of Mumbai's financial district housing corporations such as buyout fund Carlyle. The writing was on the wall. The house was on fire.

Even as the default of an unlisted blue-chip company sent shockwaves through the financial markets and threatened to engulf the system, New Delhi sacked the board and named billionaire Uday Kotak to fix the mess. At least, the action calmed the nerves.

MORE OF THE SAME

Twelve months later, the picture remains equally cheerless – dislocated financial markets, risk-averse mutual funds, wary investors, a fragile NBFC industry, and an economy where businesses are shuttering in the absence of credit, leading to worker layoffs. And not a penny of the ₹1 lakh crore of dues has been repaid.

"The 1992 securities scam, after two decades, is unresolved and not untangled," says Nilesh Shah, managing director at Kotak Mutual Fund. "Our success came in Satyam where a practical solution created value for employees, shareholders, lenders and the country."

What IL&FS leaves in the wake of its destruction are weaker banks, mutual funds, pension funds, and many more institutions. It has 348 subsidiaries and associates with operations spread from Spain to China and innumerable offices dotting the globe. Businesses range from sanitation projects to multi-lane highways to thermal power projects, and solar parks.

The sheer complexity of the operations and the lack of legal mechanism coupled with divergent interests pulling on all sides, any resolution of the IL&FS crisis could take years before the last creditor is paid off. After all, it took nearly a decade to settle claims in the Lehman Brothers bankruptcy.

"In large cases like IL&FS, banks are expected to go in for faster resolution wherein the promoters have to make sacrifices and banks as well will deal with it appropriately," RBI Governor Shaktikanta Das told ET in an interview.

IL&FS IN NUMBERS

Total debt ₹99,354 cr as on Oct 2018

PSB Exposure ₹35,382 cr

NCD Exposure ₹25,767 cr

A COBWEB OF COMPANIES

Kotak, the dealmaker, started with a bang and a plan. He hired advisors Arpwood led by former DSP Merrill Lynch's Rajeev Gupta and Nimesh Kampani's JM Financial to sell off assets.

A cash-flow solvency test was carried out to determine the ability to pay back lenders. As many as 157 out of 169 domestic IL&FS entities were categorised under three buckets - Green that could service loans, Amber reasonably sustainable with some financial engineering and Red with little hope. Under Green, the debt was worth ₹10,472 crore, Amber ₹16,372 crore, and Red ₹61,375 crore.

Orix of Japan, which is the second largest shareholder in IL&FS, bid to buy the renewable energy assets for a value that would cover the entire debt of ₹3,800 crore and result in an equity valuation of ₹500 crore.

"IL&FS has certain classes of assets which it has built. One category of assets should be grouped together, and an investor should be found who is interested in aggregate assets," says Sridhar Ramachandran, chief investment officer at IndiaNivesh Renaissance Fund that buys distressed assets. "Ultimately, the confidence will come with how quickly the group is able to monetise its assets and bring the cash-flow into the system."

While Satyam Computer Services fraud may have been resolved in a record time, the structure of IL&FS and financial dealings make it more complicated. Unlike IL&FS, Satyam did not have market borrowings and a complex corporate structure.

As infrastructure threw open opportunities in a country starved of roads, clean drinking water and electricity, it brought in as much procedural complications that became a breeding ground for red tape and corruption.

CAPITAL GIVER AND EXECUTOR

While at a parent level IL&FS was a lender, it did not stop at that. It began to be a major equity owner in roads, power companies and educational institutions. Much of its debt is equity in operating companies, which would make it difficult to recover as other assets are yet to generate cash. These businesses not only required capital at a project level but had to be ring fenced from other operations. Bureaucracy designed rules in such a way that it led to numerous legal structures for funding that ultimately became a vehicle for corruption.

The Enforcement Directorate (ED), the Serious Fraud Investigation Office (SFIO), the Delhi Police and tax authorities are all probing various alleged irregularities into the affairs of IL&FS. SFIO alleges the erstwhile management of IL&FS hid non-performing loans, falsified accounts and concealed material information for their benefit.

The probe charged former top management, including its long-time chief executive, the reticent but powerful Ravi Parthasarathy, with forming a "coterie" with its auditors and independent directors to defraud the company while running the business as their "personal fiefdom".

In a separate probe on credit rating companies, forensic auditor Grant Thornton flagged direct and indirect bribes in the form of sponsoring a football match, property deal and contribution to a trust in lieu of better ratings. The company was triple A until it defaulted. The next day it was junk.

While it piled up debt across the spectrum that led to its collapse, its quarrelling shareholders missed an opportunity to save the situation. Its IPO plan did not take off.

Shareholders such as Housing Development Finance Corp, Orix of Japan, State Bank of India and Life Insurance Corp after agreeing to buy shares in a rights issue, backed out. Furthermore, an offer from billionaire Ajay Piramal to buy a stake was turned down by LIC demanding ₹1,150 apiece against ₹750 a share offered by Piramal.

THE BEGINNING OF THE END

The financial services arm of the group – IL&FS Financial Services – defaulted on its commercial paper on August 28 but repaid it within two days. Soon after, on September 4, it defaulted on a ₹1,000-crore loan to Small Industries Development Bank of India. That sent mutual fund managers into a huddle on what could be in store for the rest if a triple A-rated company such as IL&FS defaulted.

As fund managers began to inspect their own books, they realised that the NBFC party has been going on for quite a while and that the punchbowl was being taken away.

The excesses of a bull market began to unravel. Many of the NBFCs have been borrowing for short term in the market, mainly in commercial papers (CPs), and lending to home builders and buyers for five to 20 years. The next big jolt came from mortgage firms when Dewan Housing Finance Corp Ltd (DHFL) began its slide.

On September 21, its triple A-rated bonds traded at an yield of 11% inflicting mark-to-market losses on its mutual fund portfolio. What began as a liquidity issue was beginning to emerge as a solvency issue. DHFL has since defaulted and is likely to inflict losses on lenders with a haircut of as much as 35%.

"A realisation dawned on how these guys were funding themselves," says Romesh Sobti, managing director at IndusInd Bank. "When growth was good at 20-30%, these guys got good valuations. Suddenly everybody woke up to the ALM (asset-liability mismatch) issue which brought in risk aversion."

TIMELINE OF IL&FS TAKEOVER

- **Sept 25, 2018** Ex-FM late Arun Jaitley holds urgent meeting with IL&FS stakeholders
- **Sept 27** Jaitley meets RBI officials, including former Governor Urjit Patel at his residence
- **Sept 28** Finmin officials start reaching out to potential board-member candidates
- **Sept 29** IL&FS hosts AGM to decide raising ₹15,000 crore
- **Sept 30** Finmin writes to MCA recommending IL&FS's board be ousted
- **Oct 1** Mumbai NCLT approves govt petition to fire IL&FS board

With mutual funds turning their backs on NBFCs, cost of funding climbed. The cost of funds for NBFCs has increased 60 basis points despite a 110-basis points reduction in repo rate by the Reserve Bank of India.

The slowing of the economy reflects in the economic growth rate that fell to a five-year low. Data due this week may show that the economy grew 5.7% in the quarter ended June, below the 5.8% pace seen in the previous three months. Car sales were the worst in 19 years in July, with shipments falling 31%.

POLICY REACTION

As the credit markets froze and shut out many lenders, the industry began to feel the pinch. With that came the chorus that a special liquidity package was needed to bail out NBFCs and prevent the crisis from snowballing into a larger solvency issue.

But policy makers led by the then Governor Urjit Patel and his deputy Viral Acharya stuck to their stance that imprudent business practices were at the heart of the trouble and the market should be allowed to correct itself, failing which it would be bailing out bad behaviour.

When Das succeeded Patel, there was hope. But he stuck to his predecessor's stance on special package for the industry.

"The liquidity window is a misnomer. The RBI cannot be giving clean money, unsecured money to NBFCs," Das told ET in an interview. "We have also interacted with the banks and they are trying to find market-based solutions to the problems like bringing in additional promoter equity, initiating stake sale, securitisation of assets."

But Das was generous with nearly 110-bps reduction in interest rates and pushing liquidity to surplus.

"RBI and the government have been trying to come out with policies helping NBFCs to get over the crisis to restart credit delivery," said Umesh Revankar, MD and CEO, Shriram Transport Finance.

As equity valuations fell from stratosphere, firms such as Piramal Enterprises have cut down their dependence on CPs and raised long-term funds. DHFL and Reliance Capital of Anil Ambani sold many businesses, including mutual funds.

"Well, there's an understanding that the funding model needs to change… too much dependence on short-term funds is unsustainable," says TT Ram Mohan, professor of finance at Indian Institute of Management, Ahmedabad. "The regulator has plans to introduce norms for improved liquidity at NBFCs. So, yes, some important lessons have been drawn."

The RBI and the government have announced several sops to restore confidence in the NBFC sector. Without announcing any bailout package or giving a liquidity window for the sector, it has relaxed securitisation norms, eased priority sector norms, provided partial credit guarantee, reduced rates, and recapitalised public sector banks to support growth. The Finance Bill 2019 has given powers to RBI to restructure NBFCs.

The collapse of IL&FS not only exposed imprudent business practices at the NBFCs, but also the lack of a legal framework to handle a financial market crisis. Although the government was able to enact a bankruptcy law for businesses in general, the special reform measure for the financial sector like something on the line of the FRDI Bill has been left out.

Absence of specific laws to resolve a financial services bankruptcy is also being felt. "It's hard to see that banks or systemically important NBFCs can be resolved along the same lines as non-financial companies," says Ram Mohan of IIM. "There are issues of systemic stability involved."

Sound policy making is not to let any crisis go waste. Will IL&FS lead to legislation to handle such crises in future?