IL&FS Issue

- **IL&FS - Basic Information**
  - Infrastructure Leasing and Financial Services
  - It was established in 1987
  - It was incorporated to fund/finance infra projects
  - It has invested heavily in the infrastructure projects
  - As on March 31, 2018 the stake in IL&FS was held by
    - Life Insurance Corporation of India - 25.34%
    - ORIX Corporation from Japan - 23.54%
    - Abu Dhabi Investment Authority - 12.56%
    - Housing Development Finance Corporation Ltd - 9.02%
    - Central Bank - 7.67%
    - State Bank of India - 6.42%

- **What actually happened?**
  - The debt to equity ratio was very high (18.7 which was 11.5 a year ago)
  - The passage of LARR forced the company to pay out a huge amount of compensation. It paid out compensation of about ₹ 17000 Cr
  - The company shifted from being a financier of the infra projects to owner of the projects (but this led to Asset Liability Mismatch - borrowing on short term instruments to invest in long term projects or in other terms it is a situation where your liabilities are short term in nature but the assets will generate revenue in long term). As the cost related to infrastructure projects shot up, the projects became unviable
  - Overdependence on the PPP model. The concessionaire presumed that the government would be playing an important role in getting clearances, land acquisition etc but the reality was entirely different
  - Huge amount with the government is under dispute in arbitration (the recovery rates are very poor in arbitration). As per Bloomberg article, the government owes about $90 bn to the company which have been locked because various disputes. The recovery through arbitration is very poor i.e. about 25 to 30% so the company can expect recovery of about ₹ 1200 Cr
  - The company earlier would simply finance the projects but later shifted the scope and started owning the projects

- **How it unfolded**
  - IL&FS invested in projects with a gestation period of 10 to 15 years by borrowing for a period of 8 to 10 years and then would get the project refinanced. But in the recent years the banks stopped refinancing and the company was forced to borrow from the market by issuing CPs and debentures
  - It all started in 2016 when the banks started reducing the issue of loans to the behemoth but the company borrowed money from the market on short duration debt instruments and on the other side it invested in long term assets. This led to a huge asset liability mismatch

- In August it defaulted on the payment of ₹ 1000 Cr that was issued by SIDBI, after which there were multiple defaults in the following weeks. After the company defaulted on repayments, SIDBI approached RBI
- It has also defaulted on Inter-Corporate Deposits
- The credit rating of debt instruments issued by IL&FS was rated at AAA (highest credit rating) till the end of august this year
- Since substantial part of its borrowing was in short term debt, it had a major impact on the NBFCs (some of the lenders had to sell their investments at discount in the market)
- The liquidity in the market was already tightening because of festival demand loans and advance taxes paid by the corporates, as a result of this the short term lending rates in the market increased
- To increase the liquidity RBI
  - Conducted OMO (Open Market Operations)
  - Further relaxed the norms under FALLCR (Facility to Avail Liquidity for Liquidity Coverage Ratio)
- SBI also has increased its asset buying target from NBFCs so as to increase the liquidity
- The total debt of the company for FY18 was ₹ 91091 Cr but the short term debt has increased form 9.9% of the total debt in FY14 to 15% of the total debt in FY18
- The government filed a petition at NCLT under section 241 and 242 of Companies Act which give NCLT powers to intervene in such situations. The NCLT has allowed government to take over the board of the IL&FS fearing a contagion effect. This will be the first time after 2009 (Satyam) that the government is rescuing a private company. Following this the government on 1st October appointed a new 6-member board to rescue the IL&FS, which has been headed by Mr Uday Kotak. The board held the first meeting on October 4th and is expected to provide the resolution by October 31

- **<u>The gravity of the crisis</u>**
  - It's not just an NBFC, it's a financial conglomerate as it has investments/businesses in various sectors/businesses (it is involved in building, operating and financing the infrastructure projects)
  - More than 61% of the borrowings of the company are loans from financial institutions
  - The commercial papers and debentures account for 3% of the total corporate debt market (2% and 1% respectively)
  - The mutual funds have a total investment of ₹ 6000 (i.e. they hold debt of IL&FS)
  - The total debt of IL&FS is presently pegged at over ₹ 90000 Cr
  - Bloomberg has reported that IL&FS has a debt repayment obligation of $500 mn in the next 6 months
  - Infrastructure investment will be hit (the Indian economy needs an investment to the tune of $1.5 tn in the next 10 years)
  - Borrowing will become costly for the market players

- **Concerns**
    - Spill over or contagion effect - already the lending rates have gone up by 20 to 30 basis in the market. Further if the company is not rescued, then the NBFC investors either will have to mark down (reduce the value) their investments or write them off. This would be disastrous not only for these companies, it would also suddenly lead to lower demand for such securities in the market, which would once again push up the lending rates. It is expected that there will be a shortage of close to ₹ 1 lakh Cr in the system because of the investments (in the form of CPS and NCDs - Non Convertible Debentures) getting jammed up with IL&FS
    - The mutual funds collectively are holding a debt of ₹ 6000 Cr of IL&FS are worried about their investments. If they do not realise it then it has to be written off
    - The margins of NBFCs (Non-Banking Finance Companies) and HFCs (Housing Finance Companies) will lower and in cases of losses, they will have to sell stocks which will create volatility in the market
    - This would definitely affect the shadow banking (this sector was attracting a lot of investors in the recent times and the credit growth rate was twice that of the banking sector; the instruments issued by these had an investment grade credit rating)
    - It may hinder the investments in infrastructure investment/plans
    - Revival is not easy as the whole structure of IL&FS is complicated (the board has recently stated that the number of entities under IL&FS are 348 rather than earlier expected number of 169)
    - The credibility of the credit rating agencies has come into question. The instruments of the IL&FS company were in the investment grade and the NBFCs did not have any cause of concern till it was too late (though the NBFCs have an internal mechanism to act on such investments, they get triggered only when they are downgraded)
    - Doubts over many of the infrastructure projects of the government as there would be need of huge financing
    - The commercial paper market was picking up in India in the recent times and this would be a body blow for this market
    - Corporate governance - what was the role of Board of Directors and why did they not blow the whistle earlier
    - Will the people who headed the organisation and pushed it into crisis be brought to book
    - Is it illiquid (assets not easily/quickly converted into cash) or insolvent?
- **Way forward**
    - Bring in new investors by issuing equity
    - Sell some of the assets. The company has already put its HQ in Mumbai along with 25 more assets on sale for many of which the buyers have shown the interest. It is expected that the sale of these assets would bring down the debt by ₹ 30000 Cr (the concern with this is that the whole process of sale to be completed it would take around 18 months)
    - Proposal to conduct rights issue
    - Lessons learnt from the GFC have to be acted upon

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