

**The ongoing liquidity crisis in the Indian financial system, with special reference to the  
Non-Banking Financial Companies (NBFCs)**

Author : Ria Vijay Vaghela, student at the University of Mumbai.  
Advisor : Karan Rajgopal, student at the University of Mumbai.

## Index

<b>Sr. No.</b>	<b>Particulars</b>	<b>Page No.</b>
1	<i>Author's Note</i>	1
2	<i>Abstract</i>	1
3	<i>Introduction</i>	1
4	<i>Main Body</i>	2
4A	<i>Review of Literature</i>	2
4A(I)	<i>What is NBFC?</i>	2
4A(II)	<i>How does a NBFC function?</i>	2
4A(III)	<i>Role of NBFC in the India Economy</i>	2
4A(IV)	<i>NBFC Crisis</i>	3
4A(IV)(i)	<i>Crux of the crisis</i>	3
4A(IV)(ii)	<i>Case study IL&amp;FS</i>	4
4A(IV)(iii)	<i>Effect of the crisis on the Indian Economy</i>	5
4A(IV)(iii)[a]	<i>Equity Market</i>	5
4A(IV)(iii)[b]	<i>Debt Market</i>	5
4A(IV)(iii)[c]	<i>Mutual Funds</i>	6
4A(IV)(iii)[d]	<i>FII's &amp; FPI's</i>	6
4A(IV)(iii)[e]	<i>Real Estate</i>	7
4A(IV)(iii)[f]	<i>Infrastructure Sector</i>	7
4A(IV)(iii)[g]	<i>Corrective Measures taken by the IL&amp;FS board</i>	8
4A(IV)(iii)[h]	<i>Measures taken by the Government, the RBI, and the SEBI</i>	9
4A(V)	<i>Current Liquidity Crisis and the 2008 Financial Crisis</i>	10
4A(V)(i)	<i>2008 Crisis summary</i>	10
4A(V)(ii)	<i>Comparative Analysis</i>	12
4B	<i>Data section</i>	14
5	<i>Recommendation for improvement in the Indian financial system</i>	26
6	<i>Summary</i>	27
7	<i>Conclusion</i>	28

<b>Sr. No.</b>	<b>Particulars</b>	<b>Page No.</b>
<b>8</b>	<i>Methodology</i>	28
<b>9</b>	<i>Bibliography</i>	28
<b>10</b>	<i>Appendix</i>	31

### **1. Author's Note**

This is my first research paper written for 'Symposium - The Research Paper Competition', the flagship event of Insight - NM College's Business, Finance and Economics Meet. The recent chaos in the Indian Financial Markets and the following liquidity crisis in the country caught my attention to select this topic. The entire paper shows how the entire crisis unfolded and the road ahead for India. I hope this paper gives all the substantial information needed to understand the the commonly stated "NBFC crisis" in the country and what measures have been and may be taken to revive the economy. I would like give special thanks to my advisor Mr. Karan Rajgopal without whom this research paper wouldn't have been possible. I would also like to show my hearty gratitude to all the faculty, mentors, and peers who gave their valuable inputs and generous advice for the success of the paper.

### **2. Abstract**

This research paper aims at providing an abstract look on the ongoing liquidity crisis in the Indian economy with a special reference given to the Non-banking Financial Companies (NBFCs) by not just looking at this crisis as the ultimate end of the golden days but a new beginning of something even better. It explains the series of events that unfolded the entire crisis with the help of the IL&FS crisis that created a panic and affected almost every sector and every market of the country. It further explains how the 2008 Financial Crisis and the current liquidity crisis are linked or similar yet not the same, and thus explains how the Indian economy is not very close to a crisis like the one in 2008.

The scope of this paper is heavily dependant on secondary source of information like blogs, articles, and magazines like The Economic Times, The Hindu Business Line, Livemint, Forbes, etc. which is readily available for public access.

### **3. Introduction**

The recent NBFC crisis in India caused a lot of chaos in every segment of the economy. The crisis looked very similar to the 2008 Financial Crisis which had a lot of consequences. The following study on the functioning of the NBFCs, and the comparative analysis between the causes and effects of the current crisis and the 2008 crisis will help gain great insights on the severity of the ongoing crisis and the effectiveness of the measures taken so far.

## **4. Main Body**

### **4A. Review of Literature**

#### ***4A(I). What is NBFC?***

Non-Banking Financial Company (NBFC) is a financial institution providing financial services or involving in financial activity as its principal business. Though very similar to a bank, it carries a few very interesting distinctions from a bank. It is a company registered under the Companies Act, 2013 with financial activity as their principal business and hence it cannot provide a few financial services.

1. NBFCs cannot accept demand deposits,
2. NBFCs cannot be a part of the payment and settlement system and cannot issue cheques drawn on itself, and
3. The deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs.<sup>1</sup>

#### ***4A(II) How does a NBFC function?***

If NBFCs are not allowed to accept deposits from the public (as mentioned in the RBI Act, 1934 and the Companies Act, 2013), it is important to know the functioning (how do they raise funds and how do they allocate or lend the funds) of the NBFCs.

While raising funds, CASA (Current Account Saving Account) is definitely not an advantage for the NBFCs. Thus, unlike banks, NBFCs cannot raise funds with such a small interest rate. They hence need to pay a higher interest in order to raise funds. The earning of the NBFCs is therefore dependent on the interest it pays and receives that leads to an arbitrage. The arbitrage results in the Net Interest Margin which is a value in reward for the investments made by the experts of the NBFC in the projects with higher risk-reward ratio, generating higher returns. NBFCs usually resort to borrowing loans from banks, issuing bonds, and issuing commercial papers (CPs).<sup>2</sup> They then lend this borrowed money in the retail segment.

#### ***4A(III) Role of NBFCs in the Indian Economy***

NBFCs play a very crucial role in the Indian Economy especially along with the Indian Banking Sector. From providing capital to individual borrowers in the form of EMI loans, to giving an opportunity to the bank rejected Micro, Small and Medium Enterprises (MSMEs) and their risky projects, to providing funds for infrastructure development where the returns can only be realised in a long time frame; NBFCs play a very important role in promoting inclusive growth in the country thus contributing majorly to the development of the Indian economy. P Vijaya Bhaskara, ex-Executive Director, RBI, once said that the size of the NBFC Sector has grown considerably over the years even after the slowdown of the economy. In terms of year-over-year growth rate, the NBFC sector has managed to beat the banking sector

---

<sup>1</sup> RBI Act, 1934, s 45I(f)

<sup>2</sup> Abhinav Pandey, 'How do NBFCs usually raise money in India' (iPleaders, 5 September 2017) < [blog.iplayers.in/nbfc-usually-raise-money-india/](http://blog.iplayers.in/nbfc-usually-raise-money-india/) > accessed 27 December 2018.

in most of the years between 2006 and 2013. On an average, it grew 22% every year. This shows, it is contributing more to the economy every year.<sup>3</sup>

#### **4A(IV) NBFC Crisis**

##### **4A(IV)(i) Crux of the Crisis**

NBFCs raise cash for meeting the short-term as well as the long-term requirements. Ideally, NBFCs borrow short term loans and advance them to their working capital requirements and lend as short-term loans at higher interest rates; and borrow long-term loans by issuing bonds and taking bank loans in order to lend it for long-term projects. However, in the real scenario, one cannot adhere to a perfect asset-liability balance. Their cash flows are usually imbalanced. NBFCs usually invest in very long-term and high risk projects where the returns are not likely to be covered any time soon. For example: if an NBFC has given a loan to a company for road construction, the principal and even the interest is not likely to be covered until the road is constructed and starts functioning. Also, the toll collection will take another decade for the interest and the principal to be completely covered. Furthermore, they do not have the benefit of maintaining floating cash due to a lack of CASA facility. Hence, NBFCs usually do not have fixed period receivables and thus no fixed period payables. This makes the entire functioning of the NBFCs even more risky. But such an imbalance to a certain level where short-term requirements are met is acceptable.

NBFCs, in India, started heavily borrowing CPs from mutual funds. These CPs were of three or six month duration. Being a short-term form of loan, this money should ideally have been used to advance loans for short duration and meet the working capital requirements but, that was not observed. However, after the IL&FS default, the Indian Stock Markets went considerably down. Investors started withdrawing money from mutual funds. In order to maintain liquidity within the fund and keep the fund running, the mutual funds stopped issuing CPs. Thus, a major source for raising funds was shut for the NBFCs and they faced a cash crunch. To make matters worse, when IL&FS default went live in the market, banks started getting reluctant on giving loans to NBFCs. Thus, the NBFCs started slowing down their disbursements<sup>4</sup> in order to maintain liquidity and not default on already existing loans. The fears in the market led to a hit in the stock prices of the firms.<sup>5</sup> Hence, the firms started selling their subsidiaries to raise funds and survive in the market. But this is only a temporary and a short-term solution to the cash crunch faced by the Indian NBFCs. Being the most important part of the Indian liquidity system, the NBFC crisis has led to a liquidity crisis in India where the Central Bank of the country RBI has to intervene and redress the economy of such a shock. In further sections of the paper, you will understand the severity of the crisis and the immediate need for RBI's PCA Framework to put into action.

---

<sup>3</sup> 'The role of NBFCs in the Indian Economy' (Nelito, November 2017) < [www.nelito.com/blog/the-role-nbfc-in-indian-economy.html](http://www.nelito.com/blog/the-role-nbfc-in-indian-economy.html) > accessed 27 December 2018.

<sup>4</sup> Shweta Punj, 'Can NBFCs be saved?' *IndiaToday* (New Delhi, 17 November 2018) < [www.indiatoday.in/magazine/the-big-story/story/20181126-can-nbfc-be-saved-1388905-2018-11-17](http://www.indiatoday.in/magazine/the-big-story/story/20181126-can-nbfc-be-saved-1388905-2018-11-17) > accessed 27 December 2018.

<sup>5</sup> 'How IL&FS default could impact Indian stock markets' (Livemint, 24 September 2018) < [www.livemint.com/Money/YD6mLpOi5J8EM56NfjjD4H/How-ILFS-default-could-impact-Indian-stock-markets.html](http://www.livemint.com/Money/YD6mLpOi5J8EM56NfjjD4H/How-ILFS-default-could-impact-Indian-stock-markets.html) > accessed 27 December 2018.

#### ***4A(IV)(ii) Case Study - IL&FS***

Infrastructure Leasing and Financial Services (IL&FS) was a sprawling financier of roads, bridges, and power plants. Being one of the most trusted and renowned NBFC in the country, its defaults on CPs made the entire credit system of the country jolt. A fear spread throughout the economy saying - if such a huge company can default on its payments, then how deep is the issue in its various subsidiaries? The reason why IL&FS held such a huge importance is because a large number of banks and companies were associated with IL&FS. Life Insurance Corporation of India (LIC) was a 25.3% stakeholder of IL&FS. Also, the rating agencies provided a high investment grade to IL&FS. Even after receiving such huge credibility in the market, if IL&FS can default, then there has to be some underlying problem that was huge or there has to be some huge fraud on the inside.

The IL&FS Group (the unlisted parent group of IL&FS) has 169 direct subsidiaries in the group, 135 are indirect subsidiaries, 6 joint ventures, and 4 associate companies.

The crux of the default lies in the Debt Pyramid (as stated by Forbes India) created by the parent IL&FS Group. To put it into very simple words, the parent raised INR 91,000 crore through debt, and only accumulated INR 9.83 crore through equity capital. Though a number of its subsidiaries are listed (eg: IL&FS Engineering and Construction Co., IL&FS Transportation Networks, and IL&FS Financial Services), a major portion of their equity capital was contributed by the parent group. Thus, the parent group raised debt from outside and infused the amount in the equity capital of its subsidiaries. The subsidiaries then would raise further debt (on the basis of their equity capital that was technically a debt) from outside sources.

Infrastructure projects require money on a very long-term basis. The range may vary from 15 to 30 years. The only option left with the infrastructure developers for raising such long-term funds was the government banks. However, in 2014, due to a pile up of bad debts, banks started withdrawing funds making it difficult for the developers to raise money. Also, it started becoming difficult to get environmental clearances. All this created asset-liability mismatch for IL&FS. In order to survive, IL&FS started utilising the funds raised for short-term to lend it for long-term projects. This move could have worked if the company would have been able to refinance its debt but that failed to happen. It also faced cash flow issues since it could not channelise its funds for its working capital requirement. Also, a number of its projects were stuck at various stages due to which it could not recover its loans given or its receivables claims. This created huge losses for IL&FS. The debt pyramiding which once proved to be a smart move, now put IL&FS in a huge debt trap.

An analysis of its balance sheet clearly shows that 80% of its assets are long-term in nature having a receivables claim on them. In the wake of taking corrective measures, IL&FS tried to sell off certain assets. However, that process would require a long time and the company did not have sufficient time before it could default. Finally on September 6, 2018, IL&FS defaulted on its interest payments to SEBI. The default amounted to INR 300 crore. The defaults, so far, have taken place at holding company level. The subsidiaries have managed to pay their interest on the loans.<sup>6</sup>

---

<sup>6</sup> Samar Srivastava, 'The Debt Pyramid' (2018) 10(22) Forbes India 34.

#### **4A(IV)(iii) Effect of the crisis on the Indian Economy**

##### **4A(IV)(iii)[a] Equity Market**

The crisis immediately spread panic in the market. The Non-Banking Financial Companies and the Housing Finance Companies had not expected such a crisis to occur any time soon. Also, the investors were turning risk-averse and withdrawing their money from the market. Even after publishing a number of releases that there have been no defaults on repayments by other NBFCs, the investors remained circumspect. The severity of the panic was felt when the stock price of IndusInd Bank (that had exposure to the IL&FS Group) fell by 8.52% (a 15-month low, even after making a contingent provision of INR 2.75 billion against its exposure to the IL&FS group) on BSE<sup>7</sup>; and Deewan Housing Finance Corporation's (DHFL's) stock went down by 60% on just one news stating that DSP Mutual Funds was selling DHFL's CPs at a steep discount<sup>8</sup>.

*"What is it we don't know but DSP did, was a thought that bothered us all. There was no trust left in credit rating agencies that had given AAA ratings to IL&FS before overnight labelling it as junk," Jayaraman recalls.*

The Indian Equity Markets saw a bearish tone with S&P BSE Sensex losing approximately 5547 points between 28th August 2018 to 26th October 2018. On the other hand, during the same period, Nifty50 dropped by 1708 points. However, it is to be noted here that the liquidity crisis along with the sudden rise in oil prices were the two major reasons for the downslide in the market.

##### **4A(IV)(iii)[b] Debt Market**

IL&FS crisis had greatly affected the mid-sized NBFCs. The top management of those NBFCs thus started focusing more on their solvency, and improving the management of credit, instead of focusing on growth or expansion of lending, and on other non-core business activities. The sole purpose in investing most of the time there was to calm and assure their creditors and corporate treasury heads that no such crisis exists or is about to occur in the company. The entire crisis had aroused tensions in the markets. In order to continue the cash flow cycle and survive in the market, the NBFCs (especially mid-sized NBFCs) needed Corporates and Mutual Funds to fund their papers. The sudden mass withdrawal of money from Mutual Fund sectors had compelled the Mutual Funds to stop lending and focus on their solvency. Also, as quoted in section 4A(IV)(iii)[a] *there was no trust left in credit rating agencies that had given AAA ratings to IL&FS before overnight labelling it as junk*, caused a major problem for the NBFCs to raise any debt from the market.

*"The NBFC sector is a victim of rumourmongering," rues Nirmal Jain, chairman, IIFL Group.*

---

<sup>7</sup> Nikhat Hetavkar, 'IL&FS Crisis Impact: IndusInd Bank stock falls 8.52%, hits 15-month low' *Business Standard* (Mumbai, 22 October 2018) < [www.business-standard.com/article/finance/il-fs-crisis-impact-indusind-bank-stock-falls-8-52-hits-15-month-low-118102201177\\_1.html](http://www.business-standard.com/article/finance/il-fs-crisis-impact-indusind-bank-stock-falls-8-52-hits-15-month-low-118102201177_1.html) > accessed 1 January 2019.

<sup>8</sup> Shailesh Menon, 'Panic selloff in stock market after IL&FS crisis: Is the NBFC party over?' *The Economic Times* (ET Bureau, 16 October 2018) < [economictimes.indiatimes.com/markets/stocks/news/panic-selloff-in-stock-market-after-ilfs-crisis-is-the-nbfc-party-over/articleshow/66230674.cms](http://economictimes.indiatimes.com/markets/stocks/news/panic-selloff-in-stock-market-after-ilfs-crisis-is-the-nbfc-party-over/articleshow/66230674.cms) > accessed 1 January 2019.

Due to rising non-performing assets (NPAs), the banks started narrowing their credit towards the NBFCs. On the other hand, there was a rise in the CPs and short-maturity NCDs available to the NBFCs. Thus, the NBFCs raised their lending by pumping 30% new credit in the economy. Unlike banks, NBFCs have no deposits and thus rely on more and more on outside loans in the form of CPs, NCDs and bank loans. These loans were of a short duration ranging from 1 to 3 years and the amount raised was furthered towards long term (approximately 15-year) projects creating a pressure. Finally, the loop broke and one of the biggest NBFC IL&FS defaulted in its payments. *With rate cycles in reverse and the IL&FS default, the spotlight is on an industry that has been punch drunk on declining bond yields and the CP market. "The combination of worsening liquidity and asset quality issues is plaguing the sector," agrees Devendran Mahendran of HSBC. "Redemptions from the money market and bond funds can lead to a liquidity squeeze at NBFCs and expose asset quality concerns which, in turn, could lead to more redemptions."*<sup>9</sup>

#### **4A(IV)(iii)[c] Mutual Funds**

Mutual Funds were greatly affected by the IL&FS crisis in September with a sudden 13% fall in the Assets Under Management (AUM)<sup>10</sup>. Liquid funds and Income funds experienced a halt in the inflows. On the contrary, investors started to withdraw money from the liquid and income funds. This withdrawal of money from the Mutual Funds affected the highly-leveraged small and medium sized NBFCs and HFCs a lot. But, that was not a major concern since these companies were liquid enough to pay for the CPs. They gained this confidence among the lenders as these NBFCs and HFCs used the amount borrowed from the CPs for meeting their working capital requirement. Mutual Funds confessed that they cannot ignore the NBFC and HFC sector completely. All they did was fund the papers selectively by rigorously checking the ability of the company to repay.<sup>11</sup> However, by the first week of October, surprisingly (considering the volatility in the equity market after IL&FS crisis), the retail investors regained faith in the market and started investing in equity and balanced funds, mainly through Systematic Investment Plans (SIPs)<sup>12</sup>.

#### **4A(IV)(iii)[d] FIIs and FPIs**

Uncertainty regarding the impact of the IL&FS crisis compelled the FPIs to remove money out of the Indian markets. They resorted to sector rotation by transferring the money to IT

---

<sup>9</sup> Ibid

<sup>10</sup> Suresh P Iyengar, 'MF assets fall 13% in Sept on IL&FS crisis, market mayhem' *The Hindu Business Line* (Mumbai, 8 October 2018) < [www.thehindubusinessline.com/markets/mfs-assets-fall-13-in-sept-on-ilfs-crisis-market-mayhem/article25159544.ece](http://www.thehindubusinessline.com/markets/mfs-assets-fall-13-in-sept-on-ilfs-crisis-market-mayhem/article25159544.ece) > accessed 3 January 2019.

<sup>11</sup> Shailesh Menon, 'Panic selloff in stock market after IL&FS crisis: Is the NBFC party over?' *The Economic Times* (ET Bureau, 16 October 2018) < [economictimes.indiatimes.com/markets/stocks/news/panic-selloff-in-stock-market-after-ilfs-crisis-is-the-nbfc-party-over/articleshow/66230674.cms](http://economictimes.indiatimes.com/markets/stocks/news/panic-selloff-in-stock-market-after-ilfs-crisis-is-the-nbfc-party-over/articleshow/66230674.cms) > accessed 1 January 2019.

<sup>12</sup> Suresh P Iyengar, 'MF assets fall 13% in Sept on IL&FS crisis, market mayhem' *The Hindu Business Line* (Mumbai, 8 October 2018) < [www.thehindubusinessline.com/markets/mfs-assets-fall-13-in-sept-on-ilfs-crisis-market-mayhem/article25159544.ece](http://www.thehindubusinessline.com/markets/mfs-assets-fall-13-in-sept-on-ilfs-crisis-market-mayhem/article25159544.ece) > accessed 3 January 2019.

sector. The FPI inflows and outflows in the month of September show the trend of withdrawal done by the FPIs and FIIs right after the crisis came to light. Withdrawals were observed from both the equity as well as the debt markets, however, the withdrawal rate from the equities was higher than the debt.

The private banks are most preferred by the FPIs in India. A huge withdrawal from the bellwether stocks such as HDFC Bank and Kotak Mahindra, contributed to the red trend of the entire sector. *“Barring IndusInd Bank, [...] was affected due to sizable exposure to IL&FS...,” said Digant Haria, AVP research, Antique Stock Broking*<sup>13</sup>.

#### **4A(IV)(iii)[g] Real Estate**

In the recent years, NBFCs have increased their credit towards real estate accounting for about 50% of the total financing in the sector. Real estate faced a massive cash crunch even before the crisis with banks refusing to disburse loans due to higher NPAs, delay in projects due to permission issues, and increasing debt-to-equity ratio of even the biggest developers. However, after the IL&FS crisis struck the economy, the NBFCs halted their loan disbursements to developers. In fact, some NBFCs also asked the developers to return the amount ended to them. Such a drastic step was taken due to the panic that spread in the economy. This panic led the NBFCs to be very careful about their liquidity and not end up defaulting like IL&FS as the IL&FS default had already created a problem in raising funds.

*As per the S&P BSE realty index data, the debt-equity ratio of the top 10 listed players (on a stand-alone basis) in FY2014 ranged anywhere between 0.10 to 0.85, which has increased in the current fiscal to range anywhere between 0.17 to more than 1. This may not seem overly alarming, but the situation is worse in the case of small and mid-size developers whose debt-equity ratio is much higher.*

*The major bailout option for most of these small developers is to possibly consolidate. It also needs to be highlighted that out of the approximately 10,000 developers in the country today, only 35-36 are listed. Hence, the financial numbers could be even worse.*<sup>14</sup>

#### **4A(IV)(iii)[f] Infrastructure Sector**

Infrastructure sector proved to be a cause for the crisis and also was impacted a lot due to the crisis. With the implementation and popularisation of the PPP (public-private partnership) programme in India, private companies opted for PPP model instead of EPC (engineering, procurement, construction) model. The main cause of the shift was the extent of government intervention in both the models. While in EPC, the private company was only responsible to deliver as per the contract, the government bore the costs and reaped the revenue benefits; in PPP model, the private company was completely responsible for the entire project - the private company bore the costs as well as reaped the benefits thereafter and then passed on the title to the government.

---

<sup>13</sup> Pavan Burugula, ‘FPIs offloaded private banks as IL&FS, rupee hit sentiment’ *The Economic Times* (ET Bureau, 23 November 2018) < [economictimes.indiatimes.com/markets/stocks/news/fpis-off-loaded-private-banks-as-ilfs-rupee-hit-sentiment/articleshow/66759662.cms](http://economictimes.indiatimes.com/markets/stocks/news/fpis-off-loaded-private-banks-as-ilfs-rupee-hit-sentiment/articleshow/66759662.cms) > accessed 3 January 2019.

<sup>14</sup> Shobhit Agarwal, ‘The NBFC Real Estate Crisis after IL&FS Defaults - What, Why and What Next?’ (Moneylife, 3 December 2018) < [www.moneylife.in/article/the-nbfc-real-estate-crisis-after-ilfs-defaults-what-why-and-what-next/55845.html](http://www.moneylife.in/article/the-nbfc-real-estate-crisis-after-ilfs-defaults-what-why-and-what-next/55845.html) > accessed 18 January 2019.

However, the problem with the PPP model was that the private companies (since the project decisions lied completely in their hands) refrained from taking up Greenfield projects and restricted itself to brownfield projects. The PPP model approach could have been a success in India if the companies wouldn't have faced problems of delays (due to geographical reasons, delay in permissions, etc.), reluctance of the banks to lend loans, poor health of the sponsors, stressed assets, etc. The problem escalated to an extent where the projects were not just delayed but some were taken to the bankruptcy courts. This escalation further locked doors for IL&FS as the receivables got delayed, banks refused to issue more loans, and it defaulted on its short-term repayments.

The entire crisis faced in the Infrastructure sector itself clearly shows that government needs to intervene and fund the infrastructure projects and not leave it completely in the hands of the private companies. This is required because of the domino effect prevailing in the sector i.e. a delay in one on-going project leads to a delay in all the other on-going projects<sup>15</sup>. For example; in 2013, Maharashtra's ambitious Mumbai trans-harbour link project received no bids when offered under the PPP route on concerns over viability. It was finally awarded in 2017 on contract basis. Hence, the move made by The National Highway Authority of India (NHAI) of scaling up the EPC Projects seems to be a good move for the moment<sup>16</sup>.

#### ***4A(IV)(iii)[g] Corrective Measures taken by the current IL&FS board***

After the IL&FS crisis came to the limelight, the government (a major stakeholder of the IL&FS Group through its fully owned subsidiary Life Insurance Corporation of India) intervened to help the group revive by adopting a Satyam style approach of setting up a new board in place of the old one to come up with turnaround strategies. The new board led by Uday Kotak<sup>17</sup>, started investigating the crisis and found a number of discrepancies in the business transactions of the IL&FS Group. The board finally sent its recommendation to NCLT saying that the only way to revive the group is through the divestment of either verticals or assets or subsidiaries. The board further says that the top-down approach of revival is not possible as it requires capital and capital infusion into the IL&FS Group is impossible as of now. *“Neither a takeover of all the activities of the holding company IL&FS, which had spread itself thin by a single entity, is possible nor can the company find the necessary resources by way of capital infusion in order to nurse itself and its subsidiaries back to health.”* The board feels that divestment is the only way forward. Considering the recommendations of the board, the group has already put two of its subsidiaries in the process viz. IL&FS Securities Services (ISSL), and ISSL Settlement and Transaction Services

---

<sup>15</sup> Mihir S Sharma, 'Behind the IL&FS crisis: India hasn't a clue how to pay for infrastructure' *Business Standard* (Bloomberg, 3 October 2018) < [www.business-standard.com/article/finance/behind-the-il-fs-crisis-india-hasn-t-a-clue-how-to-pay-for-infrastructure-118100300299\\_1.html](http://www.business-standard.com/article/finance/behind-the-il-fs-crisis-india-hasn-t-a-clue-how-to-pay-for-infrastructure-118100300299_1.html) > accessed 6 January 2019.

<sup>16</sup> Rachita Prasad, 'IL&FS crisis may sound death knell for PPP' *The Economic Times* (ET Bureau, 20 October 2018) < [economictimes.indiatimes.com/news/economy/infrastructure/ilfs-crisis-may-sound-death-knell-for-ppp/articleshow/66287864.cms](http://economictimes.indiatimes.com/news/economy/infrastructure/ilfs-crisis-may-sound-death-knell-for-ppp/articleshow/66287864.cms) > accessed 6 January 2019.

<sup>17</sup> 'Company overview of Infrastructure Leasing and Financial Services Limited' (Bloomberg) < [www.bloomberg.com/research/stocks/private/snapshot.asp?privcapId=3688660](http://www.bloomberg.com/research/stocks/private/snapshot.asp?privcapId=3688660) > accessed 6 January 2019.

(ISTSL). Other subsidiaries that may be divested include IL&FS Education, IL&FS Technologies, ONGC Tripura Power Company, and IL&FS Paradip Refinery Water<sup>18</sup>.

#### **4A(IV)(iii)[h] Measures taken by the Government, the RBI, and the SEBI**

IL&FS crisis spread panic all across the markets especially in the Financial Services Sector leading to a ‘liquidity crunch’ in the economy. The government, being one of the major shareholders of the IL&FS group and also the protector of the nation, had to intervene in the matter and resolve the issue. The RBI, responsible for maintaining liquidity in the economy and protecting it against the crisis led due to the IL&FS Group that is compared with the Lehman Brothers, had to intervene as well. And one of the major regulators of the Indian Markets marked with the responsibility to protect the investors - SEBI also had to intervene. The three regulators together are working on resolving the issue and assuring the investors of no such news in the future. All the measures taken by them include:

- *On 21 September 2018, RBI issued guidelines on co-origination of loans for priority sector lending and allowing banks and NBFCs to contribute credit jointly and share risks and rewards to align their respective business interests.*
- *On 27 September 2018, RBI amended the Basel III regulatory framework to incentivise banks to increase fund flow to NBFCs and HFCs. RBI allowed banks to reckon government securities held by them, up to an amount equal to the incremental outstanding credit disbursed by them to NBFCs and HFCs between 19 October 2018 and 31 December 2018, as level 1 high quality liquid assets, within the mandatory statutory liquidity ratio requirement. This move enhanced lending by banks to NBFCs and HFCs to meet their own statutory requirements.*
- *On 19 October 2018, RBI increased the single borrower exposure limit for NBFCs, which do not finance infrastructure, from 10% to 15% of capital funds till 31st March 2019. This step permitted banks to lend more to healthy NBFCs without breaching the regulatory limit.*
- *On 2 November 2018, RBI allowed banks to provide partial credit enhancement (partially stand-in as guarantors) to bonds issued by NBFCs and HFCs. This relaxation is subject to the tenor of such bonds being less than 3 years and the proceeds of such bonds being used for re-financing the existing debt of the NBFCs or HFCs. Further, the exposure of a bank to such credit enhancement has to be limited to 1% of the capital funds of the bank within the applicable single/group borrower exposure limits.*
- *On 19 November 2018, in a meeting of the central board of the RBI (Board) several points for upliftment of the financial services sector were discussed such as:*
  - *‘Economic Capital Framework’ (ECF) of RBI: ECF is essentially a framework that determines the share of RBI’s reserves and surplus to be passed on to the Government. On 26 December 2018, the RBI constituted an expert committee in consultation with the Government, to review the extant ECF. This committee has representations from the RBI as well as the Ministry of Finance and has been mandated to, amongst other things, review the status and justification of various provisions and reserves provided by the RBI, suggest adequate level of risk provisioning that the RBI must maintain and propose a suitable*

---

<sup>18</sup> S Murlidharan, ‘IL&FS crisis: Uday Kotak-led board deserves praise for quick action without going in for expensive bailout’ (Firstpost, 6 December 2018) < [www.firstpost.com/business/ilfs-crisis-uday-kotak-led-board-deserves-praise-for-quick-action-without-going-in-for-expensive-bailout-5682331.html](http://www.firstpost.com/business/ilfs-crisis-uday-kotak-led-board-deserves-praise-for-quick-action-without-going-in-for-expensive-bailout-5682331.html) > accessed 6 January 2019.

*profits distribution policy. The committee will submit its report within 90 days from the date of its first meeting.*

- *Basel regulatory framework: On the Basel regulatory framework, while the Board decided to retain the existing capital adequacy reserve ratio at 9%, it has extended the transition period for implementing the last tranche up to 31 March 2020. This implies that banks will now have more time to implement the capital adequacy reserve target. This move is aimed at reducing cost of borrowing and releasing more capital in the system.*
- *Restructuring scheme for stressed micro, small and medium enterprises (MSMEs): The Board decided to allow RBI to consider a scheme for restructuring stressed assets of MSME borrowers with aggregate credit facilities of up to INR 250 million.*
- *Relaxation of Prompt Corrective Action (PCA) norms (for meaning see Appendix 1): The Board decided to allow the Board for Financial Supervision of RBI to examine the issue related to PCA norms which imposes operational and lending restrictions on certain weak banks.*
- *On 29 November 2018, in connection with securitisation / assignment of loans by NBFCs, RBI relaxed the minimum holding period requirement for loans having maturity period of 5 years or more (until May 2019). RBI permitted the minimum holding period for such loans to be receipt of 6 monthly instalments or 2 quarterly instalments, subject to originating NBFC retaining a minimum of 20% of the book value of such loans or 20% of the cash flows from such loans.*
- *On 12 December 2018, SEBI, in its board meeting approved the exemption of specific HFCs (deposit taking HFCs and HFCs with asset size of more than 500 crores) and systemically important NBFCs from disclosure requirements under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (Takeover Regulations). Under the Takeover Regulations, shares taken by way of encumbrance are treated as acquisition and shares given upon release of encumbrance are treated as disposal and both these actions require disclosures to the stock exchanges and the target companies. HFCs and NBFCs have been exempted from such disclosure requirements.*
- *On 14 December 2018, another meeting of the Board was held for discussions on the way forward on the NBFC liquidity issue. In the wake of appointment of a new governor of the RBI, no significant decision was taken. However, extensive discussions were held on the existing liquidity status of NBFCs and the governance framework<sup>19</sup>.*

Considering the above facts regarding the measures taken already by the Government, the RBI and SEBI, it may be said that a positive way is foreseen because so far most of the measures taken have worked as expected. Also, with the rupee appreciating again and oil prices normalising again, it can be said that the country may get back on track soon.

#### **4A(V) Current Liquidity Crisis and the 2008 Financial Crisis**

##### **4A(V)(i) 2008 Crisis Summary**

After the Great Depression of 1929, the world victimised itself to yet another major crisis of 2008 often termed as ‘2008 Financial Crisis’ giving a lot of lessons to the world economics.

---

<sup>19</sup> Vidushi Gupta, ‘Flashback 2018: NBFCs stay afloat amid support from regulators’ *Financial Express* (7 January 2019) < [www.financialexpress.com/industry/banking-finance/flashback-2018-nbfc-stay-afloat-amid-support-from-regulators/1433612/](http://www.financialexpress.com/industry/banking-finance/flashback-2018-nbfc-stay-afloat-amid-support-from-regulators/1433612/) > accessed 10 January 2019.

Though the crisis originated in the US, it had its trickle down effect of many major world economies such as Iceland, China, Singapore, etc. The US faced a severe recession for two years after the crisis with effects like the fall of housing prices by 31.8% and unemployment above 9% to name a few<sup>20</sup>. It is very important for us to understand the crux of the 2008 crisis in order to understand whether India has managed to learn something from the crisis or is it on its path to yet another major crisis that may or may not hit the global markets but definitely worsen the conditions for India.

It all started when the mathematicians and innovators planned to enter the financial markets and develop something called 'financial innovation'. Derivatives was one such financial innovation that allowed the users to bet on the assets without actually owning them. They thought that they were making the markets safer (as it will help eliminate risk of loss on the stock market) but the fact was that derivatives was making the markets in the US very volatile and unstable. This is where some experts suggested regulation of derivatives segment which was denied several times. One of the top insurance companies at that time American International Group (AIG) was expected to offer \$1.6 billion to settle with regulators. It is to be noted that the volatility was so huge that the top players (refer Appendix 2) were running the economy and a collapse of any one of them lead to the collapse of the economy and hence, they were the great influencers when it came to passing bills and regulations in the financial markets. They started having a political domination.

The crisis started to take shape in early 2000's with the formation of the Securitisation Food Chain where the home buyers took loans from banks by keeping their home mortgaged with the bank. The banks put together all the types of loans such as home loans, car loans, etc. and clubbed them to form instruments like Collateral Debt Obligations (CDOs). These CDOs were sold to Investment Banks. Investment Banks got the CDOs rated where surprisingly most of the CDOs were given triple A rating which is the highest possible investment grade. They were then sold to the investors spread across the globe. So, ultimately, the home buyers were making their Mortgage Payments to the ultimate investors. Also, during the same time, there was a huge increase in the lending of subprime loans (refer Appendix 3) that eventually combined to form CDOs. Investment banks preferred subprime loans because they carried higher interest rates leading to a tremendous increase in 'predatory lending' (refer Appendix 4).

A bubble was created between 2001-08 where the housing prices shot up to a great extent due to easy mortgage loans despite the warning incidents in the same sector in the 1070's and 1980's where there was a minor rise in the housing price and the country had to bear a relatively severe recession. By 2007, the housing prices had shot up to 194% from the 1980's. The lending also increased from merely \$30 billion to an alarming \$600 billion in the last decade. The Investment Banks also started borrowing heavily to buy more loans and create more CDOs. The leverage ratios touched shocking 33-to-1 which indicated that a 3% fall in the market price will lead to a loss of more than 60% to the company. On the other hand, AIG, the security insurance company, started selling huge quantity of derivatives called 'Credit Default Swaps' (refer Appendix 5) to the investors who owned CDOs. However, it is to be noted here that Speculators were also allowed to avail Credit Default Swaps from AIG in order to bet against the CDOs they did not own. And, as these swaps were not regulated,

---

<sup>20</sup> Kimberley Amadeo, '2008 Financial Crisis' (The Balance, 7 November 2018) < [www.thebalance.com/2008-financial-crisis-3305679](http://www.thebalance.com/2008-financial-crisis-3305679) > accessed 15 January 2019.

AIG didn't bother to keep any reserves for repayment in case CDOs went bad. On the contrary, it paid huge bonuses to its employees. It meant that if the CDOs went bad, AIG will face a cash crunch and will not be able to repay the \$500 billion it of Credit Default Swaps that it had given.

In 2005, Raghuram Rajan, the then Chief Economist at International Monetary Fund, delivered a paper<sup>21</sup> at the Jackson Hotel Symposium where he said that instead of increasing profits by reducing the amount of risk, the companies were increasing the profits by indirectly increasing the amount of risk and this could lead to a huge crisis in the near future. However, he was criticised by the authorities then. By now, the borrowers had borrowed, on average, 99.3% of the price of the house, and there was more than 8000 such borrowers, and surprisingly 2/3rd of them were given a triple A rating by the rating agencies. Investment Banks like Morgan Stanley, Goldman Sachs, and Tricadia Magneter knew what was going on and hence they booked millions and billions of profits by portraying to the public that the CDOs were highly rated and that they must buy it and in private they bet against the CDOs they had designed with Merrill Lynch, J.P. Morgan, and Lehman Brothers thinking that the AIG will repay the amount to them when the CDOs went bad. So basically, the companies were booking profits at the public's losses. Also, the credit rating agencies didn't feel responsible enough to give genuine ratings and gave triple A ratings to help the investment banks. When asked to justify their ratings, all of them stated that these ratings were mere opinions and must therefore not be relied upon completely. The government also kept ignoring all the warnings given by Experts, IMF, and other world economies.

Finally the crisis unfolded in 2008-09.

1. On 16 March 2008, Bear Stearns ran out of cash and was acquired for \$2 per share by J.P. Morgan Chase. The deal was backed by \$30 billion in emergency guarantees from the Federal Reserve.
2. In September 2008, Lehman Brothers announced record losses of \$3.2 billion and its stock collapsed. Finally it was forced to declare itself bankrupt on 15 September 2008.
3. Lehman Brothers' failure caused a collapse in the Commercial Paper Markets and Money Markets which many companies depended on for meeting their operating costs.
4. Merrill Lynch was acquired by Bank of America as it was on the verge of a massive failure.
5. AIG owed \$13 billion in Credit Default Swaps that it was not able to pay because it did not have enough money.
6. On 17 September 2008, AIG was taken over by the government. The AIG bailout cost taxpayers a hefty \$150 billion.
7. Finally on 7 October 2008, President Bush signed a \$700 billion bailout bill. The bill was at a halt by the opposition of about a week and was only allowed to pass after the stock markets collapsed drastically and no other immediate redressal was foreseen.
8. By the year 2009, unemployment at reached a record high of 10% in the United States.

#### **4A(V)(ii) Comparative Analysis**

One of the major reasons why the investment banks were able to give out more CDOs before 2008 is because consumer credit and acquisition of loans increased and became very easy.

---

<sup>21</sup> Raghuram Rajan, 'Has Financial Development Made The World Riskier' *National Bureau of Economic Research*, Working Paper Series, w11728 < [www.nber.org/papers/w11728](http://www.nber.org/papers/w11728) > accessed 15 January 2019.

Later when the banks narrowed their loan disbursements due to increased NPA, the major source of funding for investment banks got blocked creating a bottleneck in the economy leading to such a huge crisis.

India has seen a rise in its consumer credit in the past years as many NBFCs provide easy EMI facility<sup>22</sup>. Also, due to a rise in the NPA's in the last two years, the banks in India have started narrowing their loan disbursements to NBFCs. This is what compelled them to raise short term funds and advance them to long term projects to some extent.

When Lehman Brothers defaulted in 2008, the world was taken aback and the markets crashed because it was termed to be "too big to fail". The same term was given to IL&FS and thus when IL&FS failed, the immediate collapse was seen in the CP Market or Money Market that many companies depend upon for their working capital and operating cycle requirement, which was exactly what was observed in the case of Lehman Brothers.

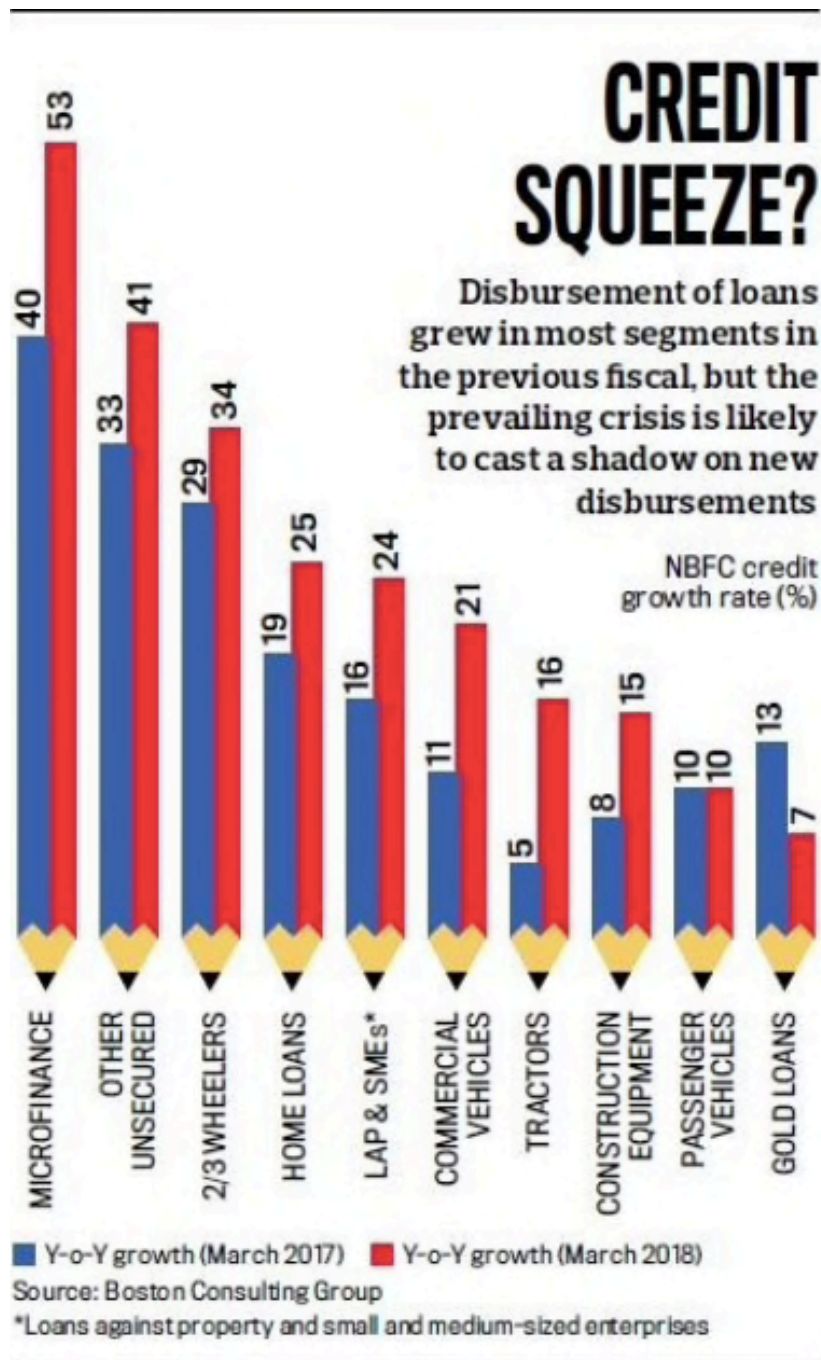
On the other hand, the rating agencies then did not give the ratings efficiently and hence, the rating of Lehman was triple A and was degraded drastically a day before it was forced to declare bankrupt. Similar was the case for IL&FS where all the rating agencies had given the top investment grade to the company and was drastically degraded to the worst grade. This clearly shows that India has failed to learn one major lesson from the 2008 crisis that is regarding the credibility of the rating agencies.

However, this liquidity crisis has not and may not escalate like the 2008 crisis as a number of measures have been taken by the concerned authorities [as stated in *4A(IV)(iii)(g)* and *4A(IV)(iii)(h)*] and efforts are under way to revive the situation.

---

<sup>22</sup> Samar Srivastava, 'The Indian Way of Debt' (2018) 10(19) Forbes India 46.

#### 4B. Data Section



Source: Boston Consulting Group

The above image shows the increase in the loan disbursements by the NBFCs in 2017-18 as compared to 2016-17. We see a sharp rise in the loan disbursements towards Micro-finance, Home Loans, LAP & SMEs, Commercial Vehicles, and Tractors. This indicates that the NBFCs were taking higher risk as the above sectors have a high chance of defaulting. NBFCs increased their unsecured lending without covering up the risk with secured loans.

# COUNTING THE LOSSES

The asset quality of NBFCs has deteriorated while complying with the 90-day NPA recognition norm

Non-performing loans (%)



Source: Boston Consulting Group

The Reserve bank of India sets NPA recognition norms in India. It says that any loans where the principal and/or the interest amount is not recovering or has been defaulted in the last 90 days of the last payment or the disbursement, it should be considered as a NPA and according to the provisions made, it should be written off as prescribed. The above graph indicates the Net and Gross NPA of NBFCs from the year 2013 to 2018. The graph definitely shows a negative result as the NPAs have drastically risen from 1.6% to 3.5% that raises concerns whether NBFCs may default in the future as well.



*Source: Yahoo Finance*

The price chart of S&P BSE Sensex showed a sharp downtrend from 28 August 2018 to 26 October 2018. The two main reasons for the start of the downfall were the IL&FS crisis marked by the fall in the Money Market and the market continued to decline due to rising oil prices. A major correction is thus made in the market and the prices show a positive sign again in 2019.



*Source: Yahoo Finance*

The price chart of NSEI Nifty50 index, also shows a similar trend as the Sensex did during the same time period. The reason was also the same. Here it is to be noted that the Financial Services Sector holds the highest weightage on the Nifty 50 index with 37.88% (*Source: NSE India Fact Sheet*). Thus, when the stocks of all the financial services companies fell after the IL&FS crisis, even though sectors like IT did well, the overall index saw a downtrend.



Source: *investing.com*

Nifty Financial Services Index certainly saw a steep fall after the crisis. However, it has managed to almost completely correct the prices and reach the levels before the crisis. It is to be noted here that the Financial Services sector has shown better performance after October as compared to the benchmark Nifty50 Index (at least as per the charts).



Source: *Yahoo Finance*

As discussed earlier in the paper, IndusInd Bank stock fell by 8.52% due to a high exposure to IL&FS. The above chart justifies the statement and shows the decline in its stock. However, IndusInd Bank has not managed to recover from the hit of the crisis.



Source: Yahoo Finance

As discussed earlier, the panic that spread after the crisis had serious impacts. The price of DHFL fell drastically after DSP released its CPs at a discounted rate. This is purely the result of emotions of fear in the market. However, DHFL is also struggling to do well right now.





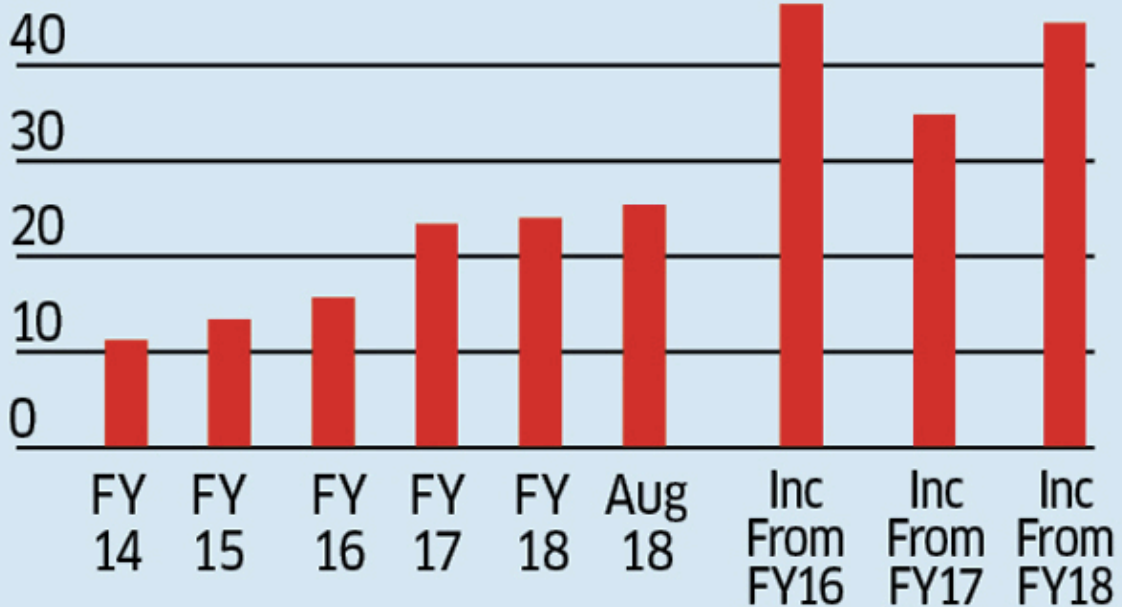
Source: Yahoo Finance

The above price charts show the trend in the prices of the subsidiaries of IL&FS group that are listed on BSE and NSE.

## Increased Reliance of NBFC/HFCs for Their Funding in Last 3 Years

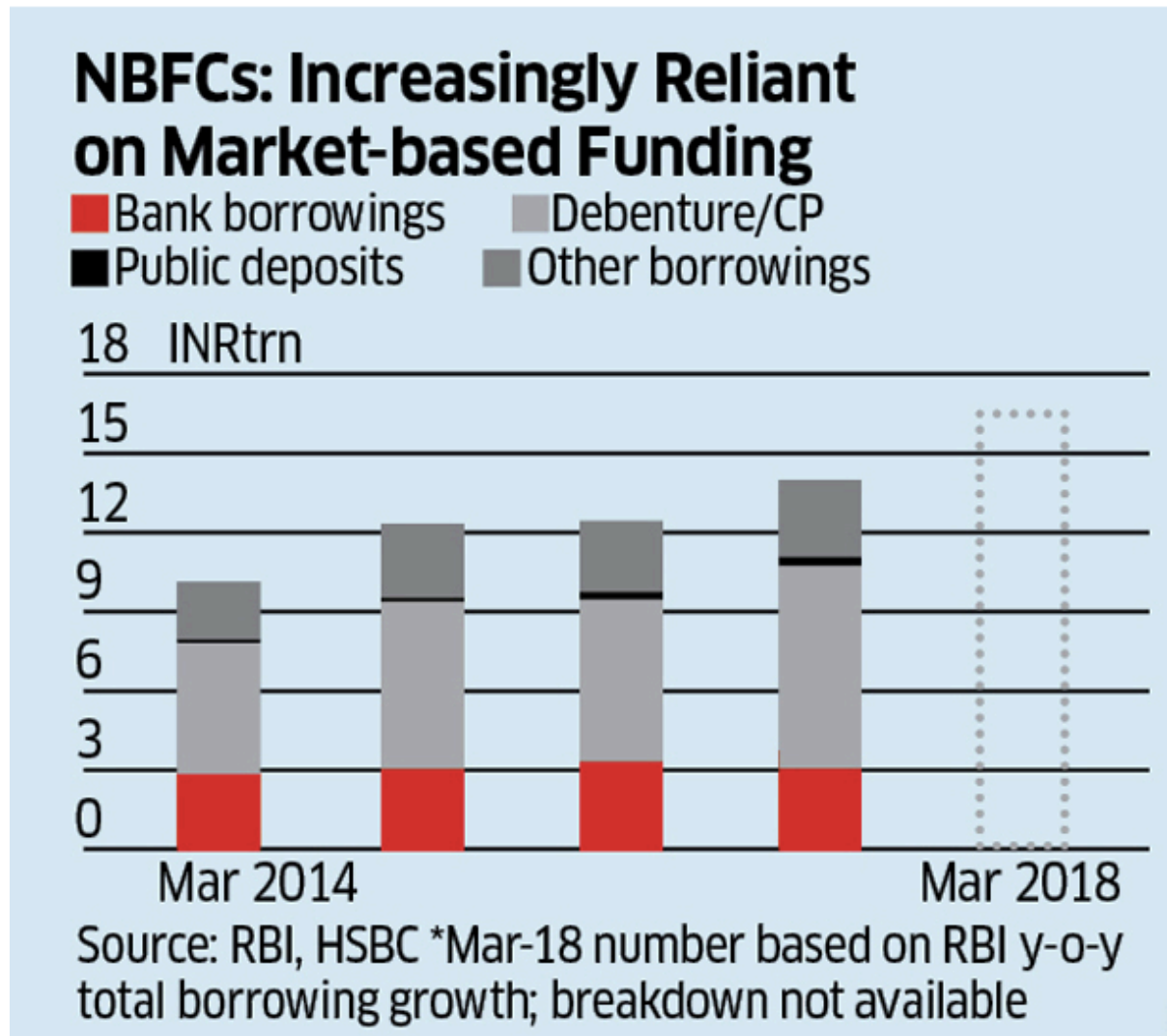
■ MFs (% of total holding)

50%

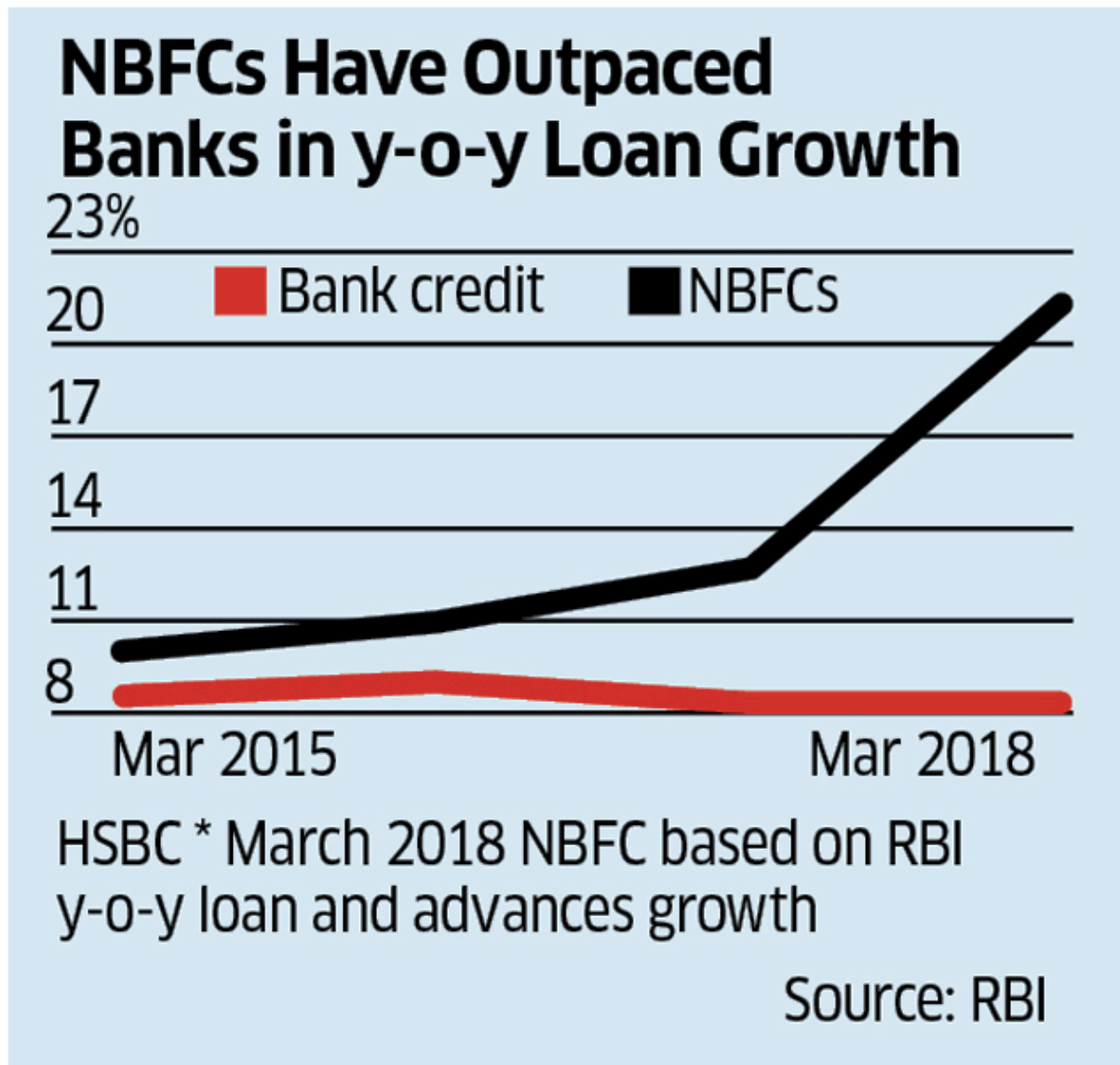


Source: ACE MF, ACE Equity, Nomura Research

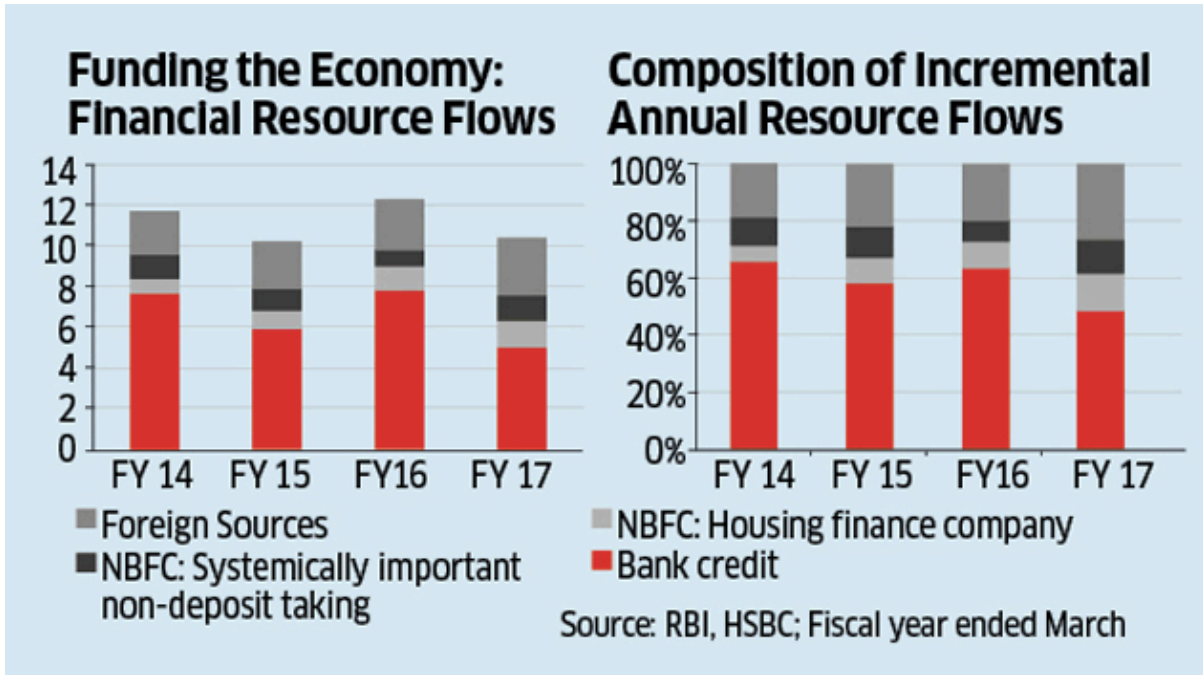
As we can observe in the above image, the NBFCs had started depending on Mutual Funds for raising funds not just in the year 2018 but the rise can be traced right from the year 2016. Thus, we can say that the NBFCs faced problems in raising funds through banks from the last two years and were relying on Mutual Funds for functioning. This created a definite asset-liability mismatch leading to such a crisis in the economy.



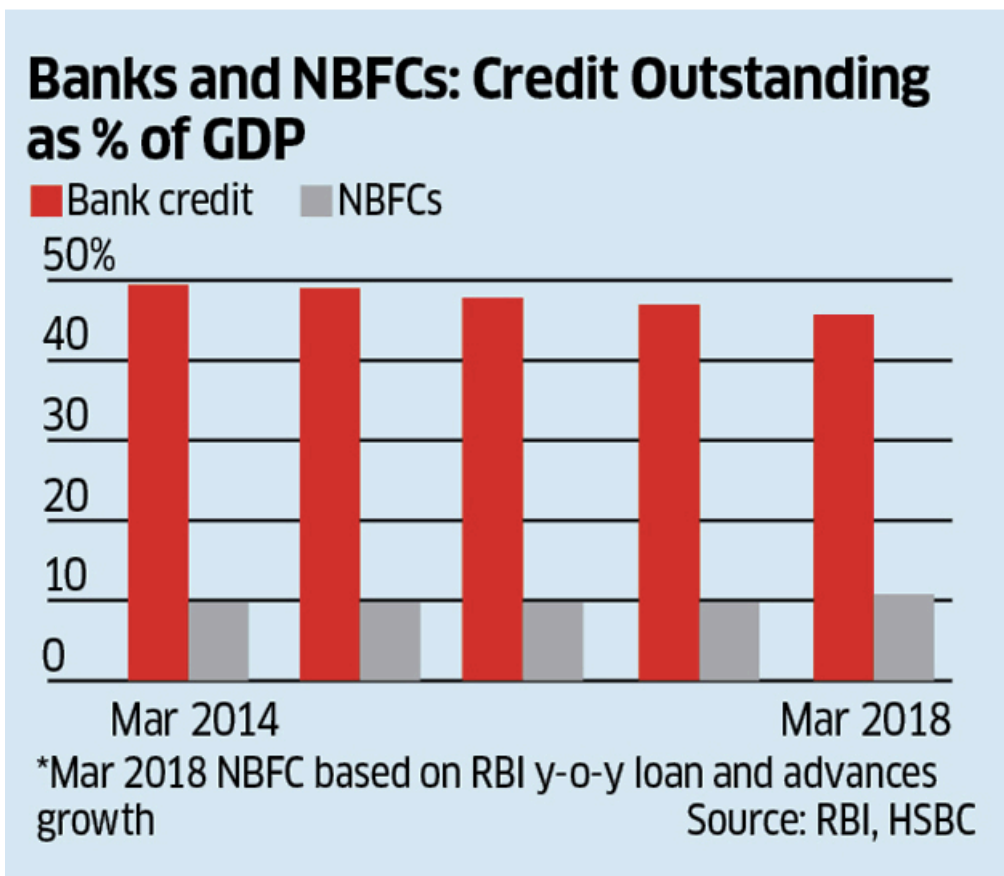
The above image clearly shows that the bank credit more or less remained constant for the NBFCs. However, the NBFCs started heavily depending on Debentures/CPs that are short term in nature.



In spite of facing problems in raising long term funds, the NBFCs continued advancing loans both long and short term. They in fact tended way more than the banks especially from the year 2016. This added on the mismatch between assets and liabilities of the NBFCs.

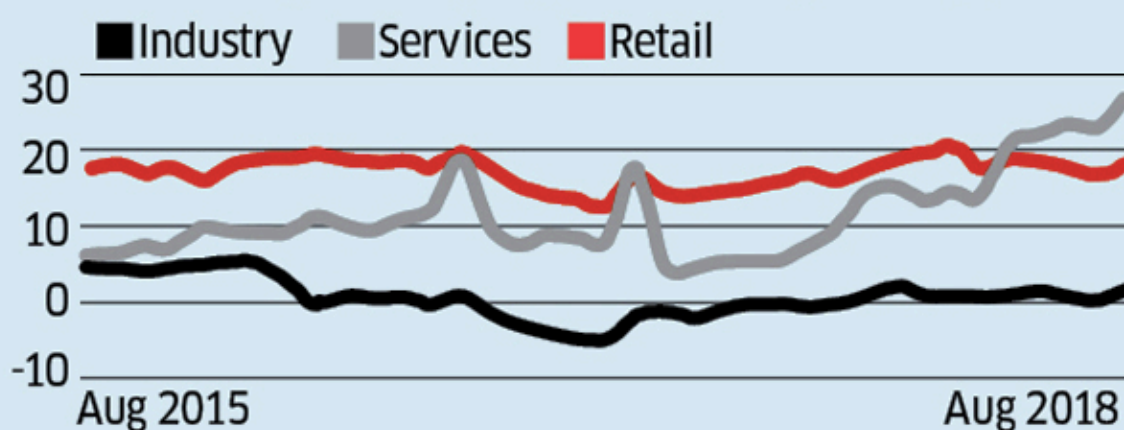


In the above chart also we observe how banks have reduced their loan disbursements but the NBFCs have managed to provide more credit in the economy even after facing issues in raising funds.



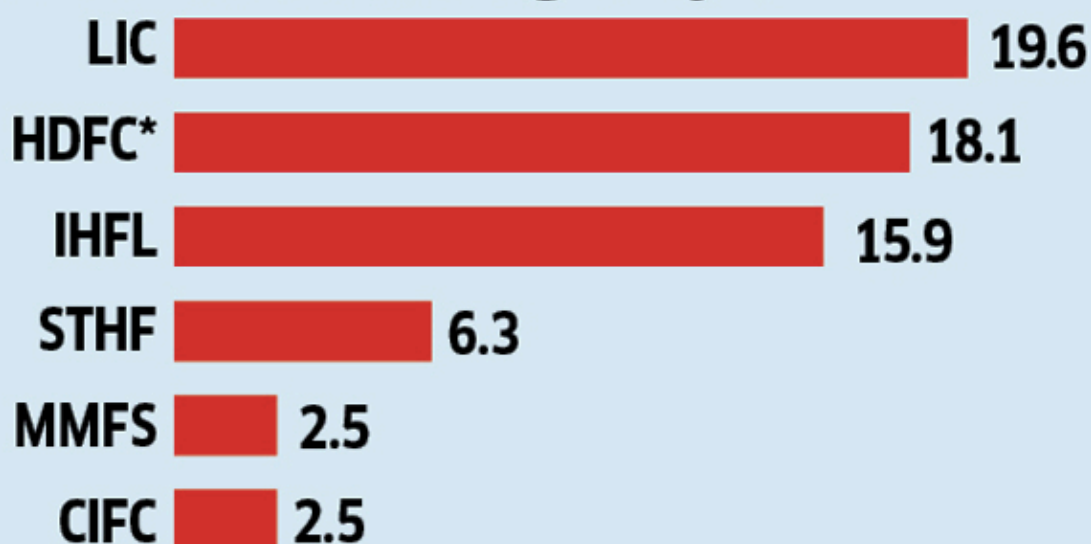
## Credit Growth Across Industry, Services and Retail Segments

Credit growth has picked up pace in the last few months. March fiscal year-end, Aug 2015 to Aug 2018 (%)



Source: RBI, Kotak Institutional Equities

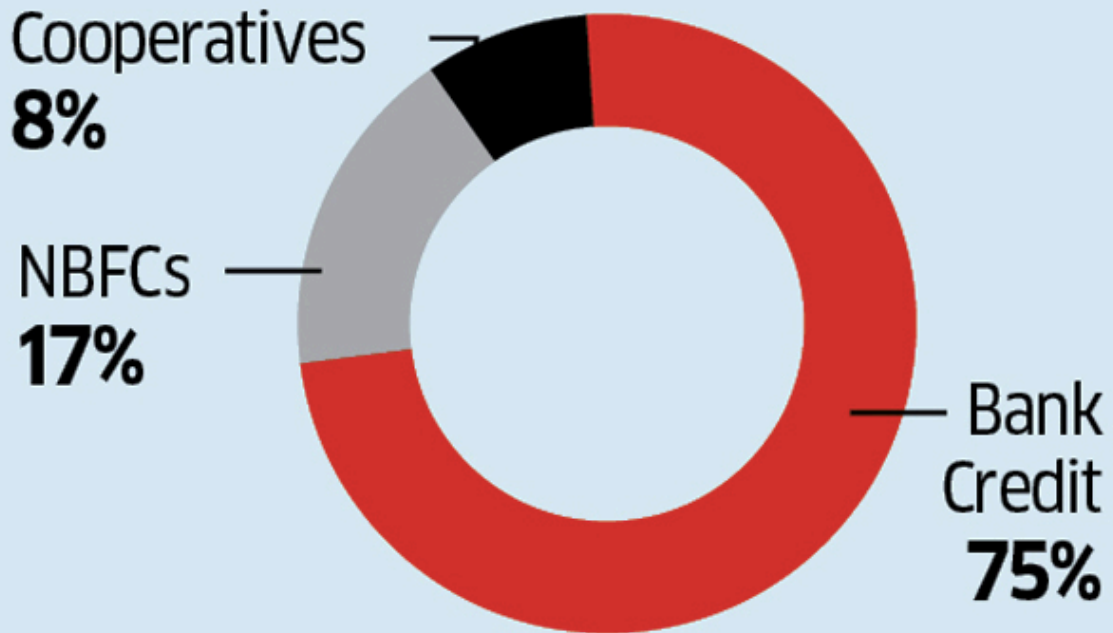
## Cash and Equivalents as a % of Liabilities Maturing in 1 year



Source: Company data, Marquarie Research Oct 2018 \*  
HDFC MF investments included as cash equivalents

## Outstanding Credit by Banks, NBFCs & Co-ops

Total as of Mar 2018: c ₹103trn (\$1.4trn)



\*Urban / Rural co-ops data as of Mar 2016 / Mar 2016  
Source: RBL, HSBC

Monthly FPI/FII Net Investments (Calendar Year - 2018)				
Calendar Year	INR crores			
	Equity	Debt	Hybrid	Total
January	13781	8523	-32	22272
February	-11423	-254	3	-11674
March	11654	-9044	51	2662
April	-5552	-10036	26	-15561
May	-10060	-19654	-61	-29776
June	-4831	-10970	7	-15795
July	2264	43	-43	2264
August	1775	3414	-44	5146
September	-10825	-10198	-11	-21035
October	-28921	-9978	-6	-38906
November	5981	5610	4	11595
December	3143	4749	-3	7889
<b>Total - 2018</b>	<b>-33014</b>	<b>-47795</b>	<b>-109</b>	<b>-80919</b>

\* The data presented above is compiled on the basis of reports submitted to SEBI/Depositories by DDP/Custodians and constitutes trades conducted by FPIs/FIIs on and upto the previous trading day(s).

\* No bifurcation of net investment data available before March 1997

*Source: National Securities Depository Limited (NSDL)*

The crisis had an impact on the FPIs and FIIs of the country. In the month of September and October, a lot of Foreign investments were withdrawn from the economy firstly because of the IL&FS crisis panic and secondly because of the raising oil prices.

### **5. Recommendation for improvement in the Indian financial system**

The liquidity in any economy depends highly on the banks and their NPAs. It is very important for the regulators to look into the matter of NPAs and try and reduce the amount of NPAs. The reason for this is clear when we understand how the banks function. Banks provide loans for either special purpose or general purpose to individuals and to corporates. When it comes to individuals, banks usually work on a “collateral basis” where the banks agree to accept a collateral in exchange of the loan and once the entire principal and interest is recovered, the collateral completely belongs to the individual. However, this is not the case when it comes to corporates because, not every time, can corporates provide a collateral since their requirement varies from operations management, working capital, inventory, infrastructure projects, etc., and in most of the cases it is not possible to keep a collateral. In such a case, to safeguard itself from having a cash crisis, banks keep reserves against the loans granted so that if there is any default, the banks are on the safer end and do not face a huge crisis. Non-performing assets (NPAs) are those loans that have not been able to recover the principal and/or interest in the last 90 days. A rise in NPAs leads to a rise in the liability of the banks and eventually leads to a decrease in the Net Profits of the bank. This is because, the banks take out certain portion from their net profits to meet the active and probable NPAs. Hence a rise in NPAs creates a mismatch between the amount deposited and lent in the bank and thus leads to a liquidity crisis. NPAs thus are a major cause of liquidity instability in any economy. India in the recent years has faced a huge rise in its NPAs. Thus, it is very important for the authorities like the RBI to intervene and work for reducing the NPAs. The PCA framework that the RBI had put into action for reducing the NPAs has not proved to show expected results so far<sup>23</sup>. However, in the near future when it hopefully works, the banks will regain faith and learn a lesson from this crisis India has faced by advancing decent amounts of loans to individuals as well as corporates only after a thorough background check (and not being biased to any of its wealthy and loyal customers). Also, this defenestration of the fear of defaults will help banks lend more to the NBFCs thus helping the NBFCs to use short term loans from CPs, etc. for short term goals and requirements of working capital and operational management and lend the long term loans from banks to the long term projects. This will help in avoiding any such liquidity standstill altogether in the economy.

It is equally important for the NBFCs to maintain their cycles well. It is crucial to ensure that short-term loans are advanced towards short-term requirements only. It is also important for them to examine the projects they invest in thoroughly before investing. Also, it is crucial to regulate the receivables well by foresting the worst, considering the current loan disbursements to NBFCs by banks and then lending. It is also necessary to regulate the group companies and ensure that the parent company does not invest the money raised from debt into the equity of its subsidiary and thus raise even more debt as this will create a debt trap and eventually a liquidity crisis.

Also, attention must be drawn towards the amount of loans that are given out to the people. India has seen a tremendous increase in the amount of EMIs and other types of loans given<sup>24</sup>.

---

<sup>23</sup> ‘Worst of the NPA crisis is over, says RBI report’ (Livemint, 1 January 2019)  
< [www.livemint.com/Industry/LohId3yWEeQ1D2rNKOVMDK/Banking-sector-on-course-to-recovery-as-NPAs-recede-RBI.html](http://www.livemint.com/Industry/LohId3yWEeQ1D2rNKOVMDK/Banking-sector-on-course-to-recovery-as-NPAs-recede-RBI.html) > accessed 20 January 2019.

<sup>24</sup> Samar Srivastava, ‘The Indian Way of Debt’ (2018) 10(19) Forbes India 46.

This can be an indicator that India is not learning something very important from the 2008 financial crisis<sup>25</sup> and may be creating a bubble.

Another major area to look upon is the Credit Rating Agencies. Credit Rating Agencies are often very laid-back when it comes to cases like the Lehman Brothers in 2008 or IL&FS in 2018. This raises a question about the reliability and accountability of the rating agencies and whether we learnt something from the 2008 crisis? The answer to the latter is definitely not. After the IL&FS crisis, SEBI, the body in-charge for looking over the performance of the rating agency adopted a disclosure-based approach to make its rate more reliable<sup>26</sup>. However, what it fails to provide is how accountable will the agency be. For that, SEBI must first cut out the “issuer pays for getting the rate” policy. This will remove any bias and conflict of interest. Also, certain strict rules must be set to hold the agencies accountable for the rates they give.

## **6. Summary**

Non-banking Financial Companies (NBFCs) are companies that cater to the needs of those who are in need of money, usually very long term in nature that banks cannot afford, by raising debt through various sources without being able to benefit from the CASA facility. In the last two years, the NBFCs in India started adopting pro-risk approach and increased their lending to a great extent. The problem here was that the amount raised by them was the same as banks started narrowing their lending to the NBFCs due to increased NPAs but the lending of NBFCs to very risky projects had increased. Thus, they started depending on short-term sources like Mutual Fund Houses that fund the money market and debt market to raise capital. They lent this short-term capital loan for long-term high risk projects that delayed over time and increased their receivables. This created an Asset-Liability Mismatch leading to a cash crunch. This scenario was unfolded and given importance only after IL&FS, one of the very highly rated NBFCs that was considered “too big to fail”, defaulted in its repayments. The panic sell off in the markets led to a crash in the equity markets with stocks related to IL&FS like IndusInd Bank and other NBFCs like DHFL crashing drastically. Some managed to correct the prices however, many still struggle to do so. The panic also affected the FIIs and FPIs in India that witnessed a very high withdrawal during September and October. Banks also started narrowing their loan disbursements making it very difficult for smaller NBFCs who had never defaulted on their payments and maintained clear books to raise sufficient funds. The Mutual Fund sector also was hugely affected due to a sudden withdrawal of money from debt schemes by the people. In order to maintain liquidity, MFs almost stopped funding the CPs for other NBFCs leading to further cash crunch for NBFCs. It was taking form of a vicious circle. Infrastructure and Real Estate were the two main sectors that included the cause and also suffered from the effect of this crisis. The delay in the projects of the sectors was a major cause for the increased receivables of the NBFCs while

---

<sup>25</sup> Vivek Kaul, ‘The World After Lehman Brothers’ (2018) 10(19) Forbes India 36.

<sup>26</sup> ‘Rate and Tell’ *The Hindu BusinessLine* (14 November 2018)

< [www.thehindubusinessline.com/opinion/editorial/sebis-move-to-see-greater-disclosures-alone-will-not-suffice-to-make-rating-agencies-accountable-for-their-slip-ups/article25498420.ece](http://www.thehindubusinessline.com/opinion/editorial/sebis-move-to-see-greater-disclosures-alone-will-not-suffice-to-make-rating-agencies-accountable-for-their-slip-ups/article25498420.ece) > accessed 20 January 2019.

the problem of raising more funds (considering the fact that it is not possible for the two sectors to raise funds only through banks and the government, and thus need the help of NBFCs) leading to a slowdown in the industry was the effect the two suffered due to the crisis. Chaos spread in the market and the crisis was compared to the 2008 Financial Crisis. It could have escalated to that extent. However, the government, the RBI and the SEBI, stepped in at the right time to revive the situation by immediately setting up a new board for reviving IL&FS that is working hard on divestment and other turnaround strategies for IL&FS; introducing and modifying the regulations and norms related to NPAs, Bank Credits, functioning of the NBFCs, Mutual Funds, and Credit Rating Agencies. The RBI also might modify its PCA framework put into action to reduce bank NPAs and may adopt another or modify the same PCA framework to respond to the crisis. In that way it may be able to induce faith back to the economy and save India from witnessing another major financial crisis in the years to come.

## **7. Conclusion**

The most definite conclusion drawn from the paper is that the current liquidity crisis is not as severe as the 2008 Financial Crisis. Albeit, the crisis demands for a prompt response from the authorities and they have managed to respond effectively so far. But, there is scope of more improvements to be implemented as quick as possible. The markets have corrected and are getting back on track after being hit by two major obstacles of the liquidity crisis and the rising oil prices with deprecating rupee value. Hence, I conclude by saying that the chaos in the economy is piping down and I anticipate that 2019 may be the year of healing for India and the economy will show positive results again after the damage has been repaired.

## **8. Methodology**

The “Desk Research” technique is used in this research paper. My advisor and I brainstormed on the structure of the paper and finalised on utilising the “external secondary sources” of information from the most reliable sources. Following the rules of this technique, we gathered the relevant information, compared the information with various other sources available and then analysed the entire data to draw worthwhile conclusions. The sources are cited using the OSCOLA (Oxford University Standard for the Citation of Legal Authorities).

## **9. Bibliography**

<sup>1</sup> RBI Act, 1934, s 45I(f)

<sup>2</sup> Pandey A., ‘How do NBFCs usually raise money in India’ (iPleaders, 5 September 2017) < [blog.iplayers.in/nbfc-usually-raise-money-india/](http://blog.iplayers.in/nbfc-usually-raise-money-india/) > accessed 27 December 2018.

<sup>3</sup> ‘The role of NBFCs in the Indian Economy’ (Nelito, November 2017) < [www.nelito.com/blog/the-role-nbfc-in-indian-economy.html](http://www.nelito.com/blog/the-role-nbfc-in-indian-economy.html) > accessed 27 December 2018.

<sup>4</sup> Punj S., ‘Can NBFCs be saved?’ *IndiaToday* (New Delhi, 17 November 2018) < [www.indiatoday.in/magazine/the-big-story/story/20181126-can-nbfc-be-saved-1388905-2018-11-17](http://www.indiatoday.in/magazine/the-big-story/story/20181126-can-nbfc-be-saved-1388905-2018-11-17) > accessed 27 December 2018.

<sup>5</sup> ‘How IL&FS default could impact Indian stock markets’ (Livemint, 24 September 2018)

< [www.livemint.com/Money/YD6mLpOi5J8EM56NfjD4H/How-ILFS-default-could-impact-Indian-stock-markets.html](http://www.livemint.com/Money/YD6mLpOi5J8EM56NfjD4H/How-ILFS-default-could-impact-Indian-stock-markets.html) > accessed 27 December 2018.

<sup>6</sup> Samar Srivastava, 'The Debt Pyramid' (2018) 10(22) *Forbes India* 34.

<sup>7</sup> Hetavkar N., 'IL&FS Crisis Impact: IndusInd Bank stock falls 8.52%, hits 15-month low' *Business Standard* (Mumbai, 22 October 2018) < [www.business-standard.com/article/finance/il-fs-crisis-impact-indusind-bank-stock-falls-8-52-hits-15-month-low-118102201177\\_1.html](http://www.business-standard.com/article/finance/il-fs-crisis-impact-indusind-bank-stock-falls-8-52-hits-15-month-low-118102201177_1.html) > accessed 1 January 2019.

<sup>8</sup> Menon S., 'Panic selloff in stock market after IL&FS crisis: Is the NBFC party over?' *The Economic Times* (ET Bureau, 16 October 2018) < [economictimes.indiatimes.com/markets/stocks/news/panic-selloff-in-stock-market-after-ilfs-crisis-is-the-nbfc-party-over/articleshow/66230674.cms](http://economictimes.indiatimes.com/markets/stocks/news/panic-selloff-in-stock-market-after-ilfs-crisis-is-the-nbfc-party-over/articleshow/66230674.cms) > accessed 1 January 2019.

<sup>9</sup> Ibid

<sup>10</sup> Iyengar S. P., 'MF assets fall 13% in Sept on IL&FS crisis, market mayhem' *The Hindu Business Line* (Mumbai, 8 October 2018) < [www.thehindubusinessline.com/markets/mfs-assets-fall-13-in-sept-on-ilfs-crisis-market-mayhem/article25159544.ece](http://www.thehindubusinessline.com/markets/mfs-assets-fall-13-in-sept-on-ilfs-crisis-market-mayhem/article25159544.ece) > accessed 3 January 2019.

<sup>11</sup> Menon S., 'Panic selloff in stock market after IL&FS crisis: Is the NBFC party over?' *The Economic Times* (ET Bureau, 16 October 2018) < [economictimes.indiatimes.com/markets/stocks/news/panic-selloff-in-stock-market-after-ilfs-crisis-is-the-nbfc-party-over/articleshow/66230674.cms](http://economictimes.indiatimes.com/markets/stocks/news/panic-selloff-in-stock-market-after-ilfs-crisis-is-the-nbfc-party-over/articleshow/66230674.cms) > accessed 1 January 2019.

<sup>12</sup> Iyengar S. P., 'MF assets fall 13% in Sept on IL&FS crisis, market mayhem' *The Hindu Business Line* (Mumbai, 8 October 2018) < [www.thehindubusinessline.com/markets/mfs-assets-fall-13-in-sept-on-ilfs-crisis-market-mayhem/article25159544.ece](http://www.thehindubusinessline.com/markets/mfs-assets-fall-13-in-sept-on-ilfs-crisis-market-mayhem/article25159544.ece) > accessed 3 January 2019.

<sup>13</sup> Burugula P., 'FPis offloaded private banks as IL&FS, rupee hit sentiment' *The Economic Times* (ET Bureau, 23 November 2018) < [economictimes.indiatimes.com/markets/stocks/news/fpis-off-loaded-private-banks-as-ilfs-rupee-hit-sentiment/articleshow/66759662.cms](http://economictimes.indiatimes.com/markets/stocks/news/fpis-off-loaded-private-banks-as-ilfs-rupee-hit-sentiment/articleshow/66759662.cms) > accessed 3 January 2019.

<sup>14</sup> Agarwal S., 'The NBFC Real Estate Crisis after IL&FS Defaults - What, Why and What Next?' (Moneylife, 3 December 2018) < [www.moneylife.in/article/the-nbfc-real-estate-crisis-after-ilfs-defaults-what-why-and-what-next/55845.html](http://www.moneylife.in/article/the-nbfc-real-estate-crisis-after-ilfs-defaults-what-why-and-what-next/55845.html) > accessed 18 January 2019.

<sup>15</sup> Sharma M. S., 'Behind the IL&FS crisis: India hasn't a clue how to pay for infrastructure' *Business Standard* (Bloomberg, 3 October 2018) < [www.business-standard.com/article/finance/behind-the-il-fs-crisis-india-hasn-t-a-clue-how-to-pay-for-infrastructure-118100300299\\_1.html](http://www.business-standard.com/article/finance/behind-the-il-fs-crisis-india-hasn-t-a-clue-how-to-pay-for-infrastructure-118100300299_1.html) > accessed 6 January 2019.

<sup>16</sup> Prasad R., 'IL&FS crisis may sound death knell for PPP' *The Economic Times* (ET Bureau, 20 October 2018) < [economictimes.indiatimes.com/news/economy/infrastructure/ilfs-crisis-may-sound-death-knell-for-ppp/articleshow/66287864.cms](http://economictimes.indiatimes.com/news/economy/infrastructure/ilfs-crisis-may-sound-death-knell-for-ppp/articleshow/66287864.cms) > accessed 6 January 2019.

<sup>17</sup> 'Company overview of Infrastructure Leasing and Financial Services Limited' (Bloomberg) < [www.bloomberg.com/research/stocks/private/snapshot.asp?privcapId=3688660](http://www.bloomberg.com/research/stocks/private/snapshot.asp?privcapId=3688660) > accessed 6 January 2019.

<sup>18</sup> Murlidharan S., 'IL&FS crisis: Uday Kotak-led board deserves praise for quick action without going in for expensive bailout' (Firstpost, 6 December 2018) < [www.firstpost.com/business/ilfs-crisis-uday-kotak-led-board-deserves-praise-for-quick-action-without-going-in-for-expensive-bailout-5682331.html](http://www.firstpost.com/business/ilfs-crisis-uday-kotak-led-board-deserves-praise-for-quick-action-without-going-in-for-expensive-bailout-5682331.html) > accessed 6 January 2019.

<sup>19</sup> Gupta V., 'Flashback 2018: NBFCs stay afloat amid support from regulators' *Financial Express* (7 January 2019) < [www.financialexpress.com/industry/banking-finance/flashback-2018-nbfcs-stay-afloat-amid-support-from-regulators/1433612/](http://www.financialexpress.com/industry/banking-finance/flashback-2018-nbfcs-stay-afloat-amid-support-from-regulators/1433612/) > accessed 10 January 2019.

<sup>20</sup> Amadeo K., '2008 Financial Crisis' (The Balance, 7 November 2018)

< [www.thebalance.com/2008-financial-crisis-3305679](http://www.thebalance.com/2008-financial-crisis-3305679) > accessed 15 January 2019.

<sup>21</sup> Rajan R., 'Has Financial Development Made The World Riskier' *National Bureau of Economic Research*, Working Paper Series, w11728 < [www.nber.org/papers/w11728](http://www.nber.org/papers/w11728) > accessed 15 January 2019.

<sup>22</sup> Srivastava S., 'The Indian Way of Debt' (2018) 10(19) *Forbes India* 46.

<sup>23</sup> 'Worst of the NPA crisis is over, says RBI report' (Livemint, 1 January 2019)

< [www.livemint.com/Industry/LohId3yWEeQ1D2rNKOVMDK/Banking-sector-on-course-to-recovery-as-NPAs-recede-RBI.html](http://www.livemint.com/Industry/LohId3yWEeQ1D2rNKOVMDK/Banking-sector-on-course-to-recovery-as-NPAs-recede-RBI.html) > accessed 20 January 2019.

<sup>24</sup> Srivastava S., 'The Indian Way of Debt' (2018) 10(19) *Forbes India* 46.

<sup>25</sup> Kaul V., 'The World After Lehman Brothers' (2018) 10(19) *Forbes India* 36.

<sup>26</sup> 'Rate and Tell' *The Hindu BusinessLine* (14 November 2018)

< [www.thehindubusinessline.com/opinion/editorial/sebis-move-to-see-greater-disclosures-alone-will-not-suffice-to-make-rating-agencies-accountable-for-their-slip-ups/article25498420.ece](http://www.thehindubusinessline.com/opinion/editorial/sebis-move-to-see-greater-disclosures-alone-will-not-suffice-to-make-rating-agencies-accountable-for-their-slip-ups/article25498420.ece) > accessed 20 January 2019.

<sup>27</sup> Shukla S., 'What is prompt corrective action' *The Economic Times* (ET Bureau, 21 August 2017) < [economictimes.indiatimes.com/markets/stocks/news/what-is-prompt-corrective-action/articleshow/58139512.cms](http://economictimes.indiatimes.com/markets/stocks/news/what-is-prompt-corrective-action/articleshow/58139512.cms) > accessed 10 January 2019.

### **10. Appendix**

1. To avoid banks from getting very weak and bankrupt, the RBI has imposed certain limits called ‘trigger points’. If the banks reach or cross such trigger points, the RBI will come to their rescue. The actions or measures or process adopted for revival at that time is known as ‘Prompt Correction Action (PCA)’<sup>27</sup>.

2.

Top 5 Investment Banks	
1	Goldman Sachs
2	Morgan Stanley
3	Lehman Brothers
4	Merrill Lynch
5	Bear Stearns
Top 2 Financial Conglomerates	
1	Citi Group
2	J.P. Morgan
Top 3 Security Insurance Co.s	
1	American International Group (AIG)
2	MBIA
3	AMBAC
Top 3 Rating Agencies	
1	Moody’s
2	Standard and Poor’s (S&P)
3	Fitch

3. Subprime loans are the most riskiest loans as these are given (though at a higher rate) to individuals of firms that may not be in the positive to acquire regular loans and are usually rejected by the regular lenders for loans. The reason why they are so risky is because the chances of them defaulting are very high.
4. Predatory lending can be explained as a behaviour of a lender where the lender is ready to lend some amount to a borrower that the lender knows will default and may even backfire towards the lender. But the higher reward involved in taking such a high risk is the trigger point.

---

<sup>27</sup> Saloni Shukla, ‘What is prompt corrective action’ *The Economic Times* (ET Bureau, 21 August 2017) < [economictimes.indiatimes.com/markets/stocks/news/what-is-prompt-corrective-action/articleshow/58139512.cms](http://economictimes.indiatimes.com/markets/stocks/news/what-is-prompt-corrective-action/articleshow/58139512.cms) > accessed 10 January 2019.

5. Credit Default Swaps provided by the AIG was like an insurance policy for investors where the investors paid a quarterly premium to AIG and AIG in turn promised to pay the amount of the CDOs to the investors if the CDOs went bad.

