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TWO DECADES OF FAULTY CREDIT POLICY LATER, AN UNENDING RIPPLING EFFECT OF FINANCIAL CRISIS AND A STAGGERING ECONOMY: INDIAN FINANCIAL SYSTEM IN A CATCH 22 SITUATION?

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ABSTRACT - India, initially termed as one of the fastest growing economies of the world has recently struggled to keep her head above deep waters. The recent fall of Yes bank, NBFC giant IL&FS and many more brought to light that the situation is far from over and India is on its inevitable way to a morbid downward spiral. The introduction of LPG promised a brighter future with in all aspects but the many advancements under the same title is proving to be otherwise with more and more financial institutions coming forward with their rather sugarcoated balance sheets, stirring anxiety and fall out of many investors and credit blocks all over the nation. While addressing a webinar organized by the Indian Chamber of Commerce (ICC) on quantitative easing and credit risk, MD and CEO, Indian Bank, Padmaja Chunduru said Indian banking system is in a Catch-22 situation, balancing between credit growth and bad loans. The banks are being put under immense pressure as on one hand they need to assess the creditworthiness of their customers or the alarmingly cascading amount of NPAs, and at the same time balance it with credit growth. This conceptual paper tries to cover the time line from the infusion of LPG and how slowly but surely lack of proper monitoring and unrestricted lending policies lead to a financial crisis big enough to halt the entire nation's economy, or the ripple effect of overlooked bad apples in the banking system.

Keywords: Economy, NBFC, LPG, balance sheet, NPA, creditworthiness, banking system

1. INTRODUCTION

The recent event with Yes Bank, PMC, and NBFC giant IL&FS came about as a shock that to many. Institutions that were believed to be so big that they could never fail were tethering on the edges of a major crash. By now the tremors are felt all across the nation as some of the biggest seated institutions that caters to the financial needs of some of the most prominent sectors are crashing. Albeit coronavirus and irregular governance is constantly put at the center of the debacle, the blocks of crisis lay at the very foundation upon which the entire system is built. RBI and other banks have found themselves in between a rock and a hard place. The economy still reeling from the effects of demonetization and GST, took the NBFC shock rather hard and situations are moving out of hand with the pandemic.

2. THE INDIAN GOLDEN ERA – LPG (1990-91)

Though many believe India had planned on to liberalize, the government attempted to close the Indian economy to the outside world. With the rupee being almost inconvertible and a central planning system, high tariffs and import licensing prevented foreign goods from making its way to the domestic markets. The economy was already

in a state of current account deficit triggered by the Gulf war and resultant surge in oil import prices. With the exports falling, credits drained and investors losing confidence, Indian was in deep economic crisis during the 1980s. These lead to deficits that had to be met by borrowings, causing the accumulated debt of the government to rise rapidly, from 35% of GDP to 53% of GDP by end of 1990-91.

By June of 1991 the foreign exchange reserve depleted by half from a 1.2 billion in January. To bridge the situation an emergency loan of 2.2 billion dollars from IMF was to be secured by pledging 67 tons of India's gold reserve as collateral. With the transport of gold, the BOP crisis was stopped at bay, but the Chandra Shekar government collapsed giving way to Narasimha Rao government.

The Narasimha Rao government ushered in several reforms that paved way to changes under the umbrella term 'liberalization'. The first was to devalue the Indian rupee. India according to the then prime minister faced no soft options and was forced to open doors to foreign investment, alongside more streamlined industrial policies and slackened red tapism.

The economic policy reforms brought forth drastic results, with foreign investments flowing into the country. With GDP rising to 3 trillion dollars by 2019, the quality of life has also shifted. Though adversities such as widening inequality gap and social issues have seen a steady rise, they were believed to be a normalcy in the state of growth.

The opening up of the economy resulted in development which was fostered by entry of new firms and products, trade reforms and industrial deregulations. In the 1990s, the economic growth was mostly driven by export-competition sector and domestically oriented service sectors. It also saw removal of uncertainties of granting license, such that investment decisions no longer belong to the whims of bureaucrats.

3. THE ECONOMIC GROWTH OF 2000s, AND THE CLOSED ECONOMIC DEALS.

Corresponding to the closed deal environment there was an altered design of growth in the 2000s. After a sustainable growth from 1990s, India's exports became engrossed upon natural resources, and the construction sector became of prime importance to financial growth, and 'high rent' non-tradable sectors such as real estate and telecommunication followed suite.

From opening up in the 1990s, the economy fell into opaque deals where environment became more 'exclusionary' and not favorable to economic vitality. These deals between the political elite and economic elite was not confined to the natural resource sector, where licenses were provided to politically enhanced beneficiaries, but also telecommunication sector. Insider trading were a growing concern as investigations later on found certain private companies were in an advantageous position over others.

There are numerous reasons as to why such opaque deals environment thrived, some of which are;

i. Increased demand for minerals from China acted as a profit generation source and political elites made preferential license allocations to exploit the opportunity.
ii. Rapid economic growth of LPG stirred demand of infrastructural sectors like telecommunication sector and real estate.
iii. Growing importance of regional political elite in coalition government resulted in deals between them and powerful economic elite.

iv. Election campaigns grew posher which meant there had to be a steady fund flow from businesses informally, in return for unrestricted contracts, resulting in the regulatory dice being loaded in their favor; or pork barreling.

These factors caused a shift back to disordered deals post 2010 through their many negative impacts.

4. EXCESSIVE AND ILLEGAL LENDING POLICY OF 2004 AND THE GLOBAL ECONOMIC CRISIS OF 2008.

From the banking perspective the boom period saw excessive lending handing out loans to individuals and companies. Rather than a sustainable boom, these were booms out of closed deals between the elite. Loans are assets only when they are profitable, and they are profitable only when returned with interest. When gone unpaid, they are worse than good.

With the country already running on closed deals which were concealed then, the economic crisis of 2008 portrayed a risk of loans going bad. Since majority of loans were handed out without due diligence and proper regulation and mostly under influence of political elite or economic elite, the viability of these projects was often overlooked. And the booming economy only backed up the bank's erroneous mentality of less than cautious lending.

The economic crisis of 2008 struck hard and many of the debtors were badly hit. But the banks continued on the representations of a healthy loan system fig-leafing the accumulating amount of bad loans and NPA beneath some good loans and falsely polished balance sheet positions.

5. ASSET QUALITY REVIEW OF BY R. RAJAN – 2013- 2015

The years following the financial crisis, 2009-12 witnessed poor performance and default in payment lead to a detailed investigation by private agency, independent of the government under former RBI governor, Raghuram Rajan in 2013. The constant probing lead to banks opening up about the excessive amounts of NPAs that were hidden, or concealed. The Asset Quality Review process by 2015 brought about the staggering state of the Indian banking system and how close it was to falling apart.

The reasons as cited by the R Rajan committee for the growing NPA were as follows;

i. **Delusive optimism** – a key amount of 'zombie' or bad loans originated in the period 2006-08 when economic growth was strong and previous infrastructure projects were accomplished on time. Banks at such times generalize theses growth to the future and led out without due diligence

ii. **Sluggish growth** – with India opening up the economy she was more integrated with the world and more in tone with global movements, be it boom or depression. A global financial crisis thus, would have parallel effects of slowing down the Indian economy too. But believing that the economy is immune and strong demands were projected amidst the crisis.

iii. **Government permission and deliberate red tape –** governance problems after coal mine allocation and fear of investigation slowed down decision making of government. Stalled projects resulted in cost over runs and continued travails of power plants in a power shortage struck India, suggest government had not picked up sufficient pace.

iv. **Loss of promoter or banker interest** – when projects got delayed promoters had

little equity left, they gradually lost interest. Prior to the bankruptcy code, bankers had little ability to threaten promoters who were incompetent or even unscrupulous with loss of their project. Writing down debt was a bonus to promoters and banks did not want to call the unwanted attention of investigators. These projects thus, continued as 'zombie' projects. Hence, it was in everyone's interest to extend the loan by making additional loans to enable promoters to pay interest and pretend it was performing. The promoter had no need to bring in equity, banks did not have to term loan as 'NPA' and thereby decline their profits and government did not have to infuse capital. Thus, banks worked on illusionary profits.

v. **Malfeasance and fraud** – malfeasance and corruption may be an inclusionary part but it is hard to tell banker exuberance, incompetence and corruption apart. Banks were over confident and did very little independent analysis and placed excessive reliance on SBI Caps and IDBI. Outsourcing of analysis and creditworthiness checks can be viewed as a weakness in the system and ushers in likelihoods of undue influence.

   a. Frauds are often labelled frauds much after it takes place and bankers are slow due to fear of harassment by investigative agencies, without substantial interest in bring fraudulent parties before the law. Hence, bankers try to close stables much after the horse has bolted.

   b. With the deep state that the banks are in, trying to clean out NPAs and bad loans are further pushed away when the government introduces 'Demonetization'. Even as NPAs accumulate the focus was shifted to understand and grab a hold of the new economic factor unfolding rather out of the blue. Though stated to 'curb black or illegal money flow' in the nation, the sudden and timely inculcation of the policy was viewed by many through skeptical lenses.

6. DEMONETIZATION AND MORE NPAs

2016 witnessed yet another major movement by the government to curb black money and circulation of illegal currency within the country. Introduction of demonetization brought forth a new wave of chaos and ambiguity and most citizens scattered to their banks to deposit the banned denomination notes of INR 500 and INR 1000. The banks nor the common man was prepared for such a drastic change overnight. The following weeks saw long queues of people lining up before ATMs to withdraw cash and deposit back the banned notes, only to find out most ATMs ran out of cash.

The shock of demonetization hit rather abruptly which caused many businesses to crumble and even cost human lives in some parts of the country. Infusion of digitalization was another agenda behind the big move. But for a population invested largely on money transaction that account for almost 86%, accessing digital banking facilities, or bank cards proved to be tiresome and unrealistic at such short notice. A large number of people still living in rural areas are far from digitalization or its impact. The move is stated to have wiped at least 1% of the country's GDP and cost at least 1.5 million jobs, but failing to wipe significant amount of unaccounted wealth – which was the pivotal rationale behind the entire fiasco.

Digital transactions have grown, but RBI also found that value of notes in circulation has also increased by approximately 38%. With banks invested heavily upon demonetization duty and catering to needs of millions, the bad loans and rising NPAs were more or less ignored or concealed. And the wake of demonetization only resulted in many other previously good loans going bad, spiking up the NPAs. Infested with demonetization, banks shifted their focus to deal on present pressing matters and handing out credit were reduced to a large extend. With banks no longer providing adequate credit, shadow banks start becoming more prominent lenders.

7. SHADOW BANKS MOVE TO THE FRONT-LINE POST DEMONETIZATION 2016- 2018

7.1. What are shadow banks?

Shadow banking takes on different forms depending on the economy. In advanced economies where financial system is more mature, the role of shadow banking is more risk transformation through securitization, while in backward or developing economies, the activities are more supplementary to banking activities. They however operate outside the regular banking system and financial intermediation takes place with lesser transparency and regulation that conventional banks. *(Nandini, Jayanthi. "Concept of Shadow Banking in India." Global Journal for Research Analysis Nov. 2014)*

Coined by Paul McCulley in 2007 'shadow banks' provide a place for institutional investors and corporates to park liquid funds that provide ready access to their money, pays higher interests and traditional banks, and manages their cash.

7.2. At what cost?

The flowery concept came with thorns like;

i. **Risk concerns** – regulatory arbitrage was used to create shadow banking entities, where sometimes banks itself composed of parts of shadow banks. These entities have no access to central banking funds or safety nets, and with the large infiltration or chains, linking the entire financial structure, they became very vulnerable to shocks. They were more likely to pull the entire system down along with them. The huge size only adding to the amount of damage that can be resulted, as was evident from the global financial crisis of 2008.

ii. **Opaque transactions** – monetary policy might face challenges and distortion of information of monetary policy due to anonymity of size, structure, operations, linkage and branches

iii. **Pro- cyclicality** - As they remain mostly unregulated, they amplified pro-cyclicality of financial, economic and business cycles.

8. THE NBFC CRISIS 2018

IL&FS was set up in 1987 when a consortium of banks decided that there was an urgent need to for a financing institution in the infrastructure space that could be technical consultants as well. They grew to be one of the prominent players profiting from the boom of the 90's. But with the slackening of growth rate of Indian economy, dropped or paused projects and delays in payments, IL&FS relied more and more on debt financing amassing up to 90,000 crores in debt and hence proving to be a liability.

Another prominent figure was the DHLF from the housing sector. Disbursing loans with repayment time frames of about 20 years, they played on safe bets through interest incomes or a house to liquidate on default of payment. But the mismatch occurred when DHLF raised fund with rather short maturity periods ranging from 3-6 months, at cheap rates. This is where the asset-liability mismatch occurred. They issued

commercial papers to roll over these short-term payment dates with more commercial papers. Much like a Ponzi scheme, until they could no longer roll as lenders refuse to invest in anymore CPs.

When NBFCs don't have money to lend, that reduces credit flow to the economy, hitting the economy hard causing defaults on different loans.

8.1. How interlinked is the system?

Most of these bonds and CP are funded by large corporates and fund houses, along with MFs. MFs pool investments from general public and invest them elsewhere to claim better returns. While MFs are believed entirely to invest in listed shares of public companies, it is not the case if CPs and bonds have a higher return which induces them to invest. Thus, now not just big corporates but also the common man is dragged into the entire link or chain. The AAA rated bonds of IL&FS were termed junk overnight and this meant that the likelihood of default was high. NBFC stock took a plummeting hit over the next few days with defaults from them rising.

One such investor who faced default was DSP, a mutual fund's investment company and in order to raise funds they sold of 300cr worth of DHFL bonds at a discount, at a time when their bonds were still at a AAA rating.

Though there were proposals to move to long term bonds from short term CPs to override the asset-liability mismatch, the lack of trust resulted in the continuing fall in prices and the stock crashed. Investors lost their money and the economy had already dried up.

8.2. Factors involved

NBFC business model was flawed with the prevalent asset-liability mismatch, in boom times funding long term loans upon short term sources maybe routine but it is not the case in tough times. The number of times they rolled over CPs or raised additional loans to cover CPs increased to a point where they couldn't meet these liabilities.

The cycle was halted by a few defaulters and fears rose and contemplation whether this would spread as an endemic. As the fear grew, institutions refused to lend to NBFCs, raising the cost of funds to a whole new high.

Post demonetization with large amounts of money in the system, MFs and investors parked large sums of money with NBFCs, with prospects of earning profits. The easily available funds resulted in NBFCs expanding their loan portfolios.

By now NBFCs branches have infiltrated the major sectors of the economy, sectors commercial banks did not enter and involved huge funds. A fall this big can only mean disastrous. With NBFCs finding it hard to raise money, or the excessive cost to do so, the flow of credit in the economy would be brought to a standstill.

The MSME sector, adversely affected by demonetization and GST was an eminent target and also demand and consumption, the drivers of the economy. This further adds to economic slowdown, which could again hit banks with mounting NPAs in real estate and infrastructural sectors. In short, spurring on a rather vicious cycle of debt, costly finance, low viability of projects, sunk cost, default, and so on.

9. THE SINKING SHIP AND THE IMPENDING DOMINO EFFECT

The IL&FS scam was caused due to a liquidity crunch. They funded their needs usually from mutual funds but with the scam, MFs are reluctant to fund them anymore and thus, shifted focus to private banks. Some of the bigger NBFCs were

able to borrow. With the impact of COVID-19 causing many businesses to go under, creating more defaulters, further risks to economic growth and asset quality are increasing.

The continuing liquidity crunch will result in increased bad loan risks for banks both from shadow banks and parties that depended on shadow banks for funds. The wreck would much likely pass spillover from NBFCs to borrowers and ultimately to banks, which in turn affect their asset quality, leaving more NPAs, profitability and negative or bad credit. Recent examples of Yes Bank and PMC accentuate on this case, where common man is equally liable to lose in the fall of the giant.

Non-banking lenders have a large share in SME loans and the retail market further widening the likely damage all the way to the ultimate consumer. Real estate companies are already burdened and curbing down funds only adds to the burden. It could lead to more NPAs for the sector as they have a direct exposure to NBFCs.

With dried up credit, many more sectors including the automobile sector, steel and iron sector, housing loan sector, construction and developmental sectors are all facing the hit right in the gut, as most of these sectors depended on cheap funds by issuing capital or debentures and big portion of their funds came from NBFCs.

Low credit availability could lead to consumers refraining from consumption or capital asset purchases gradually bring down the entire demand. With demand and consumption hitting an all-time low, the entire economy and GDP can resultantly slump. This is followed after a major blow from demonetization and GST introduced earlier.

Coronavirus, only aggravated the situation. With RBI stepping in by taking over Yes bank and providing a moratorium and indulging in OMO to prevent NBFCs plummeting to the ground while crushing the economy under it, measures were taken. But the immeasurable lockdown rubs salt to the wound. With business shutting down and the economy on a standstill, the repayment is put on hold yet again. These have set up a stage of twin crisis for the NBFC sector – COVID-19 and liquidity.

9.1. How can COVID-19 impact NBFCs in India?

i. Payment defaults
ii. Delayed EMI repayments
iii. Loss of credit
iv. Depleting capital
v. Overall earnings

10. CONCLUSION: CATCH-22 SITUATION FOR INDIA

The Indian banking system is in a Catch-22 situation – trying to balance between credit scores development and dangerous loans. Loans to MSMEs to revive and bring them back is necessary for the longer run prospects of the country but lack of genuine credit backing makes it hard to lend them adequate funds in sensitive times as such. Despite the center's advice, banks are unwilling to break character from their risk-averse nature. If enough credit is not provided, there is heightened risk of failure of business but lending too much can take a toll on the already heavy-laden balance sheets.

From these conditions, and the primary defect of liquidity crunch, a conclusion can be drawn. The profits of the last two decades was not a result of surplus money with the people but due to the heavy dependence on debt funding or financing. Debt funding grew to such extents where the asset-debt ratio of some major companies reached over 30 times. The NBFCs and mainly shadow banks, were providers of liquidity to the economy, unlike commercial banks which were believed to be. With the rising liquidity crunch, NBFCs are finding it risky to be lending to

customers termed NPAs by banks and also many MSMEs with little or no credit rating, which would be a hard blow on India's GDP.

Cruising through hard times is no easy task, especially with a staggering amount of debt, lack of liquidity, fall in general confidence and a pandemic leaving financial havoc in the wake. Here, Galileo Galilei's "too big to fail" theory comes into play. Certain financial institutions are so large and wide spread that their fall can spew fire on the entire economic system and unhinge the balance. What is unfolding as India's own Lehman Moment, is potentially strong enough to break the nations back to a point where repairs would only mean trying to hold a dam by band aids. As stated by former RBI Governor Raghuram Rajan "bold government reforms that triggers animal spirits and implemented effectively on the ground is essential for India to come out of the COVID-19 setback". Focusing on small business that were hit both by the demonetization, GST, NBFC fiasco, and gripping chokehold of the pandemic is the need of the hour. Though 'athmanirbhar' is with great intent, rectifying deficiencies need to happen and happen quick and the view that money would slowly come in as the economy opens up might prove to be a little too late as these businesses would have shut down by then.

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