IL&FS's default casts shadow on India's non-banking financial sector

by Luo Weixiao

With India's banks troubled by non-performing loans, the non-banking financial companies (NBFCs) have been gaining market share to meet the credit needs by bank excluded customers in India these years. According to Reserve Bank of India (RBI), there are around 11,000 NBFCs registered in India and NBFCs accounts for 16% of the total credit market in 2017, comparing 13% in 2015.

Infrastructure Leasing & Financial Services (IL&FS) Group, a private NBFC that provides infrastructure services and financial services across India, together with its subsidiaries, is reported to default on several payments from June to September 2018, on its debt instruments. IL&FS is considered 'systematically important' by RBI (NBFC-NDSI), which raises money mainly by short term debt and do not take deposits. The default by IL&FS triggered great turbulence in the NBFC sector and resulted a market sell-off. Investors start to avoid exposure to NBFCs with the fear of contagion from IL&FS' default and debt papers are sold at a steep discount to meet redemption demand from investors. Under liquidity pressure and redemption pressure due to its exposure to IL&FS, DSP, a fund management company, sold INR 2-3bn worth of commercial papers of Dewan Housing Finance Corp Ltd (DHFC) at a sharp discount to raise funds despite its adequate liquidity and triggered a panic sell-off. DHFC's share price also plunged and has lost nearly two thirds of its market capitalization.

IL&FS is not the only company in the sector facing high leverage. SREI Infrastructure Finance and IDFC, first tier infrastructure funding companies in India, have lower EBITDA / Interest Expense ratio and higher Net Debt / Equity ratio than other NBFC-NDSI aggregate level since FY2015. Also, as shown in Figure 1, the RMI-CRI Forward 1-year Probability of Default (Forward PD) term structures as of 19 Oct, 2018 for SREI and IDFC is higher than NBFC-NDSI aggregate level, implying a higher probability of default in the following one year. The Forward PD works similarly to a forward interest rate. For instance, the 3-month Forward 1-year PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months. The figure asserts that the credit quality of both SREI and IDFC might worsen, rising over the next few years, relative to its peers.

	EBITDA / Interest Expense (X)			Net Debt / Equity (%)		
	FY2017	FY2016	FY2015	FY2017	FY2016	FY2015
IL&FS	0.98	1.34	-	859.41	592.10	-
SREI	1.48	1.30	1.15	617.51	526.51	566.27
IDFC	1.21	1.29	1.30	292.20	240.40	295.07
All NBFC-NDSI	1.49	1.74	1.64	181.98	238.88	212.04

Table 1: Financial figures for IL&FS, SREI, IDFC and NBFC-NDSI. *Source: Bloomberg*

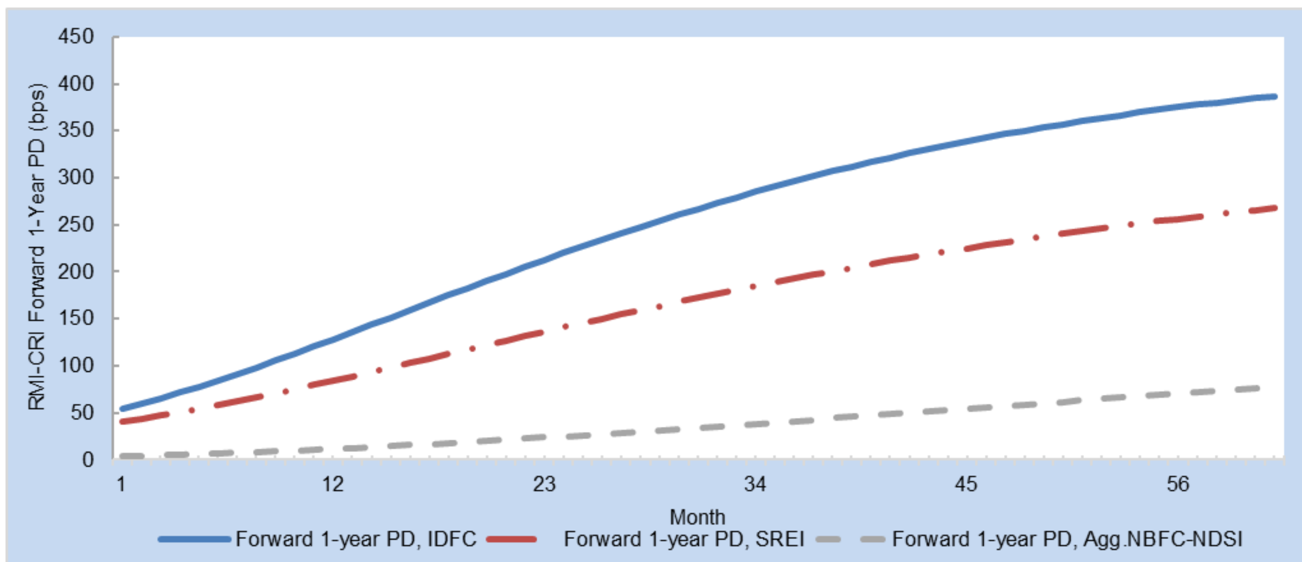

Figure 1: RMI-CRI Forward 1-year PD term structures for SREI, IDFC, and NBFC-NDSI on 19 Oct, 2018. *Source: RMI-CRI, Bloomberg.*

IL&FS was granted quasi-sovereign rating before default. Three of the biggest India's credit rating agencies, ICRA, India Ratings & Research and CARE Ratings, granted IL&FS a 'AAA' rating, indicating the highest level of credit quality, and downgraded to a rating of 'D' within a month after its default. The dramatic drop in credit rating in a short period of time causes investors to be suspicious of the credit rating quality as the rating agencies fail to flag the risks.

After getting an approval from the Insolvency & Bankruptcy Court, the government has taken control of IL&FS and instituted a new board. Going forward, NBFCs are likely to receive increasing regulatory scrutiny. RBI has initiated a special audit on IL&FS. In its recent policy statement, RBI also says it is looking at strengthening its guidelines with respect to NBFCs in the wake of the recent scare.

RBI has banned IL&FS from issuing commercial papers for up to six months. Given the potential tightening of regulations and investors' risk aversion to the sector, NBFCs are expected to face more difficulties raising money. Given the strategic role of NBFCs in the capital market, this may push up the cost of borrowing for corporates and consequently hurt the economy.

Credit News

A big secret in Japan debt market is getting harder to keep

Oct 22. The number of not-fully-sold-out corporate-note offerings in Japan is rising, despite bankers' claim that many debt sales were successful. Bloomberg noted that in September 2018 underwriters failed to fully sell at least 29% of company note offerings, twice the average over the past six months, including deals from Japan Airlines Co. and Honda Finance Co. among others. The practice is commonly done to coverup the lack of demand or to give underwriters the ability to sell discounted leftover securities to favored clients at a later timing. This practice can be detrimental to investors who have paid more for the bond at the initial offering. Regulators have acknowledged that the trading practices in the Japan bond market are opaque but changes have been slow. (Bloomberg)

Salim, Medco consortium to pump SGD 530mn into Hyflux

Oct 18. Indonesia's conglomerate Salim Group and energy giant Medco Group has entered into a binding agreement to invest SGD 530mn in troubled water treatment firm Hyflux in which the consortium, SIM Investments, will own 60% of Hyflux's equity upon completion of the deal. The consortium, which has a track record of running diverse businesses in South-east Asia and other parts of the world, will subscribe for ordinary shares representing 60% of the enlarged issued share capital in Hyflux for SGD 400mn and grant Hyflux a shareholder's loan of a principal amount of SGD 130mn. Furthermore, it will also provide Hyflux with a SGD 30mn loan for its interim working capital requirement for the period prior to the completion of the proposed investment. Before the SGD 530mn is injected to the company, however, Hyflux needs to get its

bank lenders, noteholders, preference share and perpetual securities holders onboard via a scheme of arrangement. (Business Times)

BoE warns over growth of risky corporate loans

Oct 17. Bank of England (BoE) warns over the rapid growth of loans to highly indebted companies driven by investor demand. The US is leading the USD 1.3tn global leveraged loan market, while the UK had a record GBP 38bn of loans by shadow banks last year and has recorded an additional GBP 30bn of such loans issued this year. Leveraged loans have accounted for 20% of corporate borrowing in the UK and the BoE has expressed concerns regarding the loosening lending terms and the rise of covenant-lite loans. As such, the BoE is looking to assess the risks of such leveraged loans to bank balance sheets through a stress tests which results are due in December 2018. (FT)

China local governments' hidden debt could total 40 trillion yuan: S&P

Oct 16. S&P reported that Chinese local governments' off-balance-sheet borrowings could be as high as RMB 40tn which posed huge credit risks. By including these debt, the ratio of government debt to GDP could have already reached 60% in 2017. Local government financing vehicles (LGFV), which was created by local governments in response to the borrowing limits set by Beijing, bore much of the hidden debt. Concerns about debt levels in China are on the rise as the economy cools amid an increasingly heated trade frictions with the US. Although China has vowed to keep the debt levels under control and persisted with its multi-year de-risking campaign, global rating agencies have been quick to downgrade issuers linked to Chinese regional and local governments. (The Straits Times)

Lost in transmission: China's small firms get more loans on paper but not in reality

Oct 16. Despite rounds of policy easing by the government and the banks' effort to boost lending to small firms by offering collateral waivers and setting loan targets, small and medium-sized firms (SMEs) are still finding it difficult or expensive to borrow from banks. Financing conditions remain tight as 5.04mn businesses went bankrupt in the first half of 2018. Even though lending has increased, it is barely enough to compensate for the shrinking 'shadow' loans which have been a major source of funding for SMEs. A broad measure of credit, the annual growth in outstanding total social financing, which includes off-balance sheet forms of financing slowed to 10.1% in August, a record low. SMEs are typically viewed as risky lenders due to the limited quality collateral and unstable cash flows. Since most Chinese SMEs are export-oriented, their exports are expected to be affected by the trade tensions which reduce their likelihood to invest and borrow. (Reuters)

Temasek launches first bond for retail investors - at 2.7% fixed rate (Business Times)

Moody's pushes Italy's credit rating closer to junk (FT)

China Evergrande seeks USD 1.5bn via HK tower financing: sources (Channel NewsAsia)

Regulatory Updates

China economic tsar steps in to steady ship after slowest quarter in decade, says stocks have 'high investment value'

Oct 19. Chinese regulators have implemented measures to defuse risks related to shares used as collateral for loans by ramping up support for firms that were exposed to the liquidity squeeze. The People's Bank of China will push for more debt and equity sales to ease the funding squeeze and will use monetary tools such as the relending and medium-term lending facilities to allow lenders to advance more loans to companies. The China Banking and Insurance Regulatory Commission also plan to allow insurers to issue special products to fund listed companies affected by the liquidity crunch and these products will be above the ceiling limit on insurer's equity investment. Local governments in Shenzhen and Beijing are also actively bailing out companies in their jurisdictions and have set aside tens of billions of yuan to aid listed companies. (SCMP)

Systemically important banks show marked improvement in capital levels, Basel report shows

Oct 17. Large internationally active banks have seen their final Basel III capital shortfalls drop by more than 70% as compared to that of year-end 2015, mainly due to higher levels of eligible capital. The report also said that the designated “Group 1” of major banks, which includes global systemically important banks (G-SIBs), have raised USD 66.5bn in total capital during the period, with common equity tier 1 (CET1) accounting for the majority. It is further noted that the G-SIBs were the main contributors for the decrease in the shortfall while at the same time accounting for all of the CET1 capital shortfall. These results were measuring the effects of the reforms for Basel III enacted in December 2017 which focused on enhancing the robustness on the approach for credit risk and introducing a leverage ratio buffer to further limit the leverage of G-SIBs. (Reuters)

Prudential Financial taken off US ‘too big to fail’ list (FT)

Global banks are seeking relaxed terms on Turkey loan rules (Bloomberg)

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Contributing Editor: Liu Hanlei