

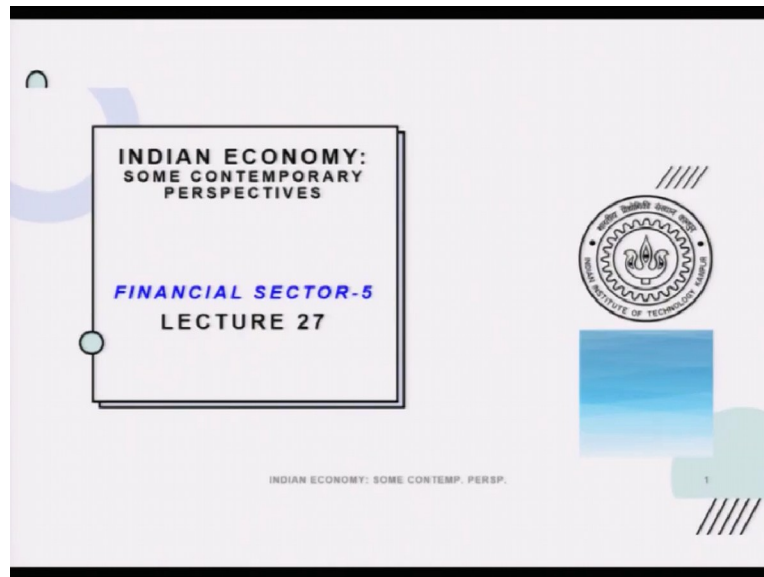
**Indian Economy: Some Contemporary Perspectives**  
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**Indian Institute of Technology, Kanpur**  
**Lecture No. 27**  
**Indian Economy - Indian Banking Crises 3**

Hi, everyone. So, let us start, we are going to talk about the India's economy in some contemporary perspective. Under that, we are covering the financial sector and this session we will be talking about the recent issues that we have faced and most of the time we are reading in the newspaper about the banking sector outflow. So, I hope, you have understood the reasons behind the banking sector upheavals.

But now, we will be focusing on the non-banking financial sector crisis. So, if you remember in September 2008, we were in a situation that was linked to the Lehman moment in case of India. So, Lehman Brothers in late 2007 had to go for bankruptcy declaration. As a result, this had triggered a shock across the world and this has resulted in a full fledged, I would say the financial crisis and that we call it as global financial crisis.

But in case of India, where we have the regulated banking system and even the RBI regulates the non-banking financial sector, for the first time we had a situation under which we were facing excessive liquidity crunch, because of the banking sector meltdown. So, in the banking sector meltdown, what had happened that the stimulus package that they were given, it was not sufficient and banks were worried about their future. And as a result, they had taken measures to control on the credit.

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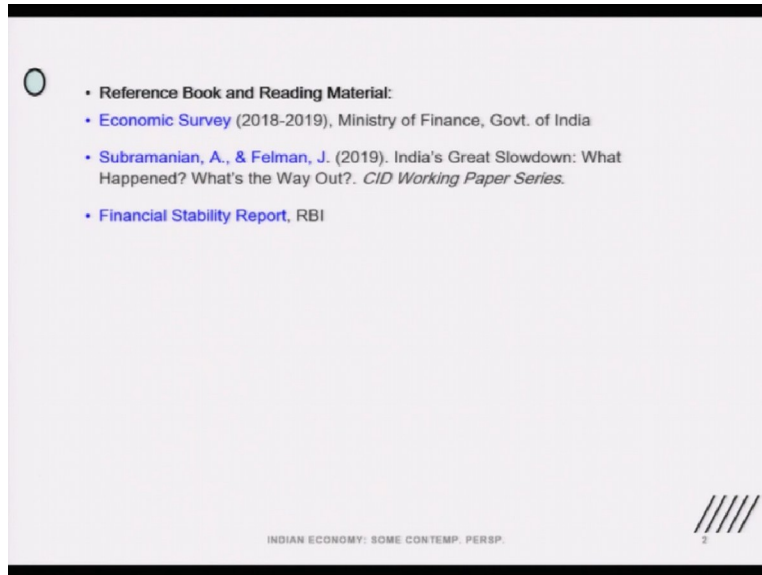


And this has resulted in India's economy in terms of credit market skews. And this has also led to one of the important topics to be discussed at that point of time. So, if you read chapter 4 of the economic survey 2016-17, so we have already discussed that and we also found that due to asset quality review banks had to go for acknowledgement of higher NPAs. And this has resulted in stock market turbulence, because this shock was transferred to the stock market, equities were doing low.

But in case of India, we have a different fund management system and one of the fund management system is called mutual funds. So, once we have the mutual fund business, so what typically happens is that under mutual fund anyone who is having the investment capacity of more than rupees 500, they can go and invest in the mutual fund different types of funds that they have.

In that, there is a one particular fund which is called debt fund, which means that this particular fund will be investing in only in the bonds of different companies or even to some extent whether it is government or non-government owned companies, so public or private. So, mutual funds were the major I would say credit supplier to the NBFCs apart from the banking system. But when you have high rise in uncertainty in the financial system then this results in a chaotic situation. So, we will be discussing that in detail. But let us first get into this particular topic.

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- Reference Book and Reading Material:
- [Economic Survey](#) (2018-2019), Ministry of Finance, Govt. of India
- [Subramanian, A., & Felman, J. \(2019\). India's Great Slowdown: What Happened? What's the Way Out?. CID Working Paper Series.](#)
- [Financial Stability Report](#), RBI

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0 Key Learning Objectives

- The non-banking segments and regulations of India's banking sector.
- Recent developments

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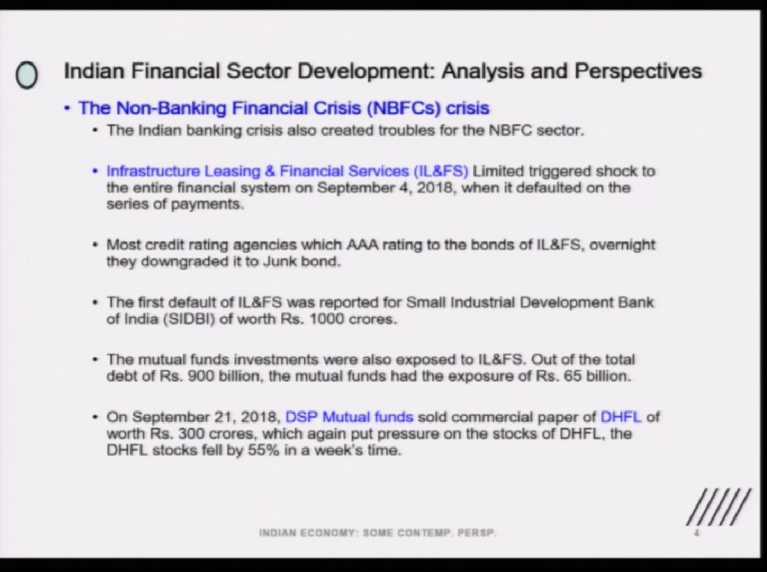
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So, we are now talking about the NBFC crisis. Under this, I found economic survey 2018-19 because the crisis started in 2018. So, it is always better to have refer to 2019. So, I have referred economic survey 2018-19, Ministry of Finance, Government of India. Then we have Subramanian and Felman, his working paper had become part of the mainstream debate and it was about India's great slowdown what happened?

As I had mentioned that after global financial crisis each and every central bank has to prepare the financial stability report. And in this, I have also referred the financial stability report just after Lehman crisis, so December 2018. And if you go through, apart from this, you can go

through different websites where you have all types of write-ups mentioning about this particular NBFC crisis. So, the objective is that what are the non-banking segments regulations? And how we can understand their progress over the years? And what are the recent developments. So, these are the key learning objectives of this.

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**Indian Financial Sector Development: Analysis and Perspectives**

- **The Non-Banking Financial Crisis (NBFCs) crisis**
  - The Indian banking crisis also created troubles for the NBFC sector.
  - **Infrastructure Leasing & Financial Services (IL&FS) Limited** triggered shock to the entire financial system on September 4, 2018, when it defaulted on the series of payments.
  - Most credit rating agencies which AAA rating to the bonds of IL&FS, overnight they downgraded it to Junk bond.
  - The first default of IL&FS was reported for Small Industrial Development Bank of India (SIDBI) of worth Rs. 1000 crores.
  - The mutual funds investments were also exposed to IL&FS. Out of the total debt of Rs. 900 billion, the mutual funds had the exposure of Rs. 65 billion.
  - On September 21, 2018, **DSP Mutual funds** sold commercial paper of **DHFL** of worth Rs. 300 crores, which again put pressure on the stocks of DHFL, the DHFL stocks fell by 55% in a week's time.

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So, let us get started. So, Infrastructure Leasing and Financial Services, IL&FS it has a more than 150 different segments, different types of forms operating in different mostly the infrastructure leasing company. And this infrastructure leasing company is a spread across all types of infrastructure activities including roadways and highways.

And in the beginning, this particular IL&FS institution is known for a lot of landmark infrastructure project and it has contributed a lot in terms of expansion in terms of highways and even they have funded to the housing projects in the country. And the most important part of this IL&FS institution was that, it was diversified across all types of economic activities. Even in infrastructure, it has different layers of forms handling the financing segment.

So, India as an as an economy, when we started looking at the liberalization process, then at that time different types of institutions were set up and a lot of injection mushroomed also during that time with a lot of credit availability and there are a lot of opportunities for the forms to grow. And at that time, we were looking for the supply constraints resolution, which means that how we can we can address the supply constraint in terms of infrastructure road highways.

So, at that time during 1980s, in 1987, this IL&FS was established. And after the establishment of IL&FS this company has got into all types of businesses providing services to real estate as I mentioned, infrastructure and all other. So, for this company, everything was going well until in September 2018 when we had a, so until in September 2018 when we for the first time it was reported that IL&FS organization is going to default on 1000 crore of rupees of the Small Industries Development Bank of India, SIDBI, its headquarters is in Lucknow.

So, for the first time this IL&FS default was reported and this has shown that and before that also, there are apprehensions about different firms operating under IL&FS defaulting on loans. And it was also found that because of the environmental infrastructure related regulations we were not able to, and these firms were not able to survive. And there was a lot of apprehension from investor side also that the true picture of IL&FS was not known for many and everyone was quite skeptical about the behavior of the firms.

And on September 4, 2018, this came out in limelight and then it was reported that this IL&FS is going to default on 1000 core loans of the SIDBI. And surprisingly, the best part was that the rating agencies were, had given the base rating outlook of the IL&FS bond. But when this crisis surfaced then after that, overnight they rated the IL&FS bond as a junk bond. So, that also became quite surprising thing that even the rating agencies had no idea about the financial health of IL&FS.

As I mentioned in the beginning, the mutual funds were also exposed to IL&FS, so out of the total debt of rupees 900 billion, the mutual fund side, the exposure of 65 billion to this particular firm. On September 28, one more saga started that DSP Mutual Fund showed the commercial papers of Dewan Housing Finance Limited, DHFL of worth 300 core, which means that if you are selling it means that someone has to pay you equivalent amount.

And this also deteriorated the financial outlook of the DHFL, that what is the concern, why this particular firm is selling the large amount. And on DSP Mutual Fund and DHFL on both investors had some concern because why the DSP is selling and it will also be found that DSP Mutual Fund is also having exposure. And DHFL also came in limelight and it was found that DHFL was also involved in different types of illegal activities, basically money transfer and the case is still going on.

But these two incidents had created a something called NBFC crisis in the full fledged NBFC crisis in the country. And this was for the first time so it can be called as an unprecedented risk that we saw for India's economy. So, Infrastructure Leasing & Financial Services Limited, IL&FS is known for this particular default. And before that also, this IL&FS had some kind of exposure to other forms also where it had defaulted. So, government finally took over the board and the and the Vice Chairman and even the head of this particular firm are now examined for their involvement in the manipulation.

It has been found that there were a lot of irregularities with regard to the pay incentives of the top management, which has been reported by the News Dailies and the case is still going on. So, these two incidences are very important to know that how IL&FS started. One of the reasons, if you go through the news reports then you find that what they mentioned that IL&FS was involved in short term borrowing.

And when you are going for short term borrowing and then, after boring in short term loans, it used to finance long term projects, which means that the money is now in stuck for more than 1 year. And whereas you are borrowing from the forms for less than 1 year in terms of by issuing low maturity debt and all. And that is why the obligation of repayment starts immediately. But your money is stuck for the longer period because in infrastructure project, short term financing is not possible.

But this particular firm used to seek financing in terms of short term and it used to facilitate the financing infrastructure in terms of long term. So, those issues are always debated and discussed. And that is why it becomes really important to explore further. So, if some of you are really interested, you can just search on internet IL&FS crisis and DSP and DHFL turmoil that we experienced in September.

So, in February 2016, we had the Indian banking crisis. By September 21, we had the full fledged the NBFC crisis. So, if you look for and against they say that since the banking crisis started in February 2016 and it was still going on and there was a lot of credit crunch in the market and that is why these NBFC felt dried up in terms of financing and they had to ultimately rely on the higher cost of borrowing, which resulted in higher default.

But that is one angle. Another angle is that this particular form had bad health and it was experiencing before 2016, but no one had even thought about that this particular well diversified group go for bankrupt and even the rating agencies, they had given the base ratings that rating agencies can provide AAA. But overnight, after September 4 episode, they had to overnight revise their credit rating and convert it into a junk bond. So, I have tried to mention here that what is the exposure of IL&FS. So, exposure to IL&FS group.

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- The Non-Banking Financial Crisis (NBFCs) crisis**

Exposure to IL&FS Group		Exposure to DHFL Group	
Fund Name	Exposure (Rs. Cr.)	Fund Name	Exposure (Rs. Cr.)
DSP	629	UTI	2,144
Aditya Birla Sun Life	608	Reliance	1,488
Tata	241	Axis	772
HSBC	105	Franklin	572
BOI AXA	104	IL&FS	434

Source: <https://www.moneylife.in/article/mutual-funds-have-more-than-rs16000-crore-exposure-to-ifa-dhfl-and-essel-group-report/56269.html> (Accessed on February 2, 2021)

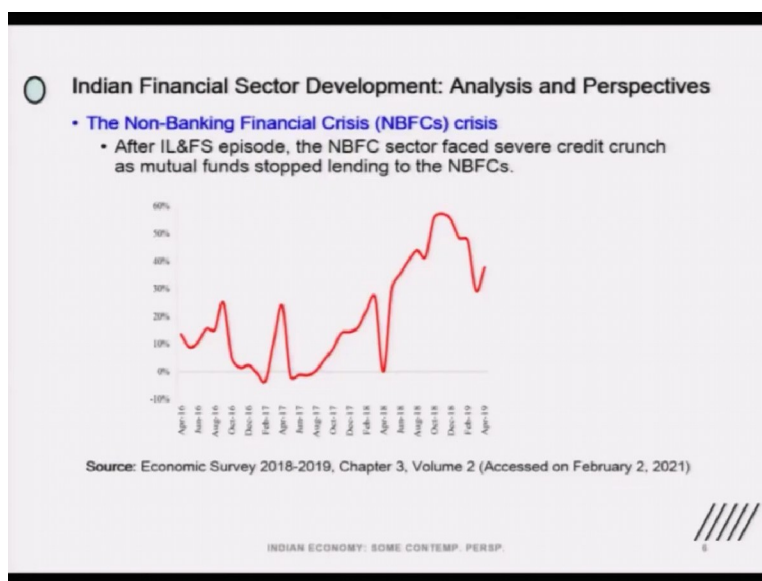
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So here, we have the DSP which has the 629 crores rupees; Aditya Birla Sun Life it has a 600; Tata it has 241; HSBC it has 105; and Bank of India AXA it is having a 104. Similarly, exposure to DHFL group, so now, you will be easily linking it that how it is happening. So, exposure to IL&FS where DSP is involved with 629 crores, then exposure to DHFL because DHFL also came because DSP has started selling the commercial papers of worth 300 core, so the exposure to DHFL group.

So, UTI had the exposure of 2144; Reliance 1488; Axis Bank 772; then Franklin 572; and IL&FS again is having 434 which means that the September 4 episode under that for the first time it was reported that IL&FS is going to default on 1000 core loans of SIDBI. But here, we find that in case of DHFL; IL&FS is also having exposure of 434 crore, which means that if you try to link it then it looks like it is all interlinked.

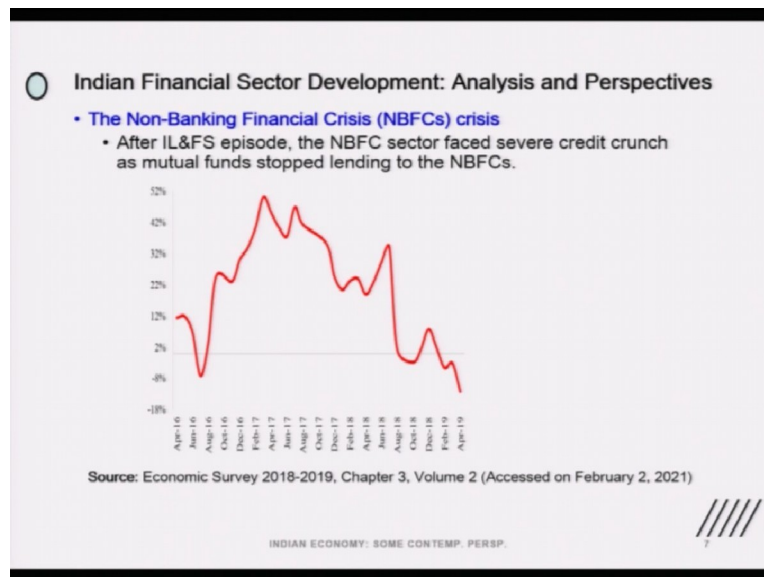
So, the unfolding of September 4 event led to the panic buy and sell with DSP and DHFL. And this was also predicted in the same way in the markets. If you read in news paper, it is always mentioned that this IL&FS saga on September 4, led to the September 21 scenarios that we have here September 21 scenarios. So, this is what it is important to note.

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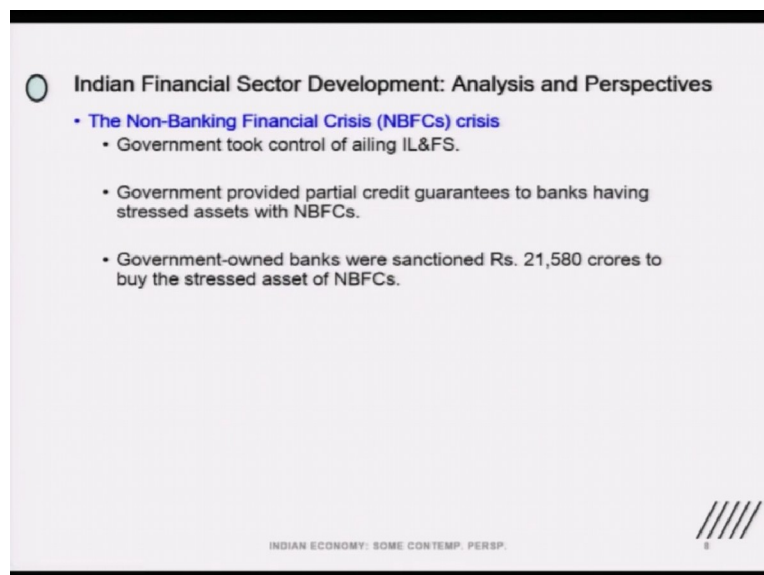
Now after this, we had the full-fledged non-banking crisis. So, under full-fledged non-banking crises you can see that after September saga, we see that there is a continuous decline in the exposure. So, this is the exposure that we have, NBFC phase severe in terms of credit crunch by mutual funds. So, this was the exposure. So, mutual fund is started taking out money from the NBFC. So, NBFC sector came in trap because of these episodes that I just mentioned.

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Then we all also saw that how this in terms of the exposures again, we have the case here and we find that after this saga, from August onwards we saw a decline and then again it started going. So, this is the supply of I would say credit to the NBFCs and this is how it looks like that it has started going down. So, the volatility and variations you see and after that the further developments also were not very favorable for the NBFCs and that is why it has started deteriorating further.

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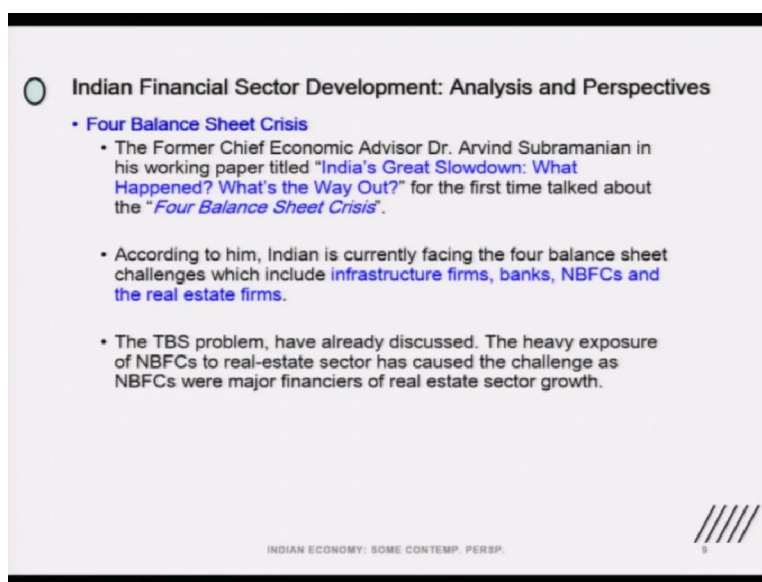


Now, in terms of non-banking crisis, I would like to mention that, after this IL&FS saga, so government had to come into picture and take over the firm. The top managements were questioned, even the government agency in terms of serious fraud agencies were looking for the top management. Even the person who headed the company for 30 years, he was also going on for leave for medical reasons that was also a big question, that after putting the company at risk the top management was leaving.

Government had also given partial credit guarantee to banks having a stressed asset with NBFC because government had a focus on the banking sector. And banking sector was given some kind of recapitalize scheme, under that they were given a stimulus package and this stimulus package, since it was more of a bank oriented and it was also found that the banks were exposed to NBFC. So, if bank will not be given some kind of guarantee, then it will again create uncertainty and then there will be further impact on the great expansion.

So, the government had gone for partial guarantee and the government owned banks were sanctioned rupees 28,580 crores to buy the stressed assets of NBFCs. So, this these 21,580 crores that were given it was just given to bring some kind of confidence among the investors and just to have the better loaning market outlook.

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**Indian Financial Sector Development: Analysis and Perspectives**

- **Four Balance Sheet Crisis**
  - The Former Chief Economic Advisor Dr. Arvind Subramanian in his working paper titled "India's Great Slowdown: What Happened? What's the Way Out?" for the first time talked about the "Four Balance Sheet Crisis".
  - According to him, Indian is currently facing the four balance sheet challenges which include infrastructure firms, banks, NBFCs and the real estate firms.
  - The TBS problem, have already discussed. The heavy exposure of NBFCs to real-estate sector has caused the challenge as NBFCs were major financiers of real estate sector growth.

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Then in 2019, we had an interesting discussion and in that it started with write-up it came out in the form of a working paper and it was written by a Former Chief Economic Adviser, Dr. Arvind

Subramanian. And he had come out with one article, it was about India's great slowdown, what happened? And what is the way out? For the first time, he talked about what is called as Four Balance Sheet Crisis.

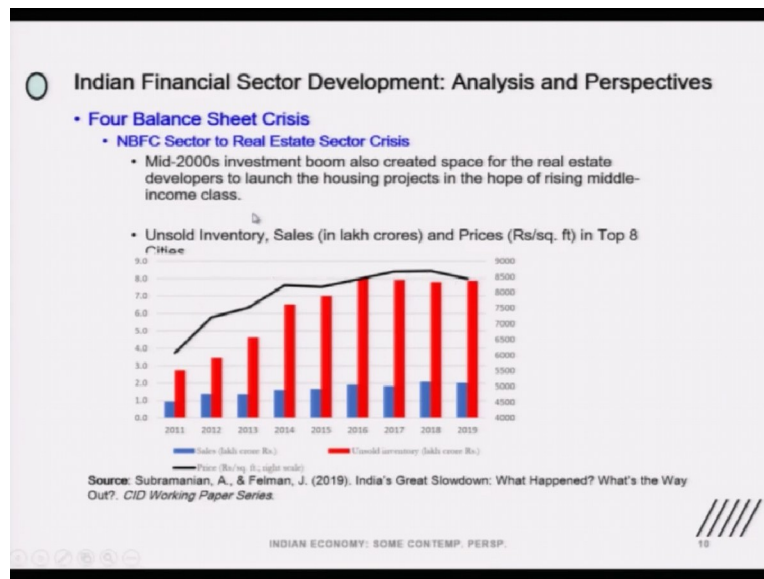
So, so far, what we have discussed is that, we had discussed about the Twin Balance Sheet crisis, under that we assume that we have bank and then we have the firm. So, bank is lending to the firms and firms are not able to repay because firms are finding it difficult to do business, their earnings are low. As a result, their balance sheet is impaired. And now this risk is being transferred to the bank balance sheet and Bank is also feeling the heat of their downturn. And this results in what we call it as Twin Balance Sheet.

But after this, two more components were added by the Former Chief Economic Adviser and it was about NBFCs and about the real estate firms. And why he had added these two because as I mentioned that in September 2018, we had the NBFC crisis. And then one more component of real estate firms it was added because it was found that since NBFCs were the major supplier of credit to the real estate firm, so once we have the NBFCs going into the crisis then this puts extra pressure on the real estate firms.

As a result, it is all now in the vicious circle and if all are interlinked, then this is going to have the negative impact on the overall growth and even in terms of credit cycle of the country. So, for the first time, the Former Chief Economic Adviser had mentioned about banks, NBFC and real estate firms. So, TBS problem, we have already discussed. The heavy exposure of NBFCs to real estate sector has caused the challenge as NBFCs were the major financials of the real estate sector growth.

So, the article is available online, you can just search and you will find out that how he is trying to justify the Four Balance Sheet Crisis. So, maybe if you try and read from the perspective of economic understanding, then you will have the idea. Since, I have already explained that mid 2000 boom led to the, but if you try and understand the linkage between NBFCs and real estate firms then that is interesting.

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So here, we have the housing market. So, housing market, so as we have discussed that Twin Balance Sheet crisis also mid-2000 boom is considered as the responsible factor for the origination of this crisis. Because at that time, there was heavy lending coming from the public sector banks to the private firms, PPP projects were open and even the firms which were not having that much good financial health, they were allowed to borrow. And as a result, they became over leveraged firm.

So, we had the case of over leveraged also and in mid-2000 since everything was going well. So, at that time, most of the real estate companies, they invested so much on the housing project. So, at that time, we had a lot of housing projects coming out because it was believed that the middle class is rising. So, based on the faith of the rising middle class, these real estate investment projects started coming and this resulted in a huge supply of housing project or in terms of built up houses. So, the capacity or the supply had increased.

But because in 2007-08 we had the global financial crisis and after that, we started feeling the heat of slowdown and in 2012-13 again, we were not doing so much good, because we were preparing for the general election at that time there were a lot of uncertainties in India, political uncertainties even economic uncertainties were there because we were trying to go for a foreign direct investment allowance in the retail sector and then there were upheavals about the law and order situation. So, it was not very favorable for the domestic scenarios.

And after that we know that in 2016 we had the banking crisis and then banking crisis again in 2016 we had to go for demonetization. And again, demonetization, again we had the shock of GST and then in 2018 it was it translated into the NBFC crisis. So, for real estate firms, it became really difficult to even think about how they will be surviving. So, once we have that kind of understanding then it becomes really important.

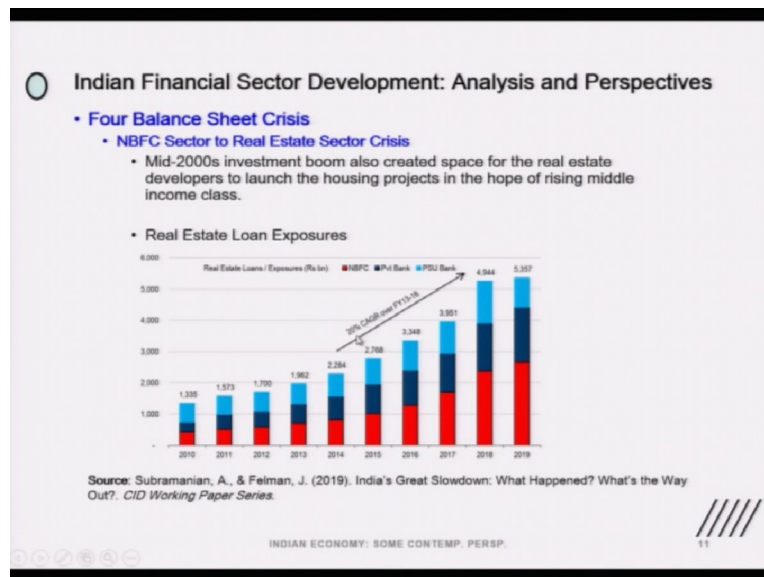
So, here you can see that, here we have the unsold inventory, which is in red. So, you can see over the year it started accumulating. So, now it is almost. So, since 2016, there is an excess supply of housing or number of completed housing projects compared to what it was sales. After 2016 when we had the banking crisis in 2018 there was slight moderate increase, but it is almost constant, which means that you have the buildings and infrastructure ready, but there are no buyers.

So, if there are no buyers, so the debt that these firms had taken from the NBFC they are not able to repay because they are investing in different activities, but it was also not successful because if the overall economic outlook is not good, then it is very difficult to sustain on alternative investments. So, the major investment that they were looking at in terms of the housing projects, most of the real estate developers they were not getting, they also do not reduce the price because they had already worked out the breakeven thing that if they are going to reduce the price then this will put a downward pressure and then their margin will also come down.

And since they were already defaulting on the loan, so they also thought that if we were going to reduce the price, then we will not able to cover up the defaulted amount. So, they did not reduce the price of the housing. And as a result, what has happened that there is no accumulation of the high amount of debt among the real estate firms. So, NBFC is not supplying. Now real estate firms are in debt as per the Former Chief Economic Adviser. So, this has resulted in additions of two more entreties to the Twin Balance Sheet problem, one is NBFCs and one is the real estate firm.

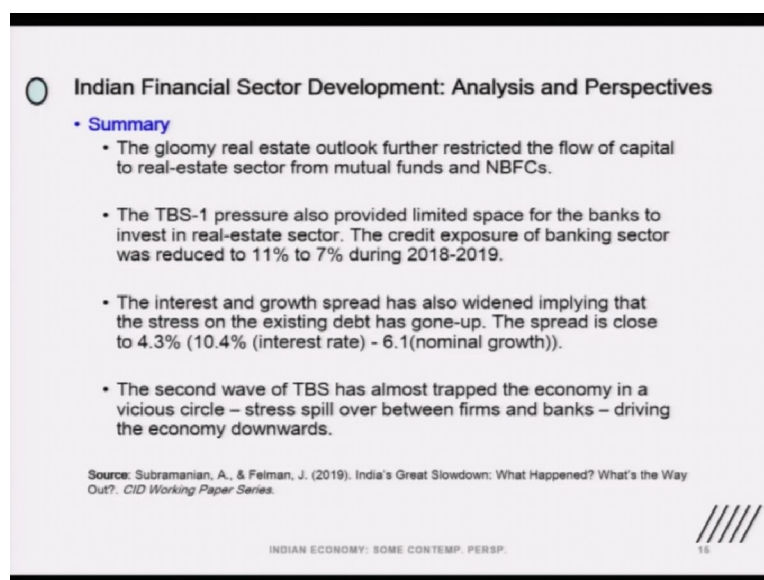
So, this is how the scenario looks like. If we go to Noida, if you go to any city, you will find that all the real estate housing projects are almost ready, but you have hardly anyone living over there. So, you have the ghost town coming up everywhere because of that. In 2015, it was experiencing this case of China, but now we are experiencing in India also.

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Here, you can see the loan exposures because of those uncertainties after 2014. Here, we have the 20 percent CAGR and now, you will see that the NBFCs had gone for even in terms of share, their share has gone up because despite having this IL&FS episode and then DSP Mutual Fund and the DHFL episode, the exposure of other NBFC had gone up, for example, that might be because of the give time to time scenario that we have seen in case of banks that since you have already invested my money. So, these NBFCs may have gone for some kind of restructuring or they may have provided extra credit to these institutions.

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So, I hope it is clear. And now, here what we are trying to see is that I will come back to this, but here we have one more scenario. So here, this has created what we call as the gloomy real estate outlook, which means that the excess supply of the housing has created extra pressure on the balance sheet and this has impaired the balance sheet of the NBFCs. We have already seen in case of infrastructure firms and the banks. So, Twin Balance Sheet plus the NBFC and real estate, so this leads to the Four Balance Sheet crisis.

So, since the recapitalization and the revival of the banks under TBS-I, Twin Balance Sheet crises one was not sufficient, so banks had also reduced the exposure. So, credit exposure of the banking sector was reduced from 11 percent to 7 percent. The interest and growth spread had also widen implying that the stress on the existing rate had gone up, which means that the Former Chief Economic Adviser gives a scenario, that if you have a nominal growth rate high, which means that if the growth rate is now going up 12 percent or 13 percent, if the borrowing rate is around 10 percent it means that you have the gain or the spread of 3 percent.

So, but if you have the borrowing rate going up, but the output growth or the economic growth is not going high in that way, then of course, this will create extra burden which means that the firm will start losing that money. So, it has happened in the case of India, that the borrowing cost, the spread between this interest rate minus the nominal growth, it is almost 4.3 percent and this 4.3 percent, it is just the approximate amount, it is just extra pressure on the investment or any kind of investment cycle of the firms which are involved in the borrowing.

So, this has created one a one more I would say negative factor for the India's growth and prosperity. And ultimately, it has formed a vicious circle, which means that these scenarios are ultimately leading to the low growth and low I would say great expansion, uncertainties in the NBFC and the real estate housing, as a result the overall economic outlook have has also come down and now in terms of growth, we are hardly having any scenario.

Now in March 2020 onwards, we are seeing completely different economic scenarios and it is in terms of the pandemic. So, government is having now limited space to focus on these things. But it is expected that once the economy will revive, which everyone is now predicting in terms of V-shape recovery, if we have V-shape recovery and if this is the Central Bank gives us sufficient scope to adjust for such thing then of course this is going to be one of the important rays of hopes for the financial sector to grow. So, this is the summary of what is called the NBFC crisis.

So, let me summarize in two lines and then we will stop. So, in summary, it all started with the Twin Balance Sheet crisis in February 2016 when under AQR process bank had to go for NPA, this created a lot of uncertainties in the in the loaning market and in the financing market credit expansion became really an issue.

And then this translated into the NBFC sector. This IL&FS episode started then it also created problem for the mutual funds. So, mutual fund also restricted the investment exposure to the NBFCs. Since NBFC has had the exposure to real estate firms and real estate firms are already facing the slowdown in terms of low sale of the completed housing project. So, it is all now in one cycle form the vicious circle that we can say. And this has resulted in the overall financial outlook of the financial sector really low.

It is expected that once we have the expected V-shape recovery then there will be more focused on this. And this may create extra scenarios for the government and it will be good for the overall economy. Thank you. Thank you so much.