Business Standard

A question of trust

For investors to return to NBFCs, trust needs to be rebuilt in the financial system and its guardrails

Akash Prakash June 18, 2019 Last Updated at 01:00 IST

There has been a degree of surprise among observers as to why the NBFC crisis continues to simmer and even worsen. Both NBFC (non-bank financial company) and HFC (housing finance company) stocks were darlings of the markets before the IL&FS default. They were growing very strongly, had good profitability and were beneficiaries of the deepening money and credit markets. At one time, they accounted for almost 25 per cent of the incremental credit growth in the system. The stocks were rewarded with high multiples and were seen as following the same value creation path delivered by the private banks previously.

If these stocks were among the best performers pre September 2018, why is no one willing to buy the sector (bar a handful of companies with strong industrial house backing) today, despite many of these stocks being down between 50 per cent and 75 per cent?

The reason for investor apathy is that there is a total breakdown of trust in the system. Public market investors do not have access to the books of these financial companies. In the absence of being able to see the loan books themselves, public market investors have to rely on external agencies for confirmation of asset quality, governance etc. It is here that there is a total breakdown of trust.

Post the IL&FS debacle, rating agencies have lost credibility. How was this highly leveraged and complex giant allowed to remain at AAA or even AA+ for so long? It was only downgraded after defaulting. On what basis were such high ratings given? What about surveillance and monitoring of the ratings? The credibility of the rating agencies was damaged even further once other large NBFCs (many of whom were rated AAA) were also downgraded to non investment grade and in some cases straight to default. Some of the downgraded institutions have a large quantum of retail fixed deposits and even retail debentures outstanding. Public market investors are currently not willing to take the ratings provided by the agencies at face value. Who knows which institution will get downgraded next? The slew of downgrades seems to indicate that IL&FS was not an isolated incident.

Many institutions which are facing short-term liquidity issues despite reasonable ratings, are suffering from this ratings distrust. In a normal environment, they should have access to liquidity. Yes, there are asset liability mismatches, but everyone does not have a solvency issue. The lack of trust in the ratings is choking off liquidity.

Another similar issue is also with the top auditors in India. All four of them have been caught in one controversy or another. If I am not mistaken, it may be possible that for the coming year none of the top four auditors will be allowed to audit a scheduled commercial bank. Again, there seems to have been serious accounting irregularities at IL&FS. If you can't trust the competence of the auditors, how do you believe the numbers they are signing off on? If you can't trust the accounts, how do you know what is the real asset quality or profitability of the institution. You also have the spectacle of audit firms suddenly resigning from the companies they have been auditing for years. They can resign in a day, but what happens to the shareholders or lenders to these firms? They are left holding the can, as they cannot exit with the stroke of a pen.

Illustration by Binay Sinha

The guardrails of the financial system. Rating agencies and auditors, both are under a cloud at the moment. In the absence of trust in these guardrails, investors will need to see the asset books of the NBFCs and HFCs themselves and come to their own judgement about asset quality and profitability. Public market investors do not have access to the books. We have to rely only on publicly disclosed and available information. In the past, when there was no trust deficit, we could rely on this publicly disclosed information to make investment decisions. There was faith in the quality of the information provided. With trust in the rating agencies and audit firms, there was no need to second guess everything. Today, it is different. The rumours and noise surrounding certain NBFCs also add to the confusion and climate of fear. It is very difficult to think calmly, deploy capital and invest in these leveraged financials when you worry about the accuracy of the numbers and ratings which are in the public domain.

The only way out of this mess, in the short term is for private equity to step up. The private equity shops can ask for access to the books and take the time to do the diligence. They have the ability to see the numbers in much greater detail than public market investors. If a credible private equity shop were to invest in one of these stressed NBFC/HFC, it would add credibility immediately and would crowd in investment from other investors. The investment would signal that what you see is what you get and that we can trust the numbers. The extent of recapitalisation will provide the growth capital needed and reopen access to liquidity.

The other alternative would be for the regulator to do a stress test on the books of these troubled financial institutions. Lay out the assumptions used in terms of stress parameters and disclose the quality of the underlying book. What are the real NPAs? What capital hole, if any, needs to be filled under the stress assumptions used (stress assumptions could be an economic recession, fall in real estate prices, rise in rates etc).

Such a stress test, blessed by the regulator, will give investors confidence around the actual condition of the asset books of many of these NBFC/HFCs and allow investment decisions to be made on hard analysis and not fear.

There is too much gossip around this sector. Every day one hears rumours about one institution or another in trouble. People are worrying about career risk when either lending to or investing in these financial companies. You have a liquidity crisis which is now morphing into a solvency crisis. The only way to kill these rumours is to have a stress test on the asset quality of the troubled institutions. This will stop all the rumours and reopen access to capital for those select institutions which are being unfairly penalised by the markets due to the current environment of distrust.

What started out as a liquidity crisis is now becoming a solvency issue. NBFC/HFCs are being forced to desperately sell good retail assets to maintain repayments. Many have been denied liquidity now for eight months. They have almost entirely stopped lending, with inevitable consequences for the economy. Most will have to be recapped and given new equity. This can only happen if trust is rebuilt in the system and its guardrails.

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