Business Standard

The unintended fallout of reforms

Measures taken to strengthen the financial system are partially responsible for the debt crisis

Akash Prakash July 02, 2019 Last Updated at 01:43 IST

The Indian financial system is going through an unprecedented clean-up. From auditors and rating agencies to the banks and funds, everyone is tightening standards. In the long term, this is a very healthy development, as it ensures that meritocracy will triumph. No longer can one get away with managing the system, rely on name-based lending or keep kicking the can down the road. Every type of market participant is running scared, and trying to be extra careful. There is accountability for action and, even more importantly, non-action.

This continues a process that began with the implementation of the Insolvency and Bankruptcy code(IBC), where post the first large resolution, promoters realised the old ways were over and they could actually lose control of their companies. Debt has consequences. Too much of it in the company and you can lose control of your company. Too much of it at the promoter level and you can lose control of all assets. Even assets with no underlying stress. Debt has always been, at least globally, a double-edged sword. In India in the past, there was little downside to being over-leveraged. You could always manage to muddle along and everyone was willing to let the charade continue. This has changed.

Too much debt and the inability to service it now have harsh consequences. It is, therefore, no surprise that we are going through a deleveraging across Indian companies and promoter group balance sheets. The definition of what is an acceptable level of debt has changed from both the borrower and the lender’s perspective. Every bank we speak to mentions that going forward, all new projects will require more equity. This deleveraging or balance sheet recession is one of the unintended consequences of the IBC. Debt-equity ratios in the system will structurally come down. This is why the government will have to continue to front-load investments. In the midst of a balance sheet recession, the private sector will not invest. It does not matter how low the rates go. If you are intent on deleveraging, to reduce your own risk, you will not take on new debt. Cash flows will not be used for new projects, but to correct the debt-equity mix today. A reduction in rates by 100-200 basis points will not change your mind. Across corporate India, if you look at the top 50 business houses, almost everyone is in deleveraging mode.

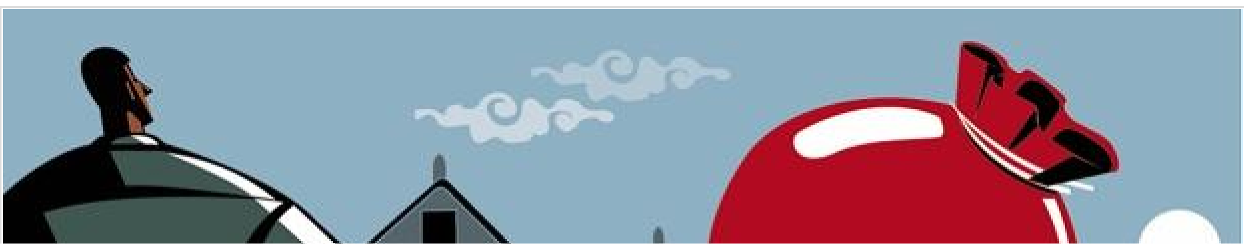

Illustration: Ajay Mohanty

This clean-up is very much required. Even though deleveraging is hurting growth today, it will eventually lead to a much more robust financial system. Standards and operating procedures across all market participants will only improve. Disclosures, ratings, audit notes will all improve and give greater confidence to the markets. We are strengthening the foundations. Strong, well-run companies will keep getting financially stronger and the weak will fade away. It should help productivity of capital for the entire system.

For the foreseeable future, the government will have to continue to do the heavy lifting on fixed asset investments. We will see in the Budget where the resources to make these investments come from. Policy-makers will hopefully take a gamble, cut taxes and bet on growth. Or alternatively give themselves more fiscal room. I genuinely hope we do not go back to the old model of increasing taxes on the same people/ products to raise the required resources. That would totally kill whatever little animal spirits are left.

A second unintended consequence came out of demonetisation. Post demonetisation, we saw a surge of liquidity flowing into both banks and debt mutual funds. The surge of flows into debt funds, supercharged our corporate debt markets, in terms of both complexity and scale. Suddenly, Non-banking Finance Companies (NBFCs) and Housing Finance Companies (HFCs) could raise large chunks of money and for long tenures. This enhanced access to funds, and combined with the absence of the public sector banks raised the growth profile of all the NBFC/HFC players. With higher growth, their valuation multiples expanded, and the treadmill began. To maintain their multiples, they had to keep showing fast growth, and to show fast growth, they had to raise even larger sums of money from these same debt markets. To show profitability, compromises in ALM (asset liability matching) were made. Post the IL&FS default, flows into debt funds have slowed and risk aversion has increased. Many of the NBFC/HFC cannot sustain these levels of borrowings in a more risk-off environment. They need better matching of assets and liabilities. Their growth ambitions have to be reined in. Beyond a certain size, the conventional wisdom remains that NBFC/ HFC will need access to retail liabilities. This has not changed.

With so much money flowing into debt funds, and rates falling across the system, we also saw a reach for yield on the part of the funds. These funds are sold largely on peer group comparisons, hence being able to offer a higher yield, immediately leads to incremental flows. Many deployed capital into higher risk (structured obligation) paper, based on promoter comfort letters, or backed by shares. Even holding companies and unlisted entities were able to access significant funds. In the search for yield, more risk was taken. Keep in mind these debt funds, unlike the banks, do not have elaborate credit departments. They rely solely on the ratings. As long as it was rated investment grade, it could be bought. It did not matter if it was promoter funding, or the only security was a comfort letter, or the entity had no underlying cash flows, the rating was paramount. In today's risk-averse environment, all this is changing. Debt funds are now far more cautious, their investors even more so. Most of these type of "special situations"paper will have no roll-over. No roll-over further accentuates the need for deleveraging among the promoter groups.

This again is normal behaviour as the market grows and matures. We will have a burst of growth, new instruments, innovative structures etc. A credit event happens, risk appetite dissipates and some of the more funky lending stops. This is normal in the maturity cycle of any asset class. Our corporate debt and structured credit markets are maturing. Eventually, all the participants will learn and make these markets more robust. In the interim, as these markets will get reined in, some of the more adventurous borrowers and lenders will suffer, but this is not a systemic risk.

Our debt markets are going through a much-needed pause. To catch their breath — so to speak. We ultimately need robust and innovative corporate debt and structured credit markets. It is important that policy-makers do not overreact to this inevitable shake-out of our debt markets. We should not overregulate them and kill all risk appetite and innovation.

There is tremendous fear and uncertainty today. Skeletons are coming out of the closet. This too will end. We will ultimately have a far healthier and more disciplined financial system. Stronger companies and more ethical business practices will prevail.

The writer is with Amansa Capital