

India seizes “shadow bank” to avert potential “catastrophic” impact on financial system

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Earlier this month, India’s BJP government seized control of a little-known company, Infrastructure Leasing and Financial Services (IL&FS), saying the “shadow bank’s” collapse could potentially inflict “catastrophic” damage on India’s “financial stability.”

In explaining the government’s sudden intervention, financial observers have said the collapse of IL&FS, the country’s largest non-bank lender, could have been India’s “Lehman Brothers moment”—a reference to the September 2008 bankruptcy that triggered the global financial meltdown.

IL&FS had a triple-A credit rating as recently as August, but defaulted on a series of payments last month including a Rs 4.5 billion (\$41 million) short-term loan from the state-owned Small Industries Development Bank of India. Subsequently, the government learned IL&FS has to repay a massive Rs 37 billion (\$500 million) over the next 6 months, but currently has just Rs. 2 billion (\$27 million) in cash reserves.

Moreover, the company is also carrying a huge debt-load of Rs 911 billion (\$12.5 billion), 63 percent, or Rs 574 billion (\$7.9 billion) of which is owed to banks.

India’s banks are themselves mired in crisis. Indeed, in recent years there has been a rapid expansion of lending through shadow banks such as IL&FS, because the country’s banks, themselves burdened by loans that have gone bad, have become chary in extending credit. India’s state-owned banks have a gargantuan Rs 13 trillion (\$178 billion) in delinquent loans. At least \$70 billion of these are “Non-Performing Assets” (NPAs), i.e., loans on which the banks have received no payment from borrowers for 90 days or more.

IL&FS’s default has severely shrunk India’s already restricted debt market, further limiting access to credit, even at relatively high interest rates, for India’s small

and medium businesses.

Following the government’s seizure of IL&FS, the Corporate Affairs Ministry filed a petition with the National Company Law Tribunal (NCLT), a juridical body constituted in June, 2016 to hasten corporate bankruptcy. The ministry charged the ousted IL&FS board of directors with numerous acts of malfeasance, including siphoning off funds through excessive executive pay, financial mismanagement, and outright fraud.

In its petition, the government said “any impairment in (IL&FS’s) ability to finance and support ... infrastructure projects would be quite damaging to the overall infrastructure sector, financial markets and the economy.”

The Hindu supremacist Narendra Modi-led BJP government never tires of promoting the supposed wonders of “free-market capitalism,” and has used executive fiat to dismantle a massive number of workplace and environmental regulations that it considers a hindrance to the profit interests of corporations.

Yet it acted with great haste to intervene in the markets and seize control of the privately-owned IL&FS, to reassure the financial markets that the Indian government will backstop the company, using untold public funds to prevent the total collapse of IL&FS and bail out its creditors.

By “nationalizing” the bankrupt IL&FS, the government aims to prevent the non-bank debt market, which serves as the primary vehicle for numerous Indian companies to raise working and investment capital, from completely seizing up.

A second objective is to bail out various government-owned entities, such as the Life Insurance Corporation of India (LIC), which are large investors in the fraud-

stricken IL&FS.

LIC is the biggest investor in IL&FS, with 25.3 percent ownership. The state-owned Central Bank of India and State Bank of India own 7.7 and 6.4 percent respectively. Other key owners are Japan's Orix Corporation—23.5 percent, and the Abu Dhabi Investment Authority—12.6 percent.

In a fashion similar to the US government's 2008 rescue of AIG and, ultimately all the banks, the Modi government, by taking over IL&FS, has implicitly guaranteed massive—if not unlimited—funds to rescue the company, its investors, and lenders..

The rapid growth of “shadow banking”

Unlike regular banks, India's shadow banks, or more formally Non-Bank Finance Companies (NBFC), don't rely on customer deposits, but instead raise funds through the debt market or by borrowing from regular banks. They then turn around and lend the borrowed funds, at high interest rates, to other institutions. NBFCs are largely unregulated and hence not backed by India's central bank, the RBI or Reserve Bank of India.

Over the past three years dubiously-run shadow banks have become a critical source of finance for cash-starved Indian businesses and customers. According to a report in India's *Economic Times*, “At last count, there were over 4,000 of these shadow banks in India” and they accounted for “30 percent of all new credit in the economy over the past three years. But unlike banks, shadow lenders didn't have access to household deposits and became increasingly reliant on wholesale funding [that is short-term debt].”

IL&FS is also India's most prominent player in India's burgeoning Public-Private-Partnership (PPP) sector. The World Bank and IMF have heavily promoted PPPs as a means of developing economic infrastructure, such as roads, water supply, bridges, and generating plants.

IL&FS's sudden unraveling is bound up with the fact that it has been able, with the active connivance of the BJP, the Congress Party and the rest of the political establishment, to exploit the country's need for

infrastructure to finance long-term projects using short-term funds, and with its own subsidiaries acting as contractors.

Following the crisis at IL&FS, several major infrastructure projects have come to a sudden halt, throwing thousands of people out of work.

The government, in filing its petition of charges against the previous board with the NCLT, also sought a 90-day moratorium on creditors or other entities filing lawsuits against IL&FS or any of its large number of subsidiaries.

No matter the immediate consequences, the unraveling of IL&FS is part of a growing crisis that threatens to roil the entire Indian economy. The Indian rupee is now trading around Rs 74 per US dollar, a decline of some 15 percent since the beginning of the year. This drop has been precipitated by a massive outflow of speculative foreign funds chasing higher returns in the US in the wake of the US Federal Reserve Board's interest rate increases. Other deleterious developments include: falling exports despite the decline in the value of the rupee; almost daily shocks from the Trump administration's trade-war policies; and surging crude oil prices. The latter impact heavily on India, as it is the world's third largest crude oil importer.

The crowing of the Modi government and the cheerleading from the World Bank and IMF about India registering “world-beating” economic growth notwithstanding, further major shocks to the Indian economy are inevitable in the weeks and months to come.



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