The IL&FS Fiasco and the Lessons Learnt

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Authors’ contributions

This work was carried out in collaboration with and with the active involvement of both the authors. Author AK designed the study, performed the literature analysis and wrote the draft version of the manuscript. Author AG reviewed the manuscript and performed the analysis of both the primary and secondary data. Both the authors have deliberated and concurred on the final manuscript.

ABSTRACT

The analysis of this paper revolves around the Infrastructure Leasing & Financial Services (IL&FS), established in 1987 as an “RBI-registered Core Investment Company”. IL&FS falls under the category of ‘shadow bank’ - this term was first advocated by Paul McCulley at the Annual Meeting of FED in 2007. It is notable that in the absence of regulatory oversight, such a system acts as a consortium of intermediaries to facilitate the creation of credit across the global financial system. The entity under review operates in multifaceted sectors like real estate, energy, transportation, and financial services. Its operations are conducted through directly as well as indirectly controlled subsidiaries, associates, and joint venture entities.

Though financial scandals and frauds are in no way new to India, it is disheartening to note a considerable rise of such instances in recent times. The IL&FS crisis came in the wake of the Punjab National Bank scam, estimated at a value of Rs. 13,600 crores. If the Satyam fraud can be considered as the Indian Enron, then the IL&FS may be dubbed as the becoming of India’s own ‘Lehman Brothers’.

Keywords: Financial crisis; shadow banking; governance; credit rating.

1. BACKGROUND

In 2014, Warren Buffet wrote to his shareholders in an Annual Letter to Berkshire Hathaway:

“Periodically, financial markets will become divorced from reality - you can count on that. Managements will look and sound authoritative [1,2]. The press will hang on their every word. Bankers will fight for their business. What they are saying will recently have ‘worked’. Their early followers will be feeling very clever. Our suggestion: Whatever their line, never forget that 2+2 will always equal 4. And when someone tells you how old-fashioned that math is - zip up your wallet, take a vacation and come back in a few years to buy stocks at cheap prices.”

The primary motivation for preparing this research paper was the diverse and multifaceted impacts this financial default had on the real
economy in general; dubbed as India’s ‘Lehman Moment’, this study focuses on

(a) The immense potential of shadow banks to streamline an economy in a particular direction, on the one hand, while reasserts
(b) The magnitude of responsibilities entrusted upon the top management, the auditors and credit agencies. The latter, while engaging on their attest functions, act as a trustee of public wealth;
(c) It reiterates that blatant abuse of power leads to not only regulatory sanctions, but loss of good faith of the people in general.

Amidst the IL&FS saga that unfolded in the year, it is easy to forget the learnings we take away from the event; it is the primary purpose of this paper to bring out the lessons our economy learned from this fiasco.

1.1 A Silver Lining

We live in an age where cynicism is a virtue. The IL&FS fiasco brought with itself a great deal of anger, sorrow, hopelessness, regulatory defiance and adamant breach of the law.

Amidst the negative aspects that envelope the entire incident, it is easy to forget the positives, or rather, the lessons we learnt from the fiasco; for example, the IL&FS eventually made way for stronger corporate governance, due diligence and better regulatory oversight on the economy in general.

During the review of literature, it became evident that few detailed studies have been undertaken to focus on the positive attributes, or the learnings that we can take away from the fiasco; little empirical work has been initiated to fathom the positives that this incident has brought out on the economy [3,4].

Thus, this study is an attempt in the direction of initiating a string of events that improved post defaults in 2018. It is believed that the reforms that the incident brought about are a little under-researched, and hence, the subject matter of this paper is to bring out the same.

2. ANALYSIS AND FINDINGS

2.1 Concept of Shadow Banking in India

The term “shadow banking” is as recent as the year 2007, which owes its inception to the former Managing Director of PIMCO, Paul McCulley. However, multiple definitions have since then emerged, making theoretical discussions difficult to correlate with institutional contexts [5,2].

Speaking at the 2007 Annual Jackson Hole Conference, McCulley defined shadow banking as “the entire alphabet soup of levered-up non-bank conduit systems”. In this study of the lessons our economy has learnt from the IL&FS fiasco, we begin with the different mechanisms of credit intermediation by the shadow banks. Thereafter, we delve into the nuances and trends encompassing some aspects of the shadow banking in India. The underlying rationale is that the subject matter of our review calls for greater regulation of the sector given the degree and magnitude of its systemic risks and economic fragility.

Shadow banking in India is more popularly called ‘Non-Banking Financial Companies’, which are a special category of companies engaged in financial activities not within the ipso-facto purview of a traditional bank. In India, we may further classify such NBFCs based on either Liabilities or Activities [6,7].

![Classification of NBFCs](image)

**Fig. 1. Classification of NBFCs**

The figure given below schematically shows the basic modus operandi of Indian NBFCs.

Historically, it is safe to say that the growth of NBFCs gained traction in the 1980s, where growth of money supply (M3) exceeded the growth of GDP. Thus, banks had new instruments to expand their balance sheets, and the need for high liquidity created a spurt in the broad money. During this phase, banks mainly in the public sector, lost their share in the total market to the NBFCs; the same is evident in the figure which shows the increasing share of NBFCs and Private Banks.
To understand the causes of the defaults, it is first necessary to delve into the primary concepts of the Commercial Papers (CP) which was, in a way, instrumental in the string of defaults. With the IL&FS defaulting CPs, inter-corporate deposits (ICDs), it was soon apparent that the company was bankrupt with an outstanding debt of 91,000 crore.

Categorically speaking, CPs refer to (unsecured) promissory notes, which generally have a short maturity period, not exceeding 270 days. The increase in the business of NBFCs in India is in direct proportion to the increase in the funds raised by issuing CPs. The following figure indicates the quantum of funds raised through CPs has almost tripled from 2011 to 2019.

The business model of IL&FS operates upon the buying and selling of securities which are collateralised by loans. In a way, it is safe to say that IL&FS relied on existing credit claims for business.

Such risks played out in 2018 with a string of defaults by one of India’s largest NBFCs, IL&FS – a company in the top 100 of the Fortune 500.
companies – exposing signs of financial fragility in the system.

To delve into the nitty-gritties of the network, it is pertinent to note that the IL&FS had a pyramid-like structure which embodied three layers: the holding company, the SPV (Special Purpose Vehicle), with the latter financing the funds for the project companies. IL&FS also worked as a massive Ponzi scheme, with the holding company acquiring funding for its loss-making project companies, utilizing its reputation in the market that was often confused as a government entity.

It is also important to pause here and retrospect on the other, not-so-obvious causes of the event: the corporate governance lapses in the organisation and how it instigated the defaults. The founder and Chief Executive Officer (CEO) of the IL&FS, Ravi Parthasarathy, together with his close team of management, were at the helm of affairs for nearly three decades.

Operationally speaking, it is apparent, as we noted, that the IL&FS spread its wings wide over the infrastructure sector; with the rapid increase of the risk aversion strategies being adopted by the commercial banks on the backdrop of the Nirav Modi-hit-Punjab National Bank and alleged mismanagement at ICICI Bank, they chose to reduce the exposure to long term infrastructure projects. This made the IL&FS to eventually resort to short term debt instruments like CPs and other short-term borrowings.

### 2.3 How the Fiasco Unfolded- A Comedy of Errors

A scrutiny of the activities of the key managerial personnel and group companies of the IL&FS reveals how the incident unfolded in front of us. In the month of June 2018, a group company called IL&FS Transportation Networks (ITNL) had to delay the repayment of Rs.450 crores of Inter-Corporate Deposits (ICD) accepted from Small Industries Development Bank of India.

Analysts started suspecting mismanagement after July 21, 2018, when the Group’s founder and Chairman, Ravi Parthasarathy, stepped down from his role citing health concerns. The bubble of the IL&FS, along with its member firms finally burst in the month of September 2018 when the rating agencies further degraded the values of the investment corpus in the IL&FS group. It exposed the inefficiency of the rating system prevalent in India: As a matter of fact, the business model of such agencies operates upon the ‘fee-based’ model which results in the compromise of independence of such agencies.

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**Fig. 4. Quantum of funds raised through CPs**

Following the default, the Mumbai-based Registrar of Companies (RoC), taking recourse u/s 208 of the Companies Act, 2013, filed a report to the Ministry of Corporate Affairs (MCA), which in an Order directed the affairs of the company to be investigated by the Serious Fraud Investigation Office (SFIO).

Moreover, on the 1st of October 2019, the Union of India, acting through the MCA, filed a petition with the National Company Law Tribunal (NCLT) to call for the immediate suspension of the Board of Directors of the entity. As a result, a new Board, proposed to be comprising Mr. Uday Kotak, Mr. Vineet Nayyar, Mr. G N Bajpai (who subsequently resigned from the Board of the Company on October 30, 2018), Mr. G C Chaturvedi, Dr. Malini Shankar and Mr. Nand Kishore, was set to replace the incumbent Board.

Further analysis reveals that the entity had fallen into an unimaginable debt trap which made it heavily dependent on short-term financing. It is important to pause here and note that at the point of the crisis, the NBFC sector was responsible with ₹8.30 trillion worth of retail assets. Sensitive sectors like Banks, Mutual Funds and Insurance are highly dependent on the sector. Any turbulence in the NBFC sector invariably sends ripples to all the other dominant sectors in the economy [8,9].

2.4 Primary Impact on the Auditors

The primary impact of the IL&FS defaults fell upon the auditors. As a rule, Standards on Auditing (SAs) placed forth by the Institute of Chartered Accountants of India (ICAI) set forth a standard of procedures, principles and rules that an auditor must adhere to while performing the audit of financial statements of an entity. Guidance Notes issued by the ICAI serve as a signpost for the auditors to help them discharge their attest functions [10,11].

In recent times, we have observed, time and again, how the auditors become a scapegoat of the mishaps in the corporate world. Every time there is a fallout resulting from misreporting, we see the auditors always being subject to regulatory sanctions and investigations. The developments in field of auditing, financial reporting and corporate governance began with the case involving Arthur Anderson LLP in the case of Enron and similar cases heightening the need of regulators to step in.

In September 2018, the defaults of the IL&FS protracted multiple rounds of investigation by regulators, including the forensic audit conducted by Grant Thornton [12]. The secretary of the MCA, Injeti Srinivas said “We are not expecting an auditor to detect a needle in a haystack, but if an elephant is in a room, they ought to find it.”

It is important to mention here that the IL&FS network of firms was being audited by 3 of the ‘Big Four’ accounting firms.

The misreporting spans out from the fact that of a total number of subsidiaries of the IL&FS (348), only 169 were reported in the books of account. Akin to the case of the Lehman Brothers, most of the unreported subsidiaries acted as a Special Purpose Entity (SPE) in the road building and infrastructure projects. In line with the requirement, the SEBI has come out with a circular that mandates all listed entities to prepare the consolidated financial statements for the limited review of accounts at the end of every quarter.

The positive impact the fiasco had on the audit services centre around the stringency in reporting framework and the rise in importance given towards quality reviews in the audit services. The professional accountants should understand that the perception of the regulators towards the auditors stands in stark contrast with their self-interests.

Table 1. Firms in the dock for audit flaws

<table>
<thead>
<tr>
<th>Year</th>
<th>IL&amp;FS</th>
<th>ITNL</th>
<th>IFIN</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018-19</td>
<td>SRBC &amp; Co. (EY)</td>
<td>SRBC &amp; Co. (EY)</td>
<td>BSR (KPMG)</td>
</tr>
<tr>
<td>2017-18</td>
<td>SRBC &amp; Co. (EY)</td>
<td>SRBC &amp; Co. (EY)</td>
<td>Deloitte and BSR</td>
</tr>
<tr>
<td>2016-17</td>
<td>Deloitte Haskin and Sells</td>
<td>Deloitte and SRBC &amp; Co. (EY)</td>
<td>Deloitte Haskin and Sells</td>
</tr>
<tr>
<td>Till 2015-16</td>
<td>Deloitte Haskin and Sells</td>
<td>Deloitte Haskin and Sells</td>
<td>Deloitte Haskin and Sells</td>
</tr>
</tbody>
</table>

While the global environment bends towards having an independent regulator, the Indian economy still has mixed perceptions on self-regulation as well as an independent oversight mechanism. The focus of the NFRA would be towards the disciplining of the auditors. The first case assigned to the NFRA was the investigation of the alleged audit lapses observed during the crisis of the debt-laden IL&FS.

To summarise, it is worth mentioning that the audit clients are prone to the quality of the audit they are subjugated to, and the following figure encapsulates the various aspects to audit quality.

### 2.5 Secondary Impact on the Credit Rating Agencies

Conceptually, an external rating is akin to an independent opinion by an external agency which is devoid of any financial or business interest in the borrower. The role of a credit rating agency is multifaceted and is directed towards evaluating and quantifying the credit risks with the purpose of effective benchmarking for the risks associated with different kinds of lenders as well as borrowers.

The bonds of the company under review enjoyed an AAA rating on the brink of its collapse, raising serious doubts regarding the modus operandi of such rating agencies. It is noteworthy that 17 percent of all Mutual Fund debt assets are held by NBFCs. Although the debt market was predicted to have an increased default over one year to the first default of the SIDBI loan, most rating agencies did not update their ratings until July 2018 [13,14].

To stress on the positive impacts, it is important to highlight that the Indian insurance and pension sectors which provide important Social Security Net (SSN) are still in a nascent stage and has huge scope of growth. NPAs in insurance sector are on the rise (near to ₹22,600 crores; up by 26% in FY17) and the IL&FS can be a wakeup call for insurance regulator IRDA to make some tougher regulation IL&FS exposure to pension fund managers (PFM) is at around ₹1,200 crores.

The responsibility bestowed upon the credit rating agencies is only amplified when we consider the extracts of the Annual Return (Form MGT-9) filed by the IL&FS as on March 31, 2018. It is a compendium of the indebtedness of the entity.

In the final analysis, it suffices to say that credit rating agencies act as a trustee of public wealth in the sense that they help channelize the savings of financial institutions who invest on the faith of the ratings. The analytical procedures performed by the rating agencies stands in stark union with the pristine beauty of operational efficiency and regular investments made in such companies. The business model of such agencies must be altered to be in line with the industry best practices to ensure their objectivity and independence.
2.6 Ancillary Impact on Corporate Governance Strategies in the India

Corporate governance refers to the use of techniques to balance the interests of the diverse stakeholder groups in an entity. The concept has its own set of rules, practices and processes of directing and controlling a firm, all with the objective of the promotion of common interests of the shareholders.

The long-standing key managerial personnel treated the company as a private fief; they created IL&FS into a network of 350 complex subsidiaries, which, after a point in time, became unmanageable. The company gained confidence by projecting itself as a public sector entity, making it easy to raise funds as and when it required while most of its peers struggled for the same. The entity and its subsidiaries took upon itself to give employment to Indian administrative service officers. This not only included executive positions, but also extended to Board positions in certain cases.

The compromise of the investors well-being is rather manifest in the Management’s Commentary of the Annual Report of the Group for the year 2018-19, wherein it is stated that “As your Company has been defaulting in
servicing its debt obligations since August 25, 2018 and that a resolution process is being implemented for your Company in proceedings pending before the Hon'ble National Company Law Tribunal...your Company is unable to pay dividend to preference and equity shareholders until the satisfaction of all its dues. Considering the magnitude of loss incurred in the financial year, the Board does not recommend any dividend for the year ended March 31, 2019.”

Suffice it is to say that mismanagement, complex holding structure, intertwined with the glaring lapses by the auditors and credit rating agencies led to the almost collapse of the IL&FS. The immediate impact was on the banks and other financial institutions, thereby exposing the vulnerabilities and the systemic risks in the economy.

3. PRIMARY DATA ANALYSIS

3.1 Data Collection

The conclusions and recommendations of this theoretical analysis are supported by a preliminary primary data analysis, the findings of which are explained in the next section (the questionnaire is included in the annexure). The data collected was through justified random sampling so that our purpose of obtaining informed responses could be served.

3.2 Analysis of Responses

The topic under study was a subjective one. The form was closed with 41 respondents and analysis of the same was done using the SPSS software and MS Excel.

We may note at this juncture that the respondents came from different professions, being bank personnel, students, teachers, professors or Chartered Accountants. This gave us a wide array of informed responses, which were necessary for our analysis.

In response to Question 4, dealing with shadow banks, the respondents strongly affirmed our hypothesis.

In response to Question 6, the respondents believe that the systemic risks associated with the IL&FS in the form of High Debt-Equity ratio, coupled with the shortcomings in the audit mechanisms, were the principle reasons for the crisis. Respondents were asked to rank the causes of the ILFS crisis on the basis of their importance (Rank 1 being the most important and so on).

A considerable majority of the respondents believed that the crisis had a significant negative impact on the commercial banks’ lending to NBFCs in general, while having a serious blow to the mutual fund houses and stock exchanges.

![An analysis of the nature of respondents](image-url)
The NBFCs that mainly constitute the Indian shadow banking system, play an important role in increasing financial spread and financial depth in the country.

41 responses

Fig. 8. An analysis of the facts of respondents

Fig. 9. Graphical representation of different parameters

In what way did the ILFS crisis affect the Commercial Banks’ Lending to the NBFCs?

41 responses

Fig. 10. Mutual fund houses and stock exchanges
We analysed the effect on the Mutual Funds and Stock Markets:

In what way did the ILFS crisis affect the Mutual Funds and Stock Markets?
41 responses

Fig. 11. ILFS crisis affect the mutual fund and stock market

The ILFS fiasco has led to a considerable credit crunch in Indian financial markets recently
41 responses

Fig. 12. Credit crunch in Indian financial markets

Fig. 13. Pie chart showing response to questionnaires
Further, we found out that the crisis created a significant credit crunch in the financial markets.

To summarise, suffice it is to say that the respondents had a mixed opinion on the fiasco being a blessing for the Indian economy, but almost everyone agreed to the hypothesis that stronger corporate governance and oversight could have averted this mishap.

4. CONCLUSION AND RECOMMENDATIONS

4.1 Conclusion

The default of the IL&FS in September 2018 was an eye-opener about the financial risks associated with the NBFC sector in India. According to the Report published by Credit Suisse in October 2018, the exposure of NBFCs to the real estate developers is estimated at 2 lakh crores. Further, it is pertinent to note that in 2017, RBI had reported that 99.70% of the shadow banking in India involves the creation of a time tranche; in other words, it involves the activity of creation of long-term loans backed by funding that is short-term in nature.

The NBFCs are regulated by the RBI, and the Securities and Exchange Board of India has an oversight over certain special classes of special institutions like mutual funds, securities-related institutions, and collective investment agencies. Even during such regulatory oversights, the IL&FS crisis has sprung up to reveal the gaping holes in the institutional systems. As the National Company Law Tribunal (NCLT) enters the framework to control further damage in the industry, it is important to stop here and have a look at the state of affairs which has been dubbed as the 2008-like financial crash.

An improved set of disclosure guidelines prescribed by the regulators for the credit rating agencies would immensely aid the investors who find avenues in the capital markets through the purchase of securities in the secondary market or using hedge or mutual funds. A uniform Probability of Default (PD) benchmark being used by the rating agencies across the industry would enable lenders as well as the investors to take a portfolio-level view of the nature of the credit level risk in the country.

The National Financial Reporting Authority (NFRA) has been set up to function as an independent person to review the quality of audits in the country. The powers entrusted upon by the NFRA include stringent penal provisions that may be imposed upon erring auditors. Thus, it is believed that the NFRA would go a long way in reducing the gaping holes present in audit reports.

4.2 Recommendations for Improvement and Scope for Further Research

This analysis encompasses the efforts directed towards analysing the primary causes of the IL&FS defaults. It further goes to pin-point the positive changes it has brought about in the economy, be it in the form of stringency in credit rating, transparent financial reporting or the use of better corporate governance strategies to avoid such future mishaps. It is instrumental to note here that we have stressed upon the lapses of the top management, the auditors as well as the credit rating agencies in general.

However, this study is confined in its magnitude in the sense that it revolves majorly about the shadow banks in the country; other financial institutions like the mutual funds, hedge funds and venture capital funds have not been researched upon. Further, the impacts on the Non-Performing Assets of the banks due to the defaults of IL&FS, the possible course of action by the Government using fiscal policies to curb such crisis are some areas of research that can be closely linked to the subject matter.

Asset-Liability mismatches can be further dwelled upon, with long-term institutional lending forming the backbone of such a study. For example, it is seen that 95 percent of the loan book of NBFCs comprise small ticket sizes with a repayment schedule ranging from two to four years.

Finally, the scope and future of the NBFCs in a developing country like India is in a topic of intensive research and analysis. It is seen that regulatory backing generally prospers such institutions towards prosperity, but we never know the extent of impact it can have in our country with steady rise in the marginal propensity to consume.

COMPETING INTERESTS

Authors have declared that no competing interests exist.
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ANNEXURES

Findings from the Primary Research Conducted

Questionnaire (Annexure-IA)

This academic survey was undertaken using Google Forms (Link to the survey: https://docs.google.com/forms/d/e/1FAIpQLSf3b6eZken8N9ObD8khiyiOCd7Pam8o6DTQwlyOAHpxJPDA/viewform?usp=sf_link) to analyse the causes and effects of the IL&FS crisis. (*) denotes mandatory field)

1. Name
2. Age (*)
   - Less than 25 years
   - 25 years to 55 years
   - More than 55 years
3. Profession (*)
   - Bank Personnel
   - Chartered Accountant
   - Teacher / Professor
   - Student (Commerce or Management)
   - Others. Specify ____________
4. The NBFCs that mainly constitute the Indian shadow banking system, play an important role in increasing financial spread and financial depth in the country. (*)

- I strongly agree with the statement
- I agree with the statement
- Neutral
- I disagree with the statement
- I strongly disagree with the statement

5. The ILFS fiasco has led to a considerable credit crunch in Indian financial markets recently (*)

- I strongly agree with the statement
- I agree with the statement
- Neutral
- I disagree with the statement
- I strongly disagree with the statement

6. How do you rank the following causes of the ILFS crisis on the basis of their importance (Rank 1 being the most important and so on) (*)

<table>
<thead>
<tr>
<th>Cause</th>
<th>Rank 1</th>
<th>Rank 2</th>
<th>Rank 3</th>
<th>Rank 4</th>
<th>Rank 5</th>
<th>Rank 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>High Debt-Equity Ratio</td>
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<tr>
<td>NPA Crisis of Most Major Banks (difficult to refinance the loans)</td>
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<tr>
<td>Complications related to Power, Road and Water Projects such as Land Acquisition Law 2013</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inappropriate Credit Ratings</td>
<td></td>
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<tr>
<td>Lapses in Audit Mechanism</td>
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<tr>
<td>Issues with the Top Management</td>
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</tbody>
</table>

7. In what way did the ILFS crisis affect the Commercial Banks' Lending to the NBFCs? (*)

- Increased Considerably
- Increased Moderately
- Remained Unchanged
- Decreased Moderately
- Decreased Considerably

8. In what way did the ILFS crisis affect the Mutual Funds and Stock Markets? (*)

- Serious Adverse Effect
- Moderate Adverse Effect
- No Effect
- Moderate Favourable Effect
- Considerable Favourable Effect

9. Do you think that stronger Corporate Governance could have averted this mishap? (*)

- Yes
- No
- Not Sure
10. The IL&FS fiasco was a blessing in disguise for the Indian economy as it served as a wake-up call for the regulators. (*)

- I strongly agree with the statement
- I agree with the statement
- Neutral
- I disagree with the statement
- I strongly disagree with the statement

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