Why IL&FS default makes a compelling case for revival of FRDI

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Companies without sufficient cash flow defaulting is normal, but what about a company with four times its quarterly payments turning away lenders? It's strange but true, thanks to Infrastructure Leasing & Financial Services (IL&FS) administration which has sent investors into a tizzy.

The default by a financially sound road operator has raised doubts about the sanctity of a legal structure that lenders rely on to fund, throwing up yet another complication in funding infrastructure, where lenders have already turned their backs on after many misadventures.

When the IL&FS-promoted Jharkhand Road Projects Implementation Co failed to pay investors their dues this month, it not only dented investor sentiment but also exposed the huge gap in the country's fledgling bankruptcy law.

Jharkhand Road, a so-called special purpose vehicle (a company which is independent of its promoters' liabilities), failed to pay Rs 76 crore to investors when the payments for its bonds were due. It cited the National Company Law Board's payment moratorium order granted to its parent IL&FS after government pleaded for it following its default in September.

"In a court of law, the SPV model should hold and its fortune should be separate from holding company," said Jyoti Vaswani, chief investment officer, Future Generali Life Insurance. "If it does not hold, then there could be question mark in the SPV model structure."

That led to rating company Crisil downgrade the bonds to the junk D category from BB. Mutual funds with investments of Rs 500 crore in six schemes had to take a knock of at least a quarter of the net asset value of these bonds. Jharkhand Road had about Rs 345 crore of liquid funds, which is about 4.5 times its quarterly repayment obligation. Its dues were Rs 76 crore this month.

"The default is a manifestation of change in the management's willingness to pay and the emergence of sharply increasing legal risks," said Crisil analysts while downgrading the bonds.

SPV sanctity goes

Infrastructure funding has been problematic with little long-term funds available to build roads or power plants even though the need for such projects is huge. Builders evolved the SPV model that would ring-fence the companies from their promoters. They were supposed to be self-financing and pay the lenders from their cash flows instead of depending on parent companies.

Nor do they have any links with any other business.

This gave the lenders the benefit to study projects and decide on lending. The parent companies' other businesses did not influence much.

A Reserve Bank of India's 1999 inhouse report, prepared by the Working Group, titled 'Asset Securitisation' says that "an SPV must be bankruptcy remote i.e. the bankruptcy of originator should not affect the interests of holders of instruments issued by the SPV."

But in the case of Jharkhand Road, this assumption has been breached.

Once bitten twice shy. Banks, the biggest lenders to infrastructure, have shrunk their loans to the sector to `8.9 lakh crore in 2017-18, from Rs 9.85 lakh crore in 2015-16.

Mutual funds have been pummelled by the default of holding company IL&FS' own bonds of Jharkhand SPV. Their aversion to ring-fenced infra projects would only grow.

"The biggest concern is that the SPVs that were ring-fenced from the promoter health are barred from repaying the outstanding liabilities," said Aneesh Srivastava, CIO, IDBI Federal Life Insurance. "Unless the issue of ring-fenced subsidiaries are resolved quickly, it may create systemic risk and well performing SPV model will come into question."

IL&FS takeover

The government in October sacked the board of directors of IL&FS and seized control of it after it defaulted on Rs 91,000 crore of loans as its failure to pay shook the financial markets and led to a freeze in lending.

It subsequently appointed Uday Kotak as its chairman to set its house in order. Since the company was in no position to meet its payment obligations after a series of defaults, it sought a moratorium on payments from the National Company Law Tribunal. The appellate authority will hear the case on February 4.

The management's decision to stop payments even at the SPV level has raised legal questions on the action, as many believe that they have the right to payments when the company is healthy.

IL&FS has 340 affiliates, including subsidiaries and SPVs, and lenders have Rs 60,000-crore exposure to the group and SPVs. Some of them are cash generating and some of them need restructuring.

Now, almost all the bonds floated by the group face an imminent downgrade to the junk status.

"We have received an opinion from a retired Chief Justice of India, confirming that regular repayment or redemption of principal and interest amount by the project SPV is not impacted by the order," said Dinanath Dubhashi, chief executive at L&T Finance, which owns the bonds of Jharkhand Road. "NCLAT order puts a stay on specific punitive actions but does not prohibit normal servicing of interest and principal repayments."

As lenders wait with bated breath on what could be in store for them, the assets that are good are also turning bad. IL&FS'

plans to sell assets to repay the lenders could turn less profitable with many of the running assets losing their value when they turn bad.

For instance, its thermal power project at Cuddalore in Tamil Nadu, which has been paying lenders has also stopped payments and lenders have been barred from taking funds from the escrow account. This has led to lenders stepping back on lending even for working capital to the power unit, which faces the threat of closure.

Time for FRDI

While the country has moved to the bankruptcy laws regarding manufacturing and services firms, financial services firms such as banks have been left out of its purview since they require a differential treatment because of depositors' funds. But there are some who believe that lenders still could proceed against the group in NCLT for resolution under the IBC.

"It is a non-banking financial services company registered under the Companies Act, they should not have a different procedure for winding up," said Ashish K Singh of Capstone Legal Services. "They will become accountable for using public money if IBC provisions are made applicable to them."

But a separate resolution mechanism could have helped to avoid the current mess.

The government proposed to come up with the Financial Resolution and Deposit Insurance (FRDI) Bill, 2017 that would have addressed the resolution of financial firms.

That Bill had proposed to set up a resolution corporation with powers relating to transfer of assets to a healthy financial firm, merger or amalgamation, liquidation to be initiated by an order of the National Company Law Tribunal for financial services companies.

It had to be junked due to misplaced fear mongering over the reduction in deposit insurance with a cap. Although there is a cap of Rs 1 lakh even now, it was campaigned that people would lose their deposits when a bank goes bankrupt.

As the IL&FS resolution meanders through the judicial process, the complications suggest that it may be time to quickly revive the FRDI Bill and pass the legislation.