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RIP project finance

It's no coincidence that every financial institution that attempted project lending has come to grief

The last bastions of long-term project financing in India seem to be crumbling. ICICI Bank recently decided to quietly shutter its project finance division. Public sector banks who have accounted for the bulk of industrial lending in recent years may not overtly say it, but they too have been withdrawing from long-term industrial loans to focus on shorter-term retail and working capital loans. After all, it was the project lending binge during the boom years of 2003 to 2010 that left them with their current burden of non-performing loans, that have proved a dead weight on their balance sheets. Even with the new Bankruptcy Code in place, seizing control of and liquidating those assets is proving a Herculean task. The proximate reason that banks cite for their retreat from project lending is the lack of demand, given the stalled capex cycle. But even if demand picks up, it is very doubtful if banks will return to this business. It is certainly no coincidence that every financial institution in India that has attempted to focus on project lending in the past has come to grief. After pouring subsidised government funds into unviable steel, textile and engineering projects in the pre-liberalisation era, development finance institutions IFCI, ICICI and IDBI had to pivot to other forms of lending to survive. IDFC and IL&FS, which stepped in to fund the later telecom, power and airport projects, have come a cropper too with the former splintering and the latter collapsing. Of late, questions are even being raised about the sustainability of sovereign-backed entities such as NHAI that have drawn on unlimited credit lines to fund the infrastructure buildout.

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These failures essentially underline structural problems that bedevil long-term project financiers in India. One, given the dearth of long-term funding sources from a rudimentary bond market, project lenders need to constantly battle asset-liability mismatches that leave their balance sheets highly vulnerable to turbulence. Two, lenders across the spectrum have displayed poor appraisal skills in their complete inability to assess project cash flows over a complete cycle. Three, the parlous state of corporate governance has led to widespread gold-plating of project costs that masks funds diversion by promoters, sometimes in collusion with lending officials. Finally, the scams, collusion and rent-seeking have triggered over-the-top judicial interventions, leading to a logjam in land acquisition, natural resource allocation and pricing, halting even legitimate projects in their tracks.

These are in fact the reasons why any renewed attempt to re-start the project lending cycle in India must address these imponderables, instead of reinventing the erstwhile development finance institutions in new avatars. Project financiers, to succeed in India, will need access to long-term funds from a deep bond market, specialist project appraisal skills relevant to their specific sectors and concerted government effort to clear the logjams in getting the projects off the ground, while being required to conduct stringent on-ground checks on the end-use of funds.

OTHER VOICES

ALL THE NEWS WITHOUT FEAR OR FAVOR
The Japan Times

Troubling developments at ASEAN summit

This year's annual summits of the ASEAN involving its member states and their dialogue partners will be remembered as potentially historic failures. The shortcomings are not by ASEAN, but by two of its diplomatic partners — the US and India — who failed to engage the organisation with the seriousness that demonstrates their commitment to the region and its future. The ASEAN summits are intended to cement the organization's "centrality" to regional discussions. TOKYO, NOVEMBER 6

GULF NEWS

Arab protests, a call for social justice

The images streaming from cities in three countries in our region — countries that, tellingly, had sat out the 2011 Arab Spring — spell it out: Demonstrators are out in the streets protesting against the miserable social, political and economic conditions that have long bedevilled their lives. They are asking their governments why they have to live destitute, truncated lives while their political elite are seemingly answerable to no one. DUBAI, NOVEMBER 6

CHINADAILY

Sage counsel for HK's future well-being

Speaking publicly for the first time about the turmoil in the Hong Kong Special Administrative Region, President Xi Jinping said that ending the violence and chaos and restoring order are the most important tasks for the SAR government at present. What the SAR is facing is an unprecedented challenge not only to its government, but also to the rule of law. Xi's remarks were a signal to the forces behind the current crisis that despite their persistence their destabilisation campaign is doomed to fail. BEIJING, NOVEMBER 5

Markets and the Trump-Modi effect

Both the S&P 500 and the Sensex are currently at record highs, largely due to political currents. This isn't a good sign

LOKESHWARRI SK

POINT BLANK

Investors in the Indian stock market have been exulting as the Sensex has been notching new life-time highs since last Friday. But the Indian benchmark is not alone in this. The S&P 500 and the Nasdaq Composite too managed to close at record levels last week and the Dow Jones Industrial Average followed suit with a record high this week.

The similarity between the benchmarks of the two countries does not end there. Stocks in both markets have been defying gravity even as the fundamentals have been flashing red. It is quite obvious that political will has a large part to play in keeping the indices buoyant in the US as well as in India. With the US Presidential elections slated next calendar and a series of State elections over the next few years in India, it is clear that leaders of both countries are using the stock market as a means to keep sentiment upbeat.

But is this practice healthy for the long-term health of equity markets?

The Trump effect

The twitterati would vouch for the fact that the POTUS has his eyes firmly glued on the stock market performance and uses it blatantly to prove the effectiveness of his governance. "The stock market hit 25,000 yesterday. Jobs are at an all-time record and that is before we fix some of the worst trade deals and conditions ever seen by any government. It is all happening!", ran his tweet in July 2018. And his latest tweet (on November 5): "Stock market hits record high. Spend your money well."

Donald Trump has also triumphantly tweeted about the number of times the Dow Jones Industrial Average has hit record highs since he took over, to prove that his has been the most successful presidential term ever.

But such obsession with market indices is perhaps preventing natural corrections that is necessary to allow stock prices to revert to mean. The Dow Jones Industrial Average has not witnessed a bear market — decline of over 20 per cent from the peak — since 2008. Towards the end of 2018 however, the Dow Jones Industrial Average declined 19 per cent from its peak between October and December 2018 due to concerns about slowing growth and global trade war. But the Federal Reserve was literally bullied into halting its interest rate hikes and slowing its monetary tightening in that period, which helped US stocks pick up steam again.

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This unwillingness to let stocks correct is however resulting in pricey valuations in the US market. According to *factset.com*, earnings of S&P 500 in the third quarter of 2019 declined 3.7 per cent, based on companies that have declared results so far. If the trend remains similar for all companies, this will be the first time the index has reported three straight quarters of year-over-year earnings declines since 2016. The forward 12-month P/E ratio for the S&P 500 is well above both the five- and 10-year averages.

The Indian scene

Similar interest in stock market indices has been displayed by many politicians in India. Back in the 1990s, it was common for the ruling government to ask the prominent mutual fund of those times to buy stocks and push prices higher, whenever there was a crash. While Finance Ministers like Pranab Mukherjee were quite disdainful about the role of stock markets in contributing to economic growth, others like P Chidambaram were very alert to factors impacting markets and quick to take actions to support stocks.

The Modi government in its first term did not really show too much interest in the Sensex or the Nifty. In fact many of the policies — such as re-introduction of long-term capital gains tax on equity and equity mutual funds and increase in surcharge and cess on corporate tax — had hurt investors and listed companies. That government perhaps had little to worry about market crash then since large-cap indices had remained elevated between 2014 and 2019, thanks to liquidity from mutual funds and pension investors.

However, in its second term the Modi government appears to be following the footsteps of the US President. While the sharp deceleration in consumption and GDP growth was purported to be behind the government's recent stimulus measures responses, the 10-per cent decline in the Sensexin July and August also seems to have made the Centre act.

The rolling back of the increase in surcharge on capital gains and the massive corporate tax cut were largely aimed at lifting the stock market sentiment. What is more, the RBI is also lock in step with the Centre to boost investor morale.

But such political intervention is distorting price discovery. Even as the Sensex hits a new life-time, the revenue and operating profits of listed stocks have declinied in the September quarter compared to a year ago, based on companies that have declared results so far. Compounded average growth in net profit of companies forming part of BSE 500 between FY14 and FY18 was -0.41 per cent. It is, therefore, not surprising that Sensex's price-earning multiple is at 20 per cent premium to its five-year average.

Investor sentiment matters?

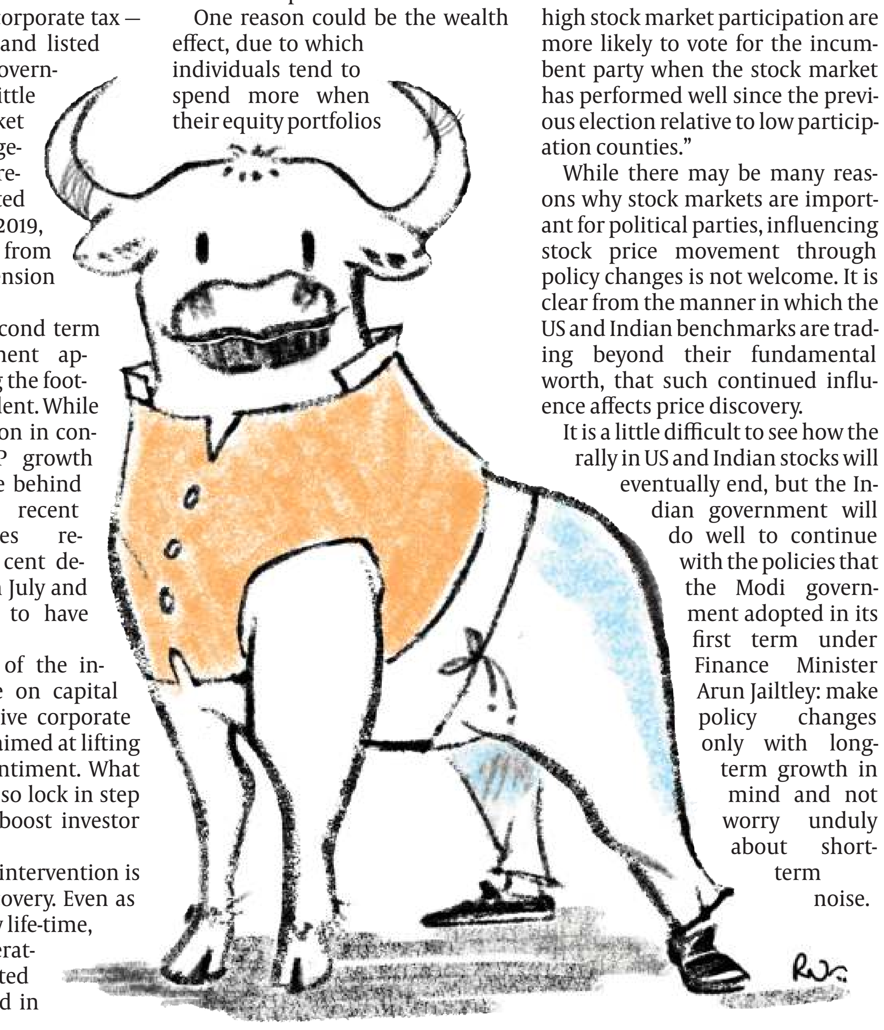
Having seen that political will influences stock prices, the next question is: Why do governments worry about stock price movement?

One reason could be the wealth effect, due to which individuals tend to spend more when their equity portfolios sport robust returns due to stock market rally. Some governments could be trying to boost consumption through this route. Two, since stock prices reflect future expectations regarding the economy and business environment, leaders such as Trump have been interpreting market moves as a vote of confidence for their governments.

Three, research shows that investor sentiment does affect election outcomes. A paper published by Alan Crane, Andrew Koch and Leming Lin that analysed the US presidential elections at county level found that "counties with high stock market participation are more likely to vote for the incumbent party when the stock market has performed well since the previous election relative to low participation counties."

While there may be many reasons why stock markets are important for political parties, influencing stock price movement through policy changes is not welcome. It is clear from the manner in which the US and Indian benchmarks are trading beyond their fundamental worth, that such continued influence affects price discovery.

It is a little difficult to see how the rally in US and Indian stocks will eventually end, but the Indian government will do well to continue with the policies that the Modi government adopted in its first term under Finance Minister Arun Jaitley: make policy changes only with long-term growth in mind and not worry unduly about short-term noise.



Testing times for securitisation deals

The NBFC crisis and the recent Bombay High Court ruling in the DHFL case pose many challenges

VINOD KOTHARI

The Indian securitisation market has faced, among other things, taxation challenges and regulatory changes. However, it has so far been immune from questions about securitisability of assets, or the structure of securitisation transactions. However, sitting at the very doorstep of defaults by some major originators, and facing a spectrum of serious servicer downgrades, the Indian securitisation market clearly faces the risk of being shaken at its very core in not too distant a future.

Sale of assets to trusts

In the interim order on plaints by some mutual fund investors in Dewan Housing Finance Corporation Ltd (DHFL), the Bombay High Court made certain observations that may hit the conduct of the originator on securitisation of receivables. For example, in the interim order of October 10, 2019, in Commercial Suit No 1034 of 2019, it was contended that the receivables which were securitised by DHFL were already charged on a *pari passu* basis to bondholders. The court observed that if the assigned receivables were already subject to a breach of the asset cover of the debentures which were also secured by the very same receivables, DHFL and "the banks participating in the securitisation of receivables already subjected to a charge may have some tough questions to answer."

The practice of *pari passu* "floating charge" on receivables is quite commonly used for securing issuance of debentures; almost every NBFC debenture issue is secured by such floating charge. The practice of floating charges has itself been discarded in the UK where from it emerged out of 19th century rulings. However, in India, owing to a technicality of "deposit" rules, the practice of secured debentures continues. World-over, corporate bonds are unsecured.

While bond issuance practices surely need re-examination, the burning issue for securitisation transactions is: If the DHFL interim ruling results in some final observations of the court about need for the bond trustee's no-objection certificate for securitisation transactions, all existing securitisation transactions may also face similar challenges.

Servicer-related downgrades

Rating agencies recently downgraded several pass-through certificate transactions of a leading NBFC by two notches from AAA ratings. The rationale given in the downgrade action, among other things, cites servicer risks, on the ground that the originator has not been able to obtain continuous funding support from banks. But how does it affect servicing capabilities of existing transactions, is a curious question. Normally, the responsibility of the collection of loans still lies with the seller or originator of loans (also called the servicing agent). It seems that in addition to the liquidity issue, which is all pervasive, the rating action in the present case may have been inspired by some internal scheme of arrangement proposed by the NBFC in question.

However, what is important is that the downgrades are muddying the transition history of securitisation ratings. The susceptibility of securitisation transactions to pure originator entity risks puts a risk which is usually not considered by securitisation investors. In fact, the flight to securitisation and direct assignments after the IL&FS crisis was based on the general notion that entity risks are avoided by securitisation transactions.

The biggest jolt may be a forced servicer transition. In something like RMBS (residential mortgage-backed securities) transactions, outsourcing of collection function is still easy. However, if it comes to more complicated assets requiring country-wide presence, borrower franchise and regular interaction, if servicer transition has to be forced, the transaction will be worse than originator bankruptcy.

Risks ahead for securitisation market

Questions on true sale

The market has been leaning substantially on the "direct assignment" route.

If the truth of the sale in most of the direct assignment transactions is questioned in cases such as those before the Bombay High Court, it will not be surprising to see the court re-characterise the so-called direct assignments as nothing but disguised loans. If that was to happen, not only will the investors lose the very bankruptcy-remoteness they were hoping for, the RBI will be chasing the originators for flouting the norms of direct assignment.

NBFCs are passing through a very strenuous time. Any abrupt strong action may exacerbate the problem. As for securitisation practitioners, it is time to strengthen practices and realise that the truth of the sale is not in merely getting a true sale opinion.

The writer is an author and consultant on securitisation

LETTERS TO THE EDITOR

Send your letters by email to bleditor@thehindu.co.in or by post to 'Letters to the Editor', The Hindu Business Line, Kasturi Buildings, 859-860, Anna Salai, Chennai 600002.

Right move on RCEP

This refers to 'India, post RCEP' (November 6). Since India's interests were not addressed it did not make sense for us to sign on the dotted line. Moreover, when our country is mainly an import-driven economy, it is all the more imperative that we do not enter into any pact that will further increase our trade deficit. In the past, such partnerships have proved to be unfavourable for India.

Small businesses which have suffered post-demonetisation and the GST would have been hit further had India accepted the RCEP deal. For the government though, the main task starts now. It has to ensure that Make in India gets the desired push and all the pending domestic reforms see the light of the day, to really make India's decision meaningful. We will have to improve our exports by several notches and that can only happen when we produce quality products and given China a run for its money in the global market.

Bal Govind
Noida

Power play

This refers to 'Doors still open for Sena: BJP' (November 6). It's really unfortunate that both the BJP and the Shiv Sena have mindlessly been indulging in dirty politics in Maharashtra. What else could explain the 'hide and seek' game being played over the post of chief ministership for the 12 days or so. While the Shiv Sena has all along been insisting on sharing the CM's post, the BJP is not for it and has, instead, offered the Sena the newly carved-out position of Deputy CM as also several key ministerial berths in the new regime.

However, what truly prevents the Sena from forming the government with support of the Congress and the NCP if the numbers add up, remains the moot question? Is it still expecting some change of heart on the part of its pre-poll ally or awaiting any better offer? Needless to say, the political image of both of them has taken a beating and one earnestly wishes that they sort out their differences early.

SK Gupta
New Delhi

The bane of bank frauds

This refers to 'Bank fraud cases: CBI conducts searches in over 185 locations' (November 6). The reported fact that the CBI has conducted these searches across as many as 16 States and Union Territories, in connection with some 42 cases related to bank frauds involving around ₹7,200 crore, obviously raises several eyebrows. Significantly, two SBI branches alone reportedly accounted for over ₹2,366 crore.

But sadly, the buck does not stop here as the list of fraud-smitten banks includes IDBI Bank, Andhra Bank and 12 other prominent public sector banks.

For sure, such a worrisome situation could be attributed to some hidden nexus between the fraudulently 'borrowing' companies/firms and the 'conniving' bank staff, who may have wilfully 'circumvented' the prudential banking norms while extending such a massive line of credit.

Kumar Gupt
Panchkula, Haryana

Beyond the law?

This refers to the news report 'Opposition: Where is Amit Shah?' (November 6). That the authorities did not act with alacrity in controlling the clashes that erupted between the policemen and the lawyers, following a parking row at Tis Hazari Court complex in New Delhi, is self-evident. It is reported that at least 20 police personnel and several lawyers were injured. However, what caused the unprecedented revolt by policemen is the suspension and transfer of some of their colleagues, following a Delhi High Court order, while no action was taken against the offending lawyers. There is video evidence of the protesting lawyers going on a rampage, stopping traffic at different places, manhandling passers-by and damaging police property.

The role of lawyers in a democratic society like India is dispute resolution between litigants, by rendering proper legal advice and where this is not effective, help the parties obtain justice from the appropriate court of law. As such, it is unbecoming of them to take the law into their own hands, behave like hooligans, meting out summary justice by assaulting whomsoever they do not see eye to eye with.

V Jayaraman
Chennai

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