DHFL Meltdown: The Corporate Governance Lapses

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Abstract

India's non-banking financial institutions (NBFIs), broadly constituting the less-regulated shadow banking sector, have been plagued with scams, triggering a domino effect in the Indian money market. Major corporate governance issues were highlighted in NBFIs with the unfurling of the ILF&S fraud; it virtually created a sub-prime crisis. In such a scenario, where the shadow banking sector was subject to change in regulations to ensure vigilance, corporate governance lapses had again led to the meltdown of Kapil Wadhawan led Dewan Housing Finance Limited (DHFL). Registering a net profit growth of 25% in the third quarter of financial year 2017, DHFL was one of India's leading housing finance companies with a value of whopping ₹1.01 trillion as its asset under management (AUM). The company had nose-dived from its coveted position, suffering a loss of ₹22.23 million for the last quarter of the financial year 2018–2019. The company's credit ratings of commercial papers and non-convertible debentures were downgraded; non-payment of interests led to enforcement of resolution plan, with the board of directors acceding to nationalized banks. The company's reputation had crashed with its share prices, amidst allegations of lookout notice issued for its promoters for siphoning funds through shell companies. The case describes the oversights and negligence of DHFL in terms of corporate governance practices in the context of the NBFC (non-banking financial company) sector. The jury is out to evaluate whether Wadhawan had followed the rules of corporate governance in letter and spirit, or the tightening noose of regulations and market sentiments around the 'shadow banking' sector of India spelt doom for DHFL.

Keywords

shadow banking, non-banking financial company or NBFC, corporate governance

Discussion Questions

1. Analyse the CG models across the globe; compare and contrast the Anglo-US and Indian CG model.

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2. Discuss CG requirements of the NBFC sector and explain CG failure in DHFL.
3. Recommend a future course of action to present DHFL management.

Introduction

Perplexed, on the morning of Monday, July 15, 2019, Kapil Wadhawan, Chairman and Managing Director, Dewan Housing Finance Limited (DHFL), was unnerved by a 32% dip in its share price (Exhibit 1), recording the lowest traded price in the past six years (DHFL, 2019b). The story of DHFL, heavily exposed through shadow banking, had unfurled with reporting a loss of ₹22.23 million for the last quarter of 2018–2019 (PTI, 2019). ‘In the backdrop of a significant slowdown in disbursement and loan growth post-September 2018, the financials of the company have been quite strained for the quarter impacting the overall performance of the year’, Wadhawan had shared, along with the audited financials of Q4 2019 (DHFL, 2019d). From the demand of an independent inquiry by Indian National Congress to the rumours of lookout notice issued by the Government of India to its promoters, in the core of Wadhawan’s jeopardy was the question, did DHFL follow the rules of corporate governance, not just in letter but also in spirit? With its more than three-decade-old existence in question, would the company be able to settle the dust about allegations of ethical issues? Would the tightening noose of regulations that surround India’s ‘shadow banking’ sector spell extinction for DHFL? On that fateful morning, the company’s nose-dive from zenith had just commenced; little was known how the future would unfold.

Rising Scrutiny on India’s Non-banking Financial Sector

‘We are monitoring NBFCs and their operations at regular intervals’, Reserve Bank Governor, Shaktikanta Das had shared after the post-budgetary meeting in July 2019. What followed was RBI’s stringent review of asset-liability mismatch (ALM) of NBFCs, which had chosen to offer easy liquidity in contrast to the Indian banks’ scepticism.

Umesh Revankar, CEO of NBFC Shriram Transport Finance, shared,

> Today, the audit is more detailed than in the past. Earlier, they were looking at credit quality… now they are looking at it in more depth. RBI is asking for top 50–100 assets that have gone bad. It gets into the details, including deviations.

RBI’s fortitude was after the unfolding of debt of ₹910 billion by Infrastructure Leasing & Financial Services Limited (IL&FS) and its subsidiaries, resulting in defaults of multiple loan repayment and an investigation by serious fraud investigation office of Enforcement Directorate, Government of India (Rajput, 2019). As a correctional measure to rectify the perceived gap in the regulatory framework of NBFIs in India, in the budget 2019–2020, the finance bill proposed amendments to the Reserve Bank of India Act, 1934, to ascertain that the central bank could supersede the board of directors of an NBFC if its operations were detrimental to the interest of the investors (GoI, 2021).

This meant that the financial turmoil of DHFL had suddenly become grimmer in the view of the rising scrutiny and changes in the policy environment (Exhibit 2). The company had raised ₹110 billion in June 2018 by a public offering of non-convertible debentures at an annual yield of 8.9–9.1% across maturity. It was trouble in paradise when, citing liquidity issues, the first pay-out of interest in June 2019 was delayed, leading to a subsequent downgrading of the company's commercial papers' credit rating by CRISIL (CRISIL, 2019). The event was unprecedented as back in December 2017, DHFL had registered a net profit growth of 25%, the profit amounting to ₹3.05 billion, for the third quarter of financial year 2017 (Exhibit 3). At that time, it was one of India's leading housing finance companies with a whopping value of ₹1.01 trillion as its asset under management (AUM).

> Since the last nine months, with single-minded focus, we have met all our financial obligations and are looking to return to business normalcy at the earliest. Since September 2018, DHFL has managed to make repayments of over ₹418 billion primarily through securitization of assets and repayment collections.
>
> With the outstanding loan book evaluated at ₹1.19 trillion in FY 2019–2020, Wadhawan's strain was evident in his statement. (DHFL, 2019d)

Could a collapse, as sudden as this, been avoidable if the regulatory framework for NBFCs been devoid of a window of opportunity for opacity to creep in? In India, how was the regulatory framework for an NBFC such as DHFL different from a bank?

Shadow Banking in India

The financial stability board (FSB), an international body monitoring the global financial system, defined 'shadow banking' as lending by institutions other than banks. In times of global financial crisis, traditional lending through banking institutions was under stress in developed and emerging economies. This gave rise to 'shadow banking' through less-regulated non-banking financial institutions. In May 2014, Mark Carney, governor of the Bank of England and head of the Financial Stability Board, defined shadow banking as the 'global bogeyman' which had the potential of a silent ticking bomb in the absence of regulations related to capital and liquidity requirements (FSB, 2019).

In India, these institutions were heterogeneously termed as Non-Banking Financial Institutions (NBFIs), regulated under the purview of Reserve Bank of India, under three distinct categories (RBI, 2002, 2018):

1. All-India financial institutions (AIFIs) consisting of apex institutions providing long-term developmental lending, like NABARD and SIDBI
2. Primary dealers (PDs), who were market makers, with pre-mandated success rates, for Government of India securities (G-Secs), Treasury bill (T-Bills), and Cash Management Bills (CMBs) (RBI, 2018).
3. Non-banking financial companies (NBFCs), with various lending services ranging from personal loans to infrastructure financing.

The NBFCs were further classified in NBFC-D and NBFC-ND, which were authorized to accept and hold public deposits and unauthorized to do so but may raise deposits from the market and banks. As of March 31, 2019, there were 9,659 NBFCs registered with the Reserve Bank of India, of which 88 were NBFC-D and 263 systemically important NBFC-ND (*Mint*, 2019a). The leading financial daily, *The Economic Times*, stated in August 2019, 'Demand for everything from cars to cookies has waned as India's lingering shadow-banking crisis weighs on private consumption, which accounts for almost 60% of the gross domestic product' (Goyal & Sarkar, 2019)

About DHFL

DHFL was a deposit-taking Housing Finance Company (HFC), thus, under the category of NBFC-D. Incorporated in 1984, DHFL primarily provided housing finance to low and lower-middle-income groups in tier-II and tier-III cities. The company also offered non-housing loans such as loan against property (LAP), developer loans, and small & medium enterprise (SME) loans. DHFL had a pan-India presence through 322 locations on March 31, 2019 (DHFL, 2019a).

The Founder Member of DHFL, Late Rajesh Kumar Wadhawan, established the company in the year 1984 with the egalitarian vision (DHFL, 2019a):

'Every Indian to own a home of his own'

Fast forward to July 2019, and the vision stood as painstaking parlance to the 'American Dream' of President of America, George W Bush, of 'working together as a nation to encourage folks to own their own home' (Becker, 2008). Both the notions gave rise to low-quality home-loans; wherein America had Government-mandated schemes disbursing loans to the low and very low-income borrowers at sub-prime lending rates resulting in a world-wide financial crisis (Wallison, 2009); DHFL struggled to forward any new loans even as their existing loans turned into non-performing assets (NPAs) rising from 0.96% in FY18 to 2.74% in FY19 (DHFL, 2019d).

Board of Directors

While the management of DHFL claimed to focus upon the company to become 'the finest organization', the structure of the board and the respective committees were noteworthy. Under Kapil Wadhawan as the Chairman and Managing Director, the board of DHFL had only one non-executive director, his brother Dheeraj Wadhawan (DHFL, 2019b). Dheeraj had the director and shareholder of the major promoter-driven holding company of DHFL, Wadhawan Global Capital (Exhibit 4). Amidst the mounting debt and the stock-price decline (Exhibits 5 and 6), the DHFL board had only four other members apart from the Wadhawan brothers; all of them were in the capacity of additional non-executive independent directors. Two members, Srinath Sridharan and Deepali Pant Joshi, were also in leadership roles of Wadhawan Global Capital (WGC, 2019).

Apart from being the Chairman & Managing Director, Kapil Wadhawan had been calling the shots as the only executive member of the board, member of the Risk Management Committee, Finance Committee, and the newly constituted special committee for sale of the strategic investments.

DHFL's Disregard for Regulations

In 2003, DHFL acquired the housing finance arm of ING Vysya Bank, followed by the Deutsche Post Bank Home Finance Ltd. (DPBHFL) acquisitioned in 2010 to enter the middle upper-middle-income segments in tier-I cities. DPBHFL was renamed First Blue Housing Finance Ltd. and was merged with DHFL in March 2013 (CRISIL, 2019). Thus, the company ventured out of its competency area, housing loans for the low and very low-income group. This had an impact on not just its business strategy but also on its book value. It was disbursing bigger ticket size loans corresponded to maintaining a higher level of capital adequacy to match higher risk exposure levels.

The National Housing Bank (NHB), under the aegis of RBI, prescribed in the NHB Act 1987 that HFCs like DHFL needed to maintain a percentage of assets in specified securities and created reserve funds; the objective was to be able to pay out the accrued interest and the accepted deposits at any point of time. The moment DHFL entered the middle and upper-middle-income loan segments, their exposure increased to a level that DHFL was hardly capable of. The audited financials, however, painted a different picture.

NHB mandated HFC to match-up their borrowings to the tune of 12 times their net-owned funds. The capital adequacy ratio was 10% at the moment and was mandated to increase to 13% by March 2020, 14% by March 2021, and 15% by March 2022 (*Mint*, 2019b). These mandates were applicable on financials audited under Indian Accounting Standards (Ind As). The NHB observed in March 2019 that DHFL's capital adequacy was marked at 10.28%. Since it tanked from a steady 17.74% in December 2018, the promoters could not have been unaware of the same (Exhibit 7). In its audited financials for FY 2019 (Exhibit 8), the company explained that the capital inadequacy observed by NHB 'relate to numbers compiled based on regulatory guidelines' and 'the Management believes that the observations as mentioned earlier may not have any implications on the same' (DHFL, 2019c).

The Audacity of Hope

In the year 2011, riding high on success, Kapil Wadhawan was amongst 14 illustrious finalists of Ernst & Young's Entrepreneur of The Year award. The nomination was titled 'Audacity of Hope'. Wadhawan was credited for being the 'mastermind behind designing and implementing new loan processing software, leading to an efficient online loan management system' (E&Y, 2011).

With its Loan Documentation process in place, the auditors expressed concerns over lacuna in the documentation of loans worth ₹207.50 billion (Exhibit 9). The concerns ranged from insufficient information and explanation regarding credit, legal, and technical evaluation. The company admitted that the loan repayment cheques were not submitted for clearance on the borrower's instance, but the receipt was issued. This was not a single instance but amounted to ₹164.87 billion of gross value per auditors (Quint, 2019).

Impoverished Offer of Credit

Inter Corporate Deposits (ICDs), unsecured and with high-interest rates, were offered by companies with an extra cash reserve. The position of DHFL post-December 2018 was not that of a company ideally in a position to offer ICD since it was barely in a position to meet its interest payments for NCDs. Yet, it chose to rollover ICDs worth ₹56.52 billion, wherein auditors questioned the borrowers' creditworthiness. (Exhibit 9)

The audited financials of FY 2019 revealed that net ICDs of ₹48.20 billion were granted during the year. The report also mentioned that there were lapses in the documentation regarding grants and rollover of ICDs. The same was being rectified, wherein a temporary loan was granted without complete evaluation of the project. On a sad note, the report observed that the management believed that the documentation deficiency will not affect the 'enforceability of the underlying asset' (DHFL, 2019c) (Exhibit 11). Further, these unsecured loans had added fuel to the fire, with rumours of DHFL orchestrating a scam through shell companies by siphoning off its earnings.

Living off Loans

How could companies like DHFL quantify the creditworthiness of their borrowers? The Responsible Lending Guidelines by World Bank stated that when a household spend more than 30% of its gross monthly income in repaying its borrowings, it was a sure sign of over-indebtedness (Prouza, 2013). In Indian Public Sector Banks, the borrower's EMI was expected to be less than 60% of the income. Most of such loans of DHFL, amounting to an aggregate of ₹400 billion, with low default possibilities and good repayment history, were bundled, rated, and sold in the process of securitization to meet its interest repayment commitments. Of these, loans aggregating to a tune of ₹120 billion were bought by Indian Public Sector Banks. This left DHFL with high-risk loans of ₹348.18 billion, including those focused on the real estate projects with no takers.

The turn of events from March 2019 had been a blow to the entrepreneurial reputation of Kapil Wadhawan. DHFL was no more the best in the business; it received scepticism from retail and institutional investors (Exhibit 10). Within the present framework of regulations, he had to accede to pass on the baton to promoting banks, including State Bank of India and Union Bank. Miniscule was left of his credibility when the NCD investors received a request for consent from DHFL's debenture trustee, Catalyst Trusteeship Limited (CTL), regarding authorizing CTL to meet the obligations of the intercreditor agreement (ICA) of the NCD, in the light of DHFL's default status on outstanding NCDs (Exhibit 12). One wondered whether the beginning of the resolution process by trustees like CTL ended in a complete takeover of the board of DHFL and marked an exit for Wadhawan.

Corporate governance in the Indian NBFC sector witnessed major violations and a digression in the past two financial years. This was eminent through a domino effect in the capital market as well as the money market. Regressing from the core business of lending to bundling and securitizing its loan portfolio, how will the debt burden of DHFL be eventually restructured? Will the banks, which have taken over the board of DHFL ever be able to turnaround DHFL? Will the poor state of DHFL's corporate governance be set right?

Declaration of Conflicting Interests

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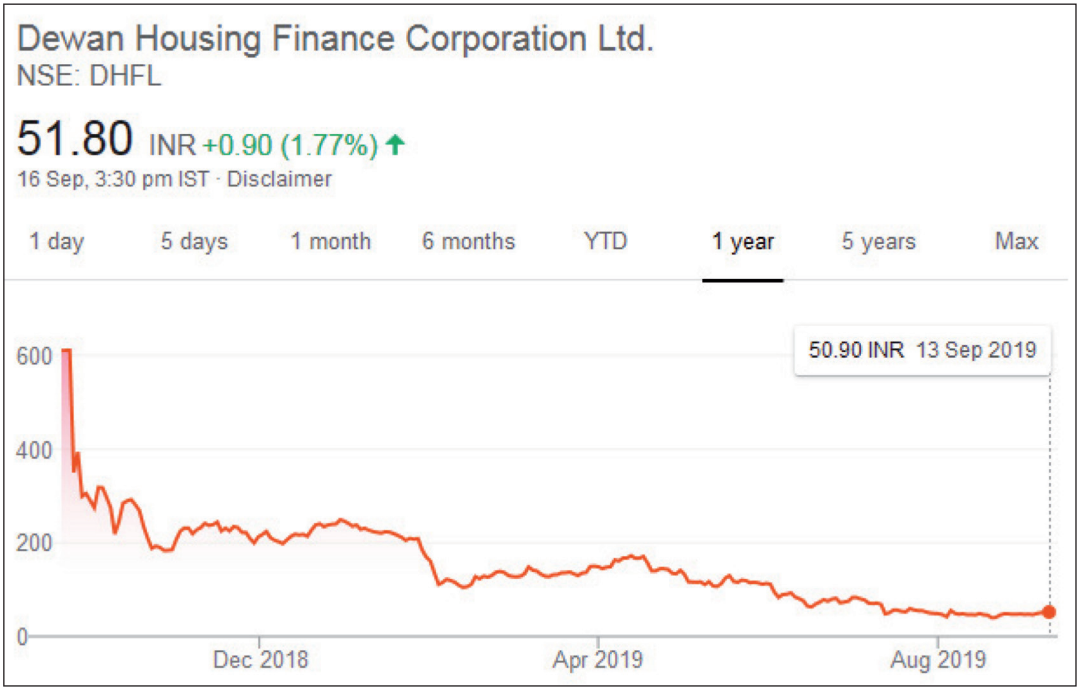

Exhibit 1. Stock Price Trend in the Past Year, as on 19 September 2019

Source: Bloomberg Quint (Quint, 2019).

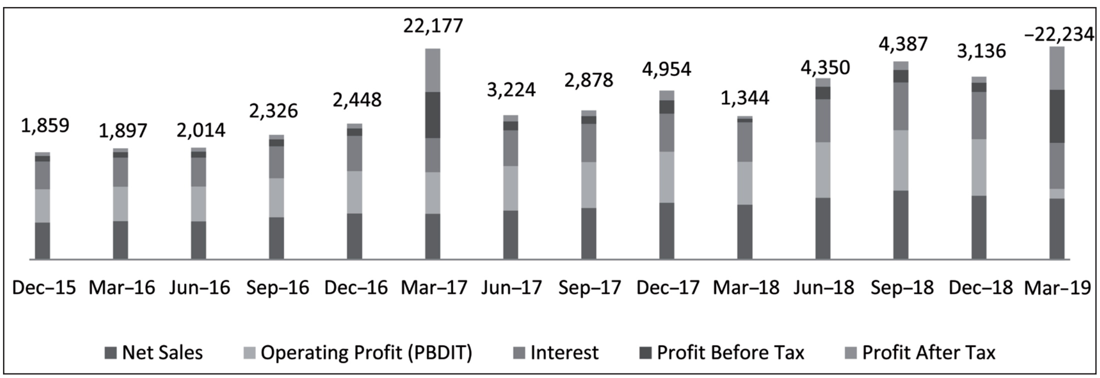

Exhibit 2. Highlights of Standalone Quarterly Results: FY2016–FY2018 (in Million Rs.)

Source: Standalone Quarterly Audited Financial Report of DHFL (December 2015–March 2019) (Quint, 2019).

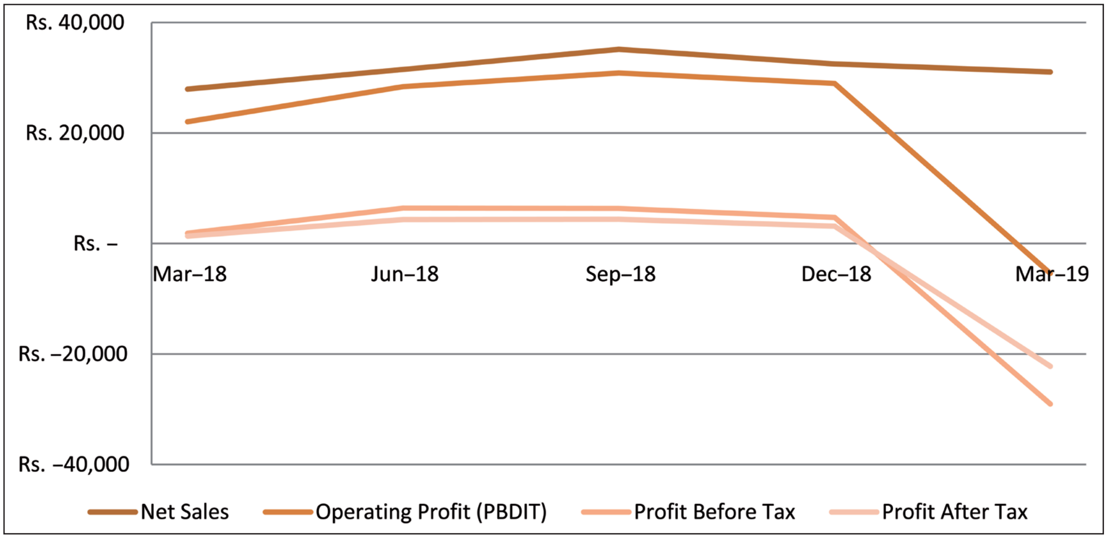

Exhibit 3. Sharp Decline in Profit: Past 5 Quarters (in Million Rs.)

Source: Standalone Quarterly Audited Financial Report of DHFL (December 2015–March 2019) (Quint, 2019).

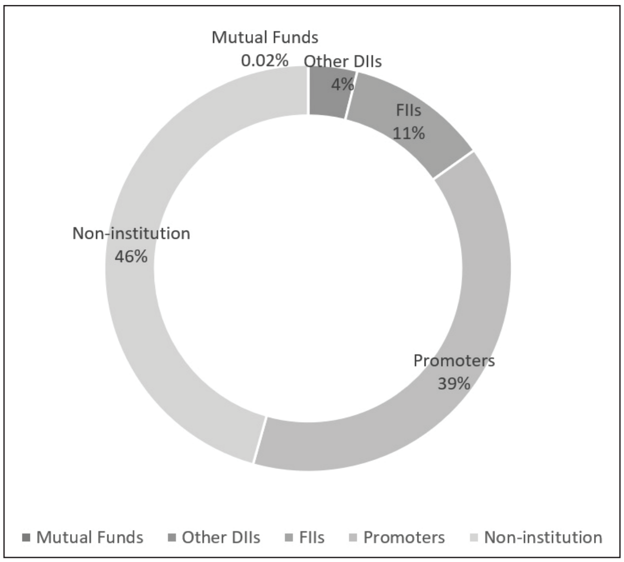

Exhibit 4. Shareholding Pattern, as on Jun 2019

Source: Bloomberg Quint (Quint, 2019).

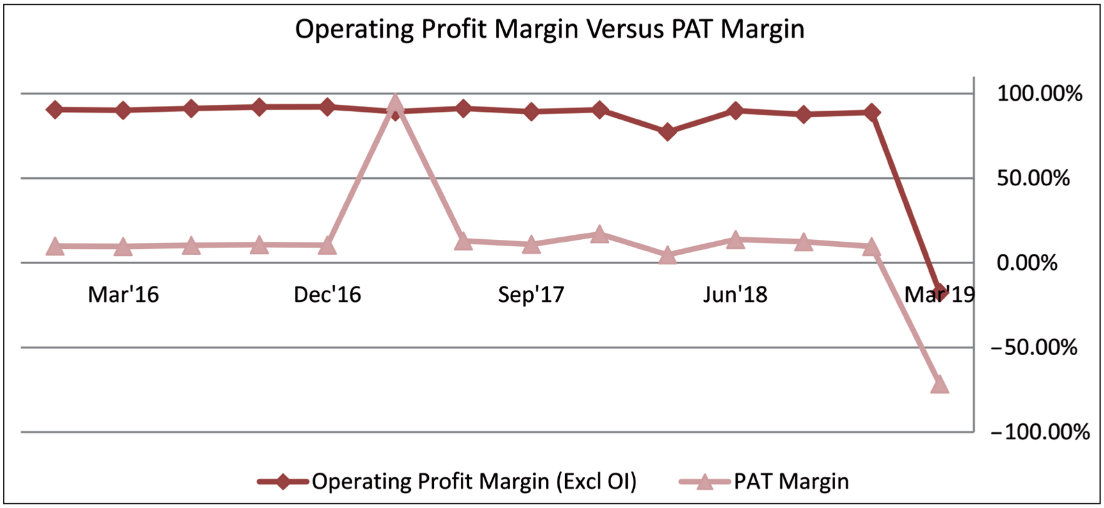

Exhibit 5. Operating Profit Margin Versus PAT Margin

Source: Standalone Quarterly Audited Financial Report of DHFL (December 2015–March 2019).

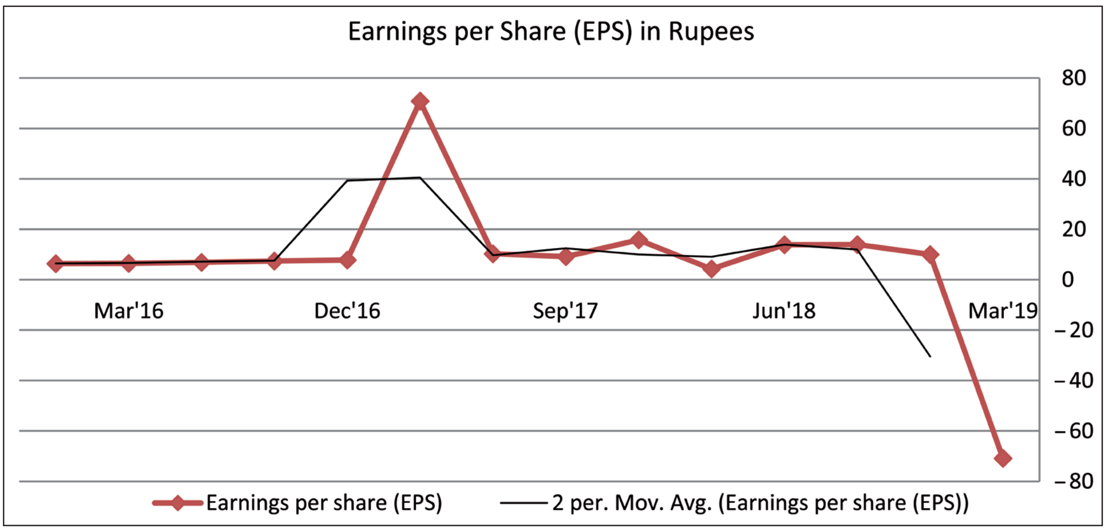

Exhibit 6. Earnings Per Share (EPS) in Rupees

Source: Adapted from Standalone Quarterly Audited Financial Report of DHFL (December 2015–March 2019) (Quint, 2019).

Exhibit 7. Standalone Quarterly Financial FY2016–FY2018 (in Million ₹)

Standalone Quarterly Results	Mar'19	Dec'18	Sep'18	Jun'18	Mar'18	Dec'17	Sep'17	Jun'17	Mar'17	Dec'16	Sep'16	Jun'16	Mar'16	Dec'15
Net Sales	31,040	32,509	35,157	31,497	27,936	28,940	26,279	24,959	23,330	23,416	21,594	19,451	19,579	18,819
Other Operating Income	36	0	0	0	462	0	0	0	0	0	0	0	0	0
Total Expenditure (Excl Depriciation)	36,521	3,610	4,343	3,162	6,430	2,770	2,816	2,196	2,513	1,840	1,717	1,709	1,934	1,783
Other Expenses	33,324	1,322	1,841	906	3,833	780	1,106	680	0	0	0	0	0	0
Operating Profit (PBDIT) excl Other Income	–5,444	28,899	30,814	28,335	21,968	26,169	23,463	22,763	20,818	21,576	19,877	17,742	17,646	17,036
Other Income	37	50	36	64	62	26	42	12	447	210	20	105	21	34
Operating Profit (PBDIT)	–5,407	28,949	30,849	28,399	22,030	26,196	23,505	22,775	21,264	21,786	19,897	17,846	17,667	17,070
Interest	23,493	24,103	24,402	21,931	20,112	19,351	19,502	18,254	17,475	18,001	16,307	14,754	14,786	14,197
Exceptional Items	0	0	0	0	0	0	0	0	19,694	0	0	0	0	0
Gross Profit (PBDT)	–28,900	4,846	6,447	6,468	1,918	6,845	4,002	4,521	23,484	3,784	3,590	3,093	2,881	2,873
Depreciation	176	131	119	86	77	73	63	64	34	67	68	64	51	68
Profit Before Tax	–29,076	4,715	6,329	6,382	1,841	6,772	3,940	4,457	23,450	3,717	3,522	3,029	2,830	2,805
Tax	–6,842	1,579	1,941	2,032	498	1,818	1,062	1,233	1,273	1,269	1,196	1,015	934	946
Provisions and Contingencies	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Profit After Tax	–22,234	3,136	4,387	4,350	1,344	4,954	2,878	3,224	22,177	2,448	2,326	2,014	1,897	1,859
Net Profit	–22,234	3,136	4,387	4,350	1,344	4,954	2,878	3,224	22,177	2,448	2,326	2,014	1,897	1,859

Source: Adapted from Standalone Quarterly Audited Financial Report of DHFL (December 2015–March 2019).

The Company has received a letter dated July 3, 2019, from the National Housing Bank containing observations emanating from the inspection carried out by NHB for the year ended March 31, 2018 as per the provisions of the National Housing Bank Act, 1987. There are observations in the letter inter-alia being impact on the Capital Adequacy Ratio of the Company as at March 31, 2018 reduced to 10.24%. NHB has directed the Company to provide a specific response to all the observations within a period of 21 days. The management does not concur with the observation of the NHB and will provide an appropriate response within the stipulated time. As mentioned in the note 14 above, on account of classification of project loans, SRA loans and wholesale mortgage loans as Fair Value through Profit or Loss (FVTPL)due to the change in business model as at March 31, 2019, has resulted in a charge of fair value loss aggregating to Rs 3,25,345 lakh to the statement of Profit and Loss. In view ofthese results being prepared using Indian Accounting Standards (Ind AS) while the NHB observations relate to numbers compiled on the basis of regulatory guidelines, the Management believes that the aforesaid observations may not have any implications on the same.

Exhibit 8. The Outcome of the DHFL Board Meeting Was Held on Monday, 22 July 2019: Audit Qualification e.4

Source: Disclosures under Regulation 30 of Securities and Exchange Board of India Regulations, 2015 (DHFL, 2019).

Further, in respect of deficiencies of documentation with respect to II(a)3(b) and II(a)9 above in respect of certain Project / Mortgage Loans, the Management is actively engaged with the loanees to remediate certain lacunae in loan documentation and expects to complete this exercise by September 2019. The management believes that deficiencies in documentation will not affect the enforceability of the underlying security. The Company is confident that the loans extended are secured and recoverable basis the cash flows arising from such project/mortgage loans and the carrying value of such loan is fully justified.

Exhibit 9. The Outcome of the DHFL Board Meeting Was Held on Monday, 22 July 2019: Audit Qualification e.2

Source: Disclosures under Regulation 30 of Securities and Exchange Board of India Regulations, 2015 (DHFL, 2019).

Exhibit 10. Valuation of Peers with Similar Market Capitalization

Sr. No.	Company	PE	EV/EBIDTA	PEG Ratio
1	HDFC	17.28	12.97	0.79
2	Indiabulls Housing	10.53	9.36	0.44
3	LIC Housing Finance	14.78	10.7	0.89
4	Gruh Finance	45.2	17.28	2.33
5	Dewan Housing	9.43	9	0.48
6	Can Fin Homes	22.81	12.29	0.34
7	Repco Home Finance	21.75	11.79	0.94
8	GIC Housing Finance	10.91	9.96	0.51
9	Coral India Finance	22.68	17.16	−0.92
10	India Home Loan	134.76	50.28	3.84

Source: Bloomberg Quint (Quint, 2019).

> The unsecured Inter Corporate Deposit (ICD) aggregating Rs 5,65,269 lakhs were outstanding as at March 31, 2019 and includes ICDs(net) of Rs 4,82,014 lakh granted during the year. Of these, ICDs aggregating Rs. 40,870 lakh have since been repaid while ICDs aggregating Rs. 3,93,699 lakh are expected to be repaid shortly. Balance ICDs aggregating to Rs. 1,30,700 crore are being converted into secured term loans. There are documentation deficiencies with respect to grant / rollover of ICDs which are being rectified. The ICDs have been advanced towards regular business activities and were either extended as a temporary loan pending full valuation of project funding or short term corporate requirements. Pending conclusion of these actions, the Management believes that no adjustments are required to the carrying value of the ICDs. This also addresses the point no.II(a) 9 of the audit qualification above.

Exhibit 11. The Outcome of the DHFL Board Meeting Was Held on Monday, 22 July 2019: Audit Qualification e.1

Source: Disclosures under Regulation 30 of Securities and Exchange Board of India Regulations, 2015 (DHFL, 2019).

> "As per the terms of offer in respect of the NCDs under each of the Series / Tranche, DHFL was expected inter-alia, to pay to the holders of the NCDs (**Debenture Holders**), the amount of interest and principal on respective due dates and was also expected to adhere to the other terms and conditions of the NCD issues. However, DHFL has committed defaults in payment of principal and interest in respect of some of the privately placed NCDs and also delayed payments in respect of the NCDs issued under public issues. Necessary action has been taken by CTL in respect of relevant issue of NCDs viz. issue of notices to DHFL pointing out the non-compliances of terms of DTDs under public issues and demanding the amount due in respect of such privately placed NCDs issued at the request of the respective Debenture Holders, where default in payment of interest / principal has occurred."
>
> "Since DHFL has committed a default in respect of certain credit facilities availed by it, in pursuance of the Regulatory Framework, the Lenders have executed the ICA recently. During the Review Period, the Lenders have decided that implementation of a Resolution Plan is the desirable resolution strategy in relation to the facilities granted to DHFL."
>
> . "The Lenders have approached CTL, being the Debenture Trustee, to consider acceding to the ICA which will allow the debenture trustee representing the Debenture Holders, to participate in the process of formulation of a resolution plan in respect of DHFL."
>
> "Debenture Holders are requested to examine the issue in the light of the present status of DHFL vis-à-vis the options available and if considered acceptable, give their consent in the format attached."

Exhibit 12. Excerpts of Communication from Catalyst Trusteeship Limited

Source: Consent for acceding to Inter Creditor Agreement of Lenders of Dewan Housing Finance Corporation Limited (DHFL, 2019).

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