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Crisis in the Indian Non-Banking Finance Companies (NBFC) Sector

Vijaya Kittu Manda, P. Sai Rani

Abstract: *Managing one-fifth of credit in the country, the Non-Banking Finance Company (NBFC) is a vital sector for the Indian economy. A series of problems are hurting the Indian NBFC sector since the default of infrastructure finance major IL&FS in September 2018. What seemed to be a liquidity crisis is looming into a solvency issue. Some major players backed by reputed promoters are going out of business. Though the downgrades & defaults do have a considerable impact on the banking and finance industry as a whole, there is sufficient panic-triggering turbulence in certain pockets of the industry. The Housing Finance Companies (HFCs) and the Asset Management Industry are found to be vulnerable and got highly hurt by the crisis. A central issue that led to the liquidity issues in the industry is the asset-liability mismatch. Regulators prefer tweaking macro-economic variables to curtail the problem rather than providing a special liquidity window. The crisis highlighted the need for much closer interaction and the interplay between regulators such as RBI, IRDA, NHB, and SEBI to avert such possibilities in future failing which bubbles like these could culminate to become a systemic risk. Findings from this paper can help various stakeholders from the NBFC, the regulators, and the Government in better preparedness.*

Keywords: Liquidity crisis, solvency issue, housing finance, debt mutual funds.

I. INTRODUCTION

Capital inputs into the economy get accelerated as we increase our pursuit of economic growth and development [7]. The financial structures of a country will be closely related to the structure of its real economy [1]. The journey of chasing investment returns at times leads to pockets of increased risk, which, if not appropriately handled, culminate to form a bubble leading to systemic risks or even a financial crisis. Global economies, however, are not ready for such events in the present situation. In extreme cases, these risks might even lead to an economic recession [5]. Crises would be limited to one or a few sectors in the initial stages. Because it is contagious, it slowly propagates. Research in economic circles documented past crises related to the banking system, currencies, stock markets, sovereign or the whole of the economy (giving rise to an economic recession or a depression). Since economies are tightly held and controlled by Governments, crisis management is often averted or handled with due legislation from time to time. Nevertheless, in rare circumstances, they become a global financial crisis, thanks to the globalization and inter-linking of global economies. Financial crises are an inevitable response that we get from the excess interplay between various macro and microeconomic factors. The financial history of every country carries stories of ups and downs economic movements. While the impact of a crisis will be on all the stakeholders involved, the responsibility of handling it and bringing stability back into the system is with the regulators and the governments only. This paper examines one such mini-bubble in the Indian context – the 2018/19 financial crisis in the NBFC sector. The paper introduces to the backdrop or the situation that led to the crisis. Then we discuss news flow and the reaction of various stakeholders. Finally, we examine the possible outcomes of these actions from a theoretical perspective.

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* Correspondence Author
Vijaya Kittu Manda*, Gim, Gitam Deemed To Be University, Visakhapatnam, India.
DR. P. Sai Rani, Dept. Of Finance, Icbm - School Of Business Excellence, Hyderabad, India.

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II. OBJECTIVES OF THE STUDY

1. To trace the series of events that lead to the Indian NBFC crisis
2. To study the implications and after-effects within various sub-sectors
3. To observe the series of actives done by various stakeholders

III. SIGNIFICANCE OF THE STUDY

1. Helps NBFCs to be better prepared to avoid a crisis and handle it if required
2. Regulators and Governments can take policy measures and strength regulation
3. Other sub-sectors can retrospect and take pro-active measures to have better risk management systems.

IV. LITERATURE STUDY

A.EXISTING LITERATURE

Several studies were done in the context of the global financial crisis of 2008-09 and give useful pointers for the same. The behavioral perspective that led to the crisis is studied by [6] who said that lender and borrower overconfidence,

failure by leading financial institutions in recognizing the risk they created, failure by regulators and credit rating agencies, and breakdown in financial markets that disallowed institutional banks from lending for short-term needs. Researchers can correlate these points to be the core of any financial crisis. [16] presented case studies on the major financial markets and intermediaries that experienced distress and how things got restored.

[10] discussed how shadow banking in India differs from other counties, the financial and legal framework in India, and that the IL&FS episode has raised doubts about the watertight regulatory system. [12] discussed commercial paper rating efficiency and felt improved informativeness of CP ratings in India could bring in more excellent grades in the A1+ category. [8] discussed the reasons that led to the liquidity crunch in the Indian NBFC and HFC sectors and various steps the banking regulator Reserve Bank of India (RBI) has taken to handle the crisis.

B. LITERATURE GAP

Growing research work and literature is coming up as the present NBFC crisis as a series of events is getting unfolded, taking a new twist every day. There is almost no work done on the regarding regulators' action in handling the crisis for the 2018/2019 crisis. Hence, this paper attempts to contribute to our body of knowledge on the topic.

V. RESEARCH METHODOLOGY

This study uses Descriptive research to gather preliminary information, observe the series of events that led to the crisis, record the actions that were taken by various stakeholders, and describe the consequences of the regulations.

VI. DATA COLLECTION

Secondary data sources were used to collect the information necessary for this study. Data from several journals, research papers, websites including from the official websites of regulators, media sources, and company annual reports formed the basis for this paper.

VII. DISCUSSION

A. THE IL&FS CRISIS AND ITS IMPACT

One-fifth of lending in India is through the NBFCs. NBFCs were lending at a faster pace than banks in the past few years, earning them the nickname "shadow banks." However, the situation changed suddenly after 2018. The financial default of its debt obligations by IL&FS in September 2018 impacted the business of several lenders such as banks, insurance companies, mutual funds, pension funds, and other NBFCs [15]. This "India's own Lehman crisis" has cast a negative shadow on sub-sectors within the NBFC's making Housing Finance Companies (HFCs), Asset Management Companies (AMCs) the most vulnerable. Credit disbursal volumes fell by 17 percent in October - December 2018 (compared to the previous year). Except for gold and personal loans, industry-wide loan sanctions fell by 31 percent in January – March 2019 (on year-on-year terms) as per Finance Industry Development Council (FIDC) statistics. Two-wheeler loans are down by 15 percent while used car loans are down 7 percent. The auto finance industry got hit because of the sales slowdown in the automobile sector. The overall NBFC industry loan sanctions fell from Rs. 9.65 lakh crores (2017-18) to Rs. 9.06 lakh crores down by 6.1 percent. The NBFCs are bleeding while their business size is collapsing at a faster pace than anticipated.

Table 1: NBFCs have better credit growth rate than Banks

Year	Bank Credit Growth Rate (%)	NBFC Credit Growth Rate (%)
2014	14	14.8
2015	9.1	17.7
2016	10.9	9.7
2017	8.2	10.5
2018	10	19.6

Source: Author compilation

Debt-paper through which NBFCs typically raise money began to get credit rating downgrades because of repayment delays and defaults (such as by DHFL and Reliance ADAG). Sentiments in the debt market got hurt as a result. AMCs that lent money to NBFCs earlier are now seeking safety and forget about fresh lending, and they want their money back at the earliest so that they can repay to demanding investors who are keener on redeeming and moving their money to safety. There is a trust deficit on debt paper, and this triggered the general risk aversion thinking of the average investor. Debt mutual funds are losing the confidence of their investors, and this will put breaks to the increasing Assets Under Management (AUM) of the booming Indian Mutual Fund industry [14] indicating a shift of money flow in the economy from investment-grade instruments back to traditional savings-grade instruments.

B. A TALE OF MISMATCHES

Indian banks are in their troubles handling the Non-Performance Assets (NPA) on the one hand and trying to raise their capital levels to acceptable levels according to RBI regulations and BASEL-III norms. Their interest in lending for large projects has become subdued in the past few years. NBFCs tried to bank on this opportunity by sourcing their funds from several sources such as banks, mutual funds, and international lending. When they are short of repayments on due dates, they restored to evergreening or rotation of funds by raising new money to repay an old loan. Their misadventures have a glaring contrasting observation, and regulators do not like the concept of evergreening of loan book because it hides the risks and facts.

The prime reason for crisis with IL&FS and most other NBFCs is that they took short term borrowings (such as from commercial papers and mutual funds) but were lending for long-term projects (such as housing loans in the form of real estate loans or loans to developers, infrastructure financing).

When fresh inflows get dried, honoring repayment payment commitments became difficult, thereby leading to liquidity stress. The real estate and property developer loan portfolios rose from 29% in FY15 to 55% in Q3FY19. As property developers were neither able to complete their projects nor sell their units on time, their debt burden increased, forcing them to be helpless in repaying outstanding loans on time.

This liquidity issue was ignored by the risk management systems at several financial institutions and has become a near-death situation for some NBFCs. So grave is their situation that NBFCs are now selling their non-core businesses or even selling their loan assets to banks to somehow stay liquid. The asset quality of some NBFCs began to come down over the years, making things worse.

Table 2: Asset quality of NBFCs has coming down

Period	Gross NPA (%)	Net NPA (%)	Capital Adequacy Ratio (%)
2013-14	2.6	1.4	27.5
2014-15	4.1	2.5	26.2
2015-16	4.5	2.5	23.6
2016-17	6.1	4.4	22.1
2017-18	5.8	3.8	22.8
Sep 2018	6.5	NA	21

Source: SBI Research

Raising fresh money got complicated, and even when it is possible, it is in the form of non-convertible debentures (NCDs) at a higher lending cost. The lending cost in the domestic debt market touched multi-year highs and is almost not viable. Giving higher importance to safety, the Employees' Provident Fund Organisation (EPFO) decided to withhold any fresh investments in private sector bonds until further notice. EPFO adds around Rs. 25,000 crores to Rs. 40,000 crores in private sector bonds. The provident fund office is so cautious that it asked its fund managers to take rating from any of the four credit rating agencies (CRISIL, CARE Ratings, ICRA, and India Ratings & Research) even when investing in public sector bonds. There was a moderation in credit spreads because of the higher international fund inflows into liquid funds during May 2019.Some companies were lucky enough to raise funds through international debt paper. Indiabulls Housing Finance was able to secure a $350m funding in its first issuance abroad when it was able to sell to Asian and European lenders at 6.37 percent. The deal appears expensive because swap costs, withholding tax, and other such things when accounted for increase the effective rate to 11 percent. Though the cost of borrowing is high, it is at least able to avoid liquidity issues. Some other companies, such as DHFL, even went to the extent of selling their non-core businesses or joint venture subsidiaries to arrange money for their debt obligations. They tried to find a wealthy partner who can infuse funds and bail them out. The credit events impacted lending to several other sectors, including automobile and consumer lending. The evolving fin-tech lending platform business got hurt amidst the crisis because funding rising became way too expensive for some of the industry players.

C.IS THE CRISIS OPPORTUNITY FOR BANKS?

Banks cannot lend to NBFCs beyond their sectoral limits. However, some ailing NBFCs can work out some short-term options such as going for securitization or selling part of their loan book to banks in their bid to raise funds. NBFCs with excellent asset quality and loan serviceability were able to do this. Even securitization regulations are not that liberal and the Finance Industry Development Council (FIDC), an NBFC representative body, sought RBI help to do away with the Minimum Holding Period (MHP) and Minimum Retention Requirements (MRR) and to defer rules related to working capital loans as a temporary relief. They sought a relaxation of MHP for loans with a maturity of two to five years to be brought down from six months to three months.

State Bank of India (SBI) brushed off the NBFC situation as not grave as only "one or two are severely impacted." They reported continued lending to the sector as usual. However, the bank wants to capitalize on the situation by increasing its mortgage and small business loans that typically have low NPAs so that the bank can build assets without compromising on asset quality. The bank has targeted 11 percent loan growth rate by March 2020, which appears to be achievable in the present circumstances. Earlier last year, the bank has put a 12 percent loan growth target.

D.RBI's TIGHTENING OF NORMS

NBFCs were asking for a relaxation of regulations or a unique liquidity window of funds, but RBI appeared reluctant to this as it feels the crisis is a cash crunch problem and is not systemic. It instead chose to bring in new operating norms for the NBFC sector – something that was long overdue. The 19th Financial Stability Report [9] said that the failure of large HFC/NBFCs can cause losses to the size of that of big banks and that greater surveillance is required.

The Union Budget 2019 opened up the liquidity tap by allowing public sector banks to continue to lend to high-quality assets of up to Rs. 1 trillion of financially sound NBFCs for which the Government will provide a one-time six-month partial credit guarantee for the first loss of up to 10 percent. Banks are thereby given the freedom to buy NBFC assets up to Rs. 1 trillion during FY20. RBI quickly came up with revised bond-holding norms for banks and clarified that government securities of up to 1 percent of the deposit base could now be considered high-quality assets under Basel III norms. Earlier to the Budgetary announcement, RBI's default approach is to strengthen the norms and expected NBFCs to come back on track themselves as they begin to make their moves towards regulatory compliance. It issued draft guidelines in June 2018 that might force consolidation in the NBFC sector, which is having over 11,000 players. More prominent NBFCs or even banks seeking product diversification might consider the crisis as an opportunity for merging or acquiring small NBFC players.

For example, Indiabulls Housing Finance and its unit are all set to merge with Lakshmi Vilas Bank (LVB).

The applicability of Liquidity Coverage Ratio (LCR) and Asset – Liability Mismatch (ALM) framework are a step towards this. The Liquidity Risk Management Framework will apply to all NBFCs managing Rs. 100 crore assets and all Core Investment Companies (CIC) registered with RBI. The Liquidity Coverage Ratio (LCR) applicable to non-deposit taking NBFCs with Rs. 5000 crore assets make it mandatory for NBFCs to set aside for highly liquid assets to meet short-term obligations.

Essentially, the company has to keep 30 days' worth of net cash outflow in low return yielding high-quality liquid assets (HQLA). So, parking of money in risk-free or near risk-free instruments for immediate use in case of an issue becomes necessary. Though this step will prevent an NBFC from entering into a crisis quickly, it will put pressure on the margins of small NBFCs. Calibrated maintenance of LCR levels over time is essential. Starting with a minimum of 60 percent LCR by April 1, 2020, the levels are to be gradually scaled up to 100 percent by April 1, 2024. HFCs will have to take much of the beating because of their higher ALM. HFCs having strong parent pedigree and promoters with excellent funding abilities will survive, but smaller ones will be left to struggle for themselves.

Part of the regulation amendment is that NBFCs will now have to appoint a Chief Risk Officer (CRO) whose primary role is the "identification, measurement and mitigation of risks of all credit products (retail or wholesale)" from an inherent and risk control perspective. CRO's role will be limited to being an adviser when it comes to deciding credit proposals.

Considering the grave situation in doing business, some NBFCs approached RBI, asking to bring out on-tap licensing to get converted into a bank. RBI introduced this new licensing system back in August 2016, giving away the ongoing "fits-and-starts" system. Most NBFCs do not want to apply using the present system because they will have to wait eternally. Unfortunately, the system has no feedback system or a method of knowing the application status.

The RBI Central Board, at its May 2019 meeting in Chennai, decided to set up a specialized cadre for supervision and regulation to strengthen these functions concerning banks and NBFCs. Hence, the regulatory intervention will be a much more active approach going forward.

E. NHB REGULATION TWEAKING

In late-June 2019, the National Housing Bank (NHB) made three amendments in its bid to strengthen the HFCs. First, there is a limit regarding accepting public deposits at three times their Net-Owned Funds (NOF). Further, overall borrowings have to be brought down from the present 16 times to 14 times March 2020 and by further 1% by March-end of the subsequent two-years. At the same time, the capital adequacy ratio (CAR) is raised from the present 12 percent to 15 percent. There will be a 1 percent per year raise for the next three years. These steps help in improving solvency and thereby able to withstand financial shocks in the system and trying to prevent HFCs from falling into debt traps or default traps.

Because of the existing high leverage position, some HFCs will not be able to raise debt that easily, and hence, equity infusion would probably be the only way out for them. ROE of these companies will consequently come down going forward.

F. SEBI AND MUTUAL FUND REGULATIONS

Debt Mutual funds who have lent money to NBFCs are in trouble when their fixed maturity plans (FMPs) matured, and they have the responsibility of repaying investors. The downgrades and defaults in NBFCs have put fund managers in a tough decision-making situation. They have to make some bold moves such as accepting mark-to-market losses, side pocketing, transferring loans to the company books, or to write-off – all of which will have financial and reputation consequences. Renowned AMCs such as Kotak Mutual Fund and HDFC Mutual Fund were in the news during the period of crisis.

Some schemes took the beating straight away and had their Net Asset Values (NAV) crashed, giving surprising negative returns – something which Indian investors are not that well prepared to hear from debt funds [13]. Investors, particularly retail investors, began to frame second thoughts about investing through the mutual fund route. Some even started switching their money from debt funds back to fixed deposits.

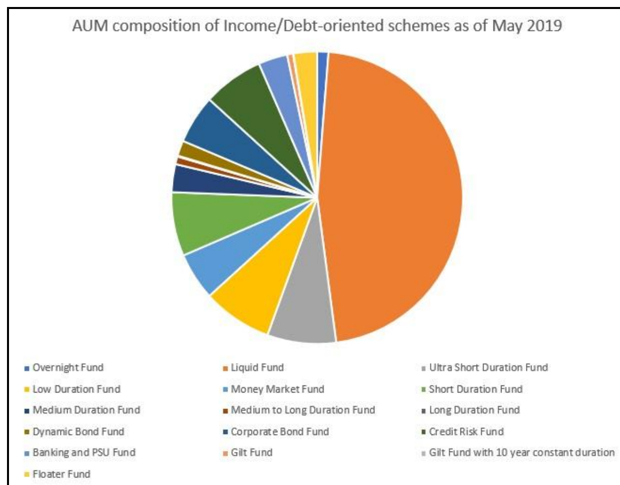
This bitter experienced made mutual funds turn cautious on lending to NBFCs. Consequently, their sector exposure has come down from 34% in August 2018 to 27% in April 2019. The exposure of NBFC Commercial paper (CP) itself has come down to 40%. Mutual funds want to play safe with their investors' money and hence have brought drown their exposure to NBFCs to 16.8% or at Rs. 60,406 crores as of May 2019.

In its Board Meeting on June 27, 2019, investment regulator – the Securities Exchange Board of India (SEBI) made some critical decisions, including reducing the sectoral limit from 25 percent to 20 percent. Additional exposure HFCs are brought down from 15 percent to 10 percent. However, 5 percent is allowed in securitized debt based on retail and affordable housing loan portfolios [11]. Also, debt and money schemes with the maturity of more than 30 days will have to get valuations on the mark-to-market method instead of amortization.

In order to aoid liquidity crisis within liquid funds, SEBI wanted at least one-fifth of the assets to be in cash or equivalents. Schemes are already having an average holding of 10 percent to 15 percent in Treasury bills and Government securities. The new mandate would increase allocation towards this along with increased low-interest yielding bank fixed deposits and in commercial paper (CPs) or certificate of deposits (CDs). Because the schemes are seeking safety, the returns from the liquid funds would come down marginally by 10 – 50 bps from the present one-year liquid fund category whose average returns are at 6.94%. Further, there will be increased volatility.

Bucking the global trend, SEBI introduced a seven-day exit load which would trigger short-term money outflow to other peer categories such as the recently introduced but striving for attention - overnight funds, or the stable ultra-short duration funds. The Rs. 50,000 crores to Rs. 60,000 crore incremental inflows coming into liquid funds would get impacted. Corporates would even seriously consider investing directly in treasury bills rather than investing via liquid funds. With 46.6% of income / debt-oriented schemes money into liquid funds, its share on Assets Under Management (AUM) charts might come down a bit though it continues its lead and dominate [2].

Chart 1: Liquid funds have the highest AUM amongst debt market mutual fund schemes



Source: AMFI

Promoters of listed companies used to borrow money from debt mutual funds by pledging their shares. Mutual funds are their preferred choice over banks and NBFCs because they can get more credit by giving fewer shares as collateral. However, with the Zee crisis, SEBI insisted that mutual funds ask for a four-times collateral cover before they lend. Companies are thereby forced to go back to banks and NBFCs to get debt. Even if promoters still want to access mutual funds route, they wish to hold for shorter durations over longer durations. As much as Rs. 50,000 to Rs. 60,000 crores of money lent in the form of promoter pledging, and there will be severe pressure as it gets unwound. SEBI was unhappy at "standstill arrangements" that mutual funds signed with individual companies and reminded AMCs that they are in the business of investing and not in banking.

G. LIQUIDITY CRISIS LEADING TO SOLVENCY CRISIS

Liquidity is the oil of the economic growth engine. Predict defaults is attempted by [3]. Findings from the study are that the average level of the boundary is 66 percent of the face value of debt. A framework by [4] gave importance to balance sheet, solvency, and stability to determine the source of stress events and the effect of various funding structure characteristics on financial stability. Prolonged liquidity crisis will lead NBFCs into a solvency crisis, and because of inter-linkages, even those entities who are not affected earlier would now get affected too. Hence timely solution in the form of suitable regulation is necessary, failing which solvency issues will crop up, leading to systemic risk at later stages.

VIII. FINDINGS

1. Indian financial intermediaries and institutions appear to be working more closely than ever before to avoid a potential crisis.
2. Regulators made a timely intervention to handle the crisis. However, higher importance is attributed to the regulatory approach over creating a liquidity window for NBFCs.
3. Tweaking regulations would cause short term pain for long term gains. At the end of the crisis, only the fittest NBFCs will survive the crisis.
4. The crisis and regulations would trigger consolidation amongst the already well-diversified Indian NBFCs sector.

IX. RECOMMENDATIONS

1. NBFCs do not have, but duly require, specific tools to measure and check the quality of their underlying assets. While the complex natures of the businesses make it difficult to build such tools, there should be some start to address this need.
2. RBI or the Government should create a funding line or something as such to bring in short-term liquidity at short notice. These steps will help smaller issues from not culminating into long-term solvency issues.
3. RBI can consider special audits to ensure that there is no issue with the asset quality of the books of NBFCs. In doing so, lenders to the sector can get confidence in the NBFC business.
4. Good quality NBFCs ought to get adequate liquidity. The idea should not be to leave the industry to find its course, but when confidence is getting hurt and when the size of the business is shrinking, even the good ones would collapse sooner or later. Liquidity windows are not new, as can be seen in prior instances of the 1980s and 2008.

X. SCOPE FOR FURTHER STUDY

1. India is home for thousands of NBFCs, most of whom are tiny and fragmented. At least a tenth of them qualifies for getting converted into a bank. The consequences of doing so could be studied.
2. The interplay of regulations with a focus on how NBFCs are surviving amidst a plethora of regulations can be of potential research interest.
3. The impact of increasing net worthiness for NBFC to be eligible to get a license is a topic for study.
4. Cascading of NBFC crisis on the mutual fund industry can be further studied.

XI. CONCLUSION

This paper highlights that the 2018 Indian NBFC crisis is limited to be a liquidity issue and if not handled properly on time, it would make it into a solvency issue and can cause a massive dent to the NBFC sector, which is already losing its business to its rival category – banks. The housing finance sector who borrowed and the mutual funds which lend the money are primarily affected. Regulators chose to tweak regulations to bring in long-term gain at the cost of short-term pain by introducing liquidity coverage ratio for NBFCs, by limiting mutual funds from lending to any sector beyond limits or by specifying capital adequacy ratio for HFCs. The crisis will surely be an unforgettable lesson in the pages of Indian banking and financial history.

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AUTHORS PROFILE

VIJAYA KITTU MANDA is a Research Scholar with special interest on the areas of financial crisis, asset management, fintech and disruption technologies such as Blockchain. He presented his research works both in India and aboard. Several of his papers were published in reputed research journals. He has 10 postgraduation degrees from different streams/disciplines. He is a trainer on investing in Equity shares, mutual funds and alternative investing. He is a columnist on Equities to several India newspapers. He co-authored the academic book *Foreign Exchange Management*.

DR. P. SAI RANI is a Professor and the Head of the Department – Finance at the ICBM – School of Business Excellence, Hyderabad, India. She is a M.Com, MBA, PGDFM, CMA Inter and a Ph.D. She has guided several researchers in the areas of Finance and General Business. She chaired and convened several national and international research conferences.

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