INDIAN BANKING: HOW BAD ASSETS WERE CREATED AND WHAT THE FUTURE HOLDS

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The CEOs of India's debt-laden state-owned banks probably celebrated Christmas ahead of its arrival in December – after an extremely stressful year, relentlessly chasing rogue corporate borrowers for recovery of the monies lent. Finance Minister Arun Jaitley played Santa Claus for them by seeking Parliament's approval for Rs. 410 billion capital infusion in these banks.

The government had budgeted for Rs. 650 billion fund infusion during the current year, of which Rs. 420 billion is still to be allotted. This means, Rs. 830 billion will flow into the public sector banks (PSBs), taking the total sum to Rs. 1.06 trillion by March, 2019.

In October, 2017, the government had announced a staggering Rs. 2.11 trillion capital infusion in phases into PSBs that have little less than 70% share of the assets of the Indian banking industry. The new package, for which Parliament's nod has been sought, is part of that.

Incidentally, between 1985-86 and 2016-17, in little over a decade, the government had injected Rs. 1.5 trillion into these banks; the bulk of this flowed in since the global financial crisis of 2008, triggered by the collapse of the iconic US investment bank Lehman Brothers Holding Inc.

To ward off the impact of the crisis, the Reserve Bank of India (RBI) flooded the banking system with money and brought down the policy rate to a historic low, less than the savings bank rate which was regulated then. With too much money, coupled with pressure from various quarters to lift consumption, banks lent recklessly and that led to the creation of bad assets.

IS THE SCENE GETTING BETTER?

In September, 2018, after the annual ritual of a review meeting with the chiefs of PSBs, Jaitley said that non-performing assets (NPAs) with these banks were on the decline and Rs.1.8 trillion worth of recovery of bad loans could happen during fiscal year 2019.

According to him, in the first quarter of the year (April-June, 2018), the lenders recovered Rs. 365.5 billion. This is 49% higher than the corresponding quarter of the previous year. During the entire 2018 fiscal year, banks recovered Rs. 745.6 billion. "It's still early days of the IBC (Insolvency and Bankruptcy Code), but already the impact is clearly visible," Jaitley said.

He also said that the NPAs with the PSBs were declining. "The last quarter saw PSU banks with a net profit. On the basis of the last quarter and what their expectations are looking ahead, the good news is that NPAs are on the decline because recoveries have picked up."

Indeed, the recovery of bad loans at PSBs gained momentum in the June, 2018 quarter; their operating profits rose and the overall asset quality improved. Besides, the provision coverage ratio of these banks has gone up to 63.8%, he pointed out.

The listed banks' kitty of gross NPAs dropped marginally—a little more than 2% from Rs.10.25 trillion in March to Rs. 10.03 trillion in June. For PSBs, the drop is 2.5%, from Rs. 8.97 trillion to Rs. 8.74 trillion. In September, it dropped further – Rs. 8.69 trillion.

Clearly, the pace of fresh slippage has slowed. Aided by provision and aggressive write-offs, the net NPAs of all listed banks have dropped a little over 6%, from Rs. 5.18 trillion to Rs. 4.85 trillion in June and Rs. 4.83 trillion in September.

Incidentally, the PSBs' share in bad loans is far higher than their share in banking assets.

All these data say that things are getting better, but a closer look at some of the banks' bad loan pile-ups clearly signal that the party time has not arrived as yet.

Let us take a look at some individual banks. Twelve of the 21 PSBs were in losses in September, 2018. Among them, IDBI Bank posted loss in 10 of the past 12 quarters, since December, 2015 (when the NPAs of the banking system started rising following the RBI intervention), to the tune of Rs. 236 billion. The trio of Indian Overseas Bank, Central

Bank of India and UCO Bank have made losses in all 12 quarters (collectively, Rs. 375 billion). Dena Bank and Bank of Maharashtra seem better off – they have recorded losses in 11 quarters (Rs. 94 billion).

Overall, during this period, the PSBs recorded Rs. 1.84 trillion losses, around 1.2% of India's GDP. This also exceeds the total capital infusion in 31 years between 1986 and 2017, one-third of which — Rs. 500 billion — flowed in 2016 and 2017. By the December quarter, the losses will probably exceed the big bang recap of Rs. 2.1 trillion.

Four PSBs' advance portfolios declined in the September quarter compared with June and, if we compare them with a year-ago period, as many as 11 of them have shrunk their loan books. For two of them, the drop is as much as 10% or more. Similarly for PSBs, the deposit kitties shrank in the September quarter compared with June; if we compare them with the year-ago period, then seven banks have shrunk their deposit portfolios. The RBI restrictions do not impact deposit mobilisation.

Finally, six banks' gross NPAs surged in September from the June level. Ditto about five banks' net NPAs. In September, at least one bank (IDBI Bank) had more than 30% gross NPAs and another five (UCO Bank, Indian Overseas Bank, Dena Bank, United Bank, Central Bank) more than 20% but less than 25%, even as six banks had more than 15% gross NPAs. When it comes to net NPAs, nine of them had more than 10% and up to 17.3%; for a few of them the asset quality deteriorated further in September.

THE NPA SAGA

The NPA saga started in 2014 but gained momentum in 2016 after the Reserve Bank of India (RBI), under former Governor Raghuram Rajan, instituted an asset quality review (AQR) whereby the inspectors of the Central bank audited the banks' loan books and identified bad assets. The exercise was completed in October, 2015 and the banks were directed to come clean in six quarters between December, 2015 and March, 2017.

In a detailed presentation to a Parliamentary Committee, Rajan has explained what went wrong in the Indian banking system.

According to him, a larger number of bad loans originated in 2006-2008 when the Indian economy grew at over 9% for three years in a row. "This is the historic phenomenon of irrational exuberance, common across countries at such a phase in the cycle."

In the aftermath of the collapse of Lehman Brothers, the world witnessed an unprecedented liquidity crisis and India too could not escape the fallout. The strong demand projections for various projects started looking increasingly unrealistic as domestic demand slowed down.

Around the same time, a variety of governance problems, such as the suspect allocation of coal mines coupled with the fear of investigation, slowed down the government decision-making. As a result of this, cost overruns escalated for stalled projects and they became increasingly unable to service debt.

And, once the projects got delayed to the extent that the promoters had little equity left in the project, they lost interest. "Ideally, projects should be restructured at such times, with banks writing down bad debt that is uncollectable, and promoters bringing in more equity, under the threat that they would otherwise lose their project. Unfortunately, until the Bankruptcy Code was enacted, bankers had little ability to threaten promoters, even incompetent or unscrupulous ones," Rajan has said.

He has also mentioned that unscrupulous promoters who had inflated the cost of capital equipment through over-invoicing were rarely checked and the PSBs continued financing promoters even as the private sector banks were getting out. Finally, too many loans were made to well-connected promoters who had a history of defaulting on their loans.

What Rajan has not mentioned is that most Indian banks do not have the expertise for project financing. Till the late 1990s when RBI pulled down the walls between commercial banks and development financial institutions (DFIs) and the DFIs were allowed to die while the commercial banks turned themselves into universal banks, these banks were primarily into financing the working capital needs of corporations. They got into term lending after the demise of DFIs but never acquired the expertise to do so.

Do all these banks know how to lend? Had they known, they would not be in such a mess. Typically, the PSB bosses blame the state of the economy for the rise in bad loans but this is not convincing as the private banks too operate in the same milieu and many of them have far better asset quality.

BANK RECAPITALISATION

Officially, the government does not want to treat this as a dole. Both the government and the RBI seem to be keen that banking reforms and recapitalisation must go hand-in-hand. In other words, the taxpayers' money will not be continuously pumped in just to keep PSBs alive.

To put the story of bank recapitalisation in context, capital is core to banks for expanding credit, earning interest and growing their balance sheets so that they can drive economic activities. The government is the majority owner of PSBs in India. The statutory requirement in the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, and the State Bank of India Act, 1955, ensure that the Indian government shall, at all times, hold not less than 51% of the paid-up capital in such banks.

In 2010, the Cabinet Committee on Economic Affairs (CCEA), after taking into account the trends of the economy, had decided to raise government holding in all PSBs to 58%. The objective was to create a headroom and enable PSBs to raise capital from the market when they need it, without compromising their public sector character.

Subsequently, in December, 2014, the CCEA decided to allow PSBs to raise capital from the public markets through instruments such as follow-on public offer or qualified institutional placement by diluting the government holding up to 52%, in a phased manner.

The regulatory requirements of capital adequacy and credit growth are the two main drivers for bank capitalisation. The regulatory architecture is globally framed by the Basel Committee on Banking Supervision — a committee of bank supervisors consisting of members from representative countries. Its mandate is to strengthen the regulation, supervision and practices of banks and enhance financial stability.

So far, three sets of Basel norms have been issued. The Basel I norms were issued in 1988 to provide, for the first time, a global standard on the regulatory capital requirements for banks. The Basel II norms, introduced in 2004, further strengthened the guidelines for risk management and disclosure requirements.

This called for a minimum capital adequacy ratio (CAR) — or, capital to risk-weighted assets ratio (CRAR) as it is the ratio of regulatory capital funds to risk-weighted assets — which all banks with an international presence are to maintain. These norms were revisited again in 2010 — known as Basel III norms — in the wake of the sub-prime crisis and large-scale bank failures in the US and Europe. Basel III emphasised on capital adequacy to protect shareholders' and customers' risks and set norms for Tier I and Tier II capital.

The capital can come either from their dominant shareholder (the government of India) or the capital market. The PSBs' underperformance and the pile of bad loans leading to low book value come in the way of accessing the capital market. There is a significant gap between the book value and market value of PSB shares, with most PSBs having a lower market value, compared with their book values. Hence, the government as the majority stakeholder needs to step in to rescue PSBs.

THE FUTURE TRAJECTORY

How long will it take for the Indian banks to bring down their NPAs? The December, 2017 Financial Stability Report of the RBI, a bi-annual reality check of the Indian financial system, had suggested that the gross NPAs in the Indian banking system may rise from 10.2% in September, 2017 to 10.8% in March, 2018, and an even higher 11.1% by September, 2018. The actual bad loan figure of March, 2018 was higher than the estimate.

And the June, 2018 Financial Stability Report said the gross NPAs may rise from 11.6 % in March, 2018 to 12.2% by March, 2019. Besides, the system-level capital-to-risk-weighted assets ratio (CRAR) may come down from 13.5% to 12.8% during the period; 11 public sector banks under prompt corrective action framework may experience a worsening of their gross NPA ratio from 21% in March 2018 to 22.3% with six PSBs likely experiencing capital shortfall relative to the required minimum CRAR of 9%.

The AQR is just the beginning of the RBI actions to unearth the mound of NPAs. At the next stage, the Central bank took a series of steps to force the banks to chase the defaulters for recovery as well as punish the banks for not doing enough to clean up their balance sheets.

MORE DISCLOSURES

In April, 2017, an RBI notification said, "There have been instances of material divergences in banks' asset classification and provisioning from the RBI norms, thereby leading to the published financial statements not depicting a true and fair view of the financial position of the bank." The regulator advised the banks to make adequate disclosures of such divergences in the notes to accounts in their annual financial statements.

RBI inspectors found these when they took a close look at the loan books of all banks while carrying out the asset quality review in 2015.

Under the regulatory norms, when a borrower is not able to service a loan for three months, it becomes an NPA and the lender needs to set aside money or provide for it. However, there could be divergence as under certain circumstances, one can take a "view" on whether a particular loan is good or bad. For instance, when the principal or interest payment for a particular loan is overdue between 61 and 90 days (and not exceeding 90 days), this becomes a special mention account-2 (SMA-2). If a loan exposure continues to be in this category for months, a prudent banker would prefer to classify it as an NPA even though technically it can continue to be treated as a standard asset.

Then, there are complexities for some of the restructured infrastructure loans. There have been cases where banks have given the borrowers more time, depending on the date of commencement of commercial operations. Many such loans have been restructured twice and continue to be tagged as standard assets in banks' books. Often, the date of commencement of commercial operations is subject to interpretation and the RBI may not be comfortable with such cases.

While conducting the AQR, RBI inspectors had found many instances of the same loan exposure being classified as bad by one bank but good by another.

The annual reports of quite a few banks in the past two years showed "divergence" or a difference – which in some cases was quite huge – between the lender's assessment of bad loans and that of the RBI. As a result of this divergence, the difference in provisioning is also stark and banks have shown lesser NPAs than what the RBI assessment had suggested. In other words, had there been no divergence, these banks would have shown lesser profit and higher NPAs.

Subsequently, in May, 2017, the RBI was empowered through an Ordinance to issue directions to banks to initiate insolvency proceedings against borrowers for resolution of stressed assets. The Banking Regulation (Amendment) Ordinance, 2017 was promulgated on 4th May, 2017. This Ordinance empowered the RBI to direct banking companies to initiate insolvency proceedings in respect of a default under the provisions of the Insolvency and Bankruptcy Code, 2016 (IBC). It also enabled the RBI to constitute committee/s to advise banking companies on resolution of stressed assets.

Armed with the Ordinance, the Central bank in June, 2017 asked banks to initiate insolvency proceedings against 12 large bank defaulters with a total debt of over Rs. 2 trillion, around 25% of the banking system's bad assets at that time.

It followed this up in August, 2017 by sending a second list of 28 defaulters to the lenders to initiate debt resolution before December 13, failing which these cases would have to be sent to the National Company Law Tribunal (NCLT) before December, 2017. Between them, these 40 loan accounts have roughly 40% share of the Rs. 10 trillion bad assets in the Indian banking system.

THE FEBRUARY 2018 CIRCULAR

Finally, in February, 2018, the RBI tightened its rules on bank loan defaults, sought to push more large defaulters towards bankruptcy courts and abolished all existing loan-restructuring platforms. The objective was to speed up the process of resolution of the bad loans.

The recovery drive for the banking industry started with the Debts Recovery Tribunals (DRTs), set up under the Recovery of Debts Due to Banks and Financial Institutions (RDDBFI) Act, 1993. Almost a decade later, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interests (SARFAESI) Act, 2002 came into force to help banks and financial institutions enforce their security interests and recover dues. Still, the recovery did not get momentum. For instance, in 2013-14 recovery under DRTs was Rs. 305.9 billion while the outstanding value of debt sought to be recovered was close to Rs. 2.37 trillion.

The platforms such as corporate debt restructuring (CDR), strategic debt restructuring (SDR) and the scheme for sustainable structuring of stressed assets (S4A) which were used to clean up the bank balance sheets were all abolished late night on 12th February, 2018.

SDR, introduced in June, 2015, gave banks the power to convert a part of their debt in stressed companies into majority equity, but it didn't work because promoters delayed the restructuring, dangling the promise of bringing in new investors. Before that, in February, 2014, RBI had allowed a change in management of stressed companies. The principle of the restructuring exercise was that the shareholders must bear the first loss and not the lenders; and the promoters must have more skin in the game.

This was done after the regulator realised that the CDR mechanism, put in place in August, 2001, could not do much to alleviate the pain of the lenders. Any loan exposure of Rs. 10 crore and more (including non-fund limits) and involving at least two lenders could have been tackled on this platform.

The S4A scheme allowed the banks to convert up to half the loans of stressed companies into equity or equity-like securities. Meant for restructuring companies with an overall exposure of at least Rs. 500 crore, this scheme could come into play only when the bankers were convinced that the cash flows of the stressed companies were enough to service at least half of the funded liabilities or "sustainable debt". Not much, however, could get resolved under this scheme either.

After ushering in a new bankruptcy regime in 2016, the RBI got more powers in 2017 to force the lenders to deal with 40 biggest corporate loan defaulters. The February, 2018 norms took the story forward.

The rules, released on 12th February, stipulate that starting 1st March, lenders must implement a resolution plan within 180 days for defaulted loan accounts above Rs. 2,000 crore. Failing to do so, the account must be referred to insolvency courts. They also mandate banks to report defaults weekly to RBI, even if loan payments are delayed by a day. These norms replaced earlier schemes such as strategic debt restructuring, 5/25 refinancing, the Corporate Debt Restructuring Scheme, and the Scheme for Sustainable Structuring of Stressed Assets, among others, with immediate effect. "All accounts, including such accounts where any of the schemes have been invoked but not yet implemented, shall be governed by the revised framework," the RBI said.

It warned that any failure on the part of banks to meet the prescribed timelines, or any actions they take to conceal the actual status of accounts or evergreen stressed accounts, will expose banks to stringent actions, including monetary penalties.

The rules around resolution plans were also tightened and restructuring of large accounts with loans of Rs.100 crore or more would need independent credit evaluation by credit rating agencies authorised by the Central bank. Loans of Rs. 500 crore or more would need two such independent evaluators.

NO LONGER IN A DENIAL MODE

As a result of the series of steps taken by the regulator, Indian banks are no longer in denial mode. Indeed, in the past, they were slow in recognising bad assets as such recognition hits their profitability since they need to provide for or set aside money for NPAs. Which is why, traditionally, bankers try hard not to allow any loan to slip into NPAs through various ways. But the relentless pressure of the banking regulator has changed the scene. The bankers are not taking any chances for any loan account any more. Once it's gone bad, they are swift in classifying it as an NPA and providing for it.

Once shy in recognition and resolution of NPAs for fear of being hit on profitability and a backlash from investors, bankers are now bold and walking the extra mile to settle with loan defaulters. They don't care much about the depth of the haircut and impact on their balance sheets.

However, this detoxification exercise has its own challenges through early recognition of stressed assets and increased provisioning. To add to the banker's woes, frequent involvement by investigative agencies, arrests of a few bankers and stripping the powers of a few others have created a fear psychosis. Bankers are tending to opt for a relatively safer and optically transparent path, even at the cost of recovery maximisation.

Today, the impact of major economic reforms such as Demonetisation, GST, RERA has stabilised and recognition of the bad loans has largely been done. We are probably at the final stage of detoxification.

Though this period has been mired by quite a few litigations, which were expected, IBC being a new legislation, the message has been conveyed aptly to the corporate world. The IBC has not only provided a legal framework to systematically address the NPAs of the banking system with a strong armoury to lenders, but also put borrowers who were looking for an easy escape route from the situation on the back foot.

Japan, which introduced the bankruptcy law in 2004, takes six months to settle a case and the recovery rate is close to 93%. For UK, which introduced it in 2002, the recovery rate is 88.6% and settlement within a year, while US, where insolvency law is 40 years old, it takes 18 months to settle a case at a recovery rate of 80.4%. It's still early days in India but the IBC has made a new beginning for the banking system. With the recovery picking up, albeit slowly, the banks are being encouraged to lend and support economic growth. The first signs of this are already visible – the credit growth in India is at a four-year high. ■