Capital erosion of banks

The past two years or so have witnessed rapidly increasing stress in the Indian banking sector, with non-performing assets (NPAs) steadily climbing from under 3% to over 13% of total assets. Loan loss provisioning for these NPAs has eroded the capital base of a number of banks, thereby limiting their ability to make further loans.

There are quite a few reasons behind the value erosion, including growing incidents of fraud, ballooning bad assets and a sharp drop in profitability. In FY 2018, the pack of 21 public sector banks (PSBs) posted a net loss of INR 0.9 trillion. The banks posted such massive losses as they had to provide for their rising bad loans as well as erosion in the value of their bond portfolio because of the rise in yields, even as there was no significant rise in their interest income and fee income. Banks do not earn any interest on their bad loans and they also need to provide for such loans or set aside money, which could have earned interest if lent.

This has been bleeding PSBs, leading to losses at many banks and eroding their capital base and restricting their capacity to lend to make profit. Two main indicators of the performance of banks, among others, are return on assets (RoA) and return on equity (RoE). RoA of PSBs has been consistently lower, compared with other scheduled commercial banks, while RoE of PSBs has been lower since 2012-13. Since 2015-16, both RoA and RoE for most PSBs were negative, indicating a loss to the banks and a concern for the government.

MSME lending has also suffered as weak banks have been placed under lending restrictions and NBFCs are facing a liquidity crunch. The government and the RBI need to work together to ensure easy access to funds for MSMEs.

Much of the problems currently being faced by the banking sector arise from a fundamental change that occurred in the Indian banking sector after 2002. Prior to that, Indian banks mainly had two types of loans – working capital loans to production entities, firms and farmers, which accounted for 76% of the banking portfolio, and retail term loans to households for housing and durable goods, which was around 24%. Since then, banks have been aggressively making term loans to companies for fixed capital investments, such as land, building and machinery. This now accounts for 38% of the banking portfolio, with working capital at 42% and retail at about 20%. Bulk of the NPAs by value are long-term loans to corporates.

This high exposure to companies in fixed assets, especially in project finance, happened at the behest of successive governments. It began with a decision taken by the government in 1997 to stop issuance of tax-free bonds by the Development Finance Institutions (DFIs), which were the main source of term finance for corporates. This closed the only source of relatively low-cost funds for these institutions and was instrumental in some of them converting to commercial banks and others shutting down. Consequently, Indian commercial banks were forced to fill the vacuum and in effect, convert themselves to universal banks.

The problem escalated due to the government's focus on infrastructure during 2002-09 period, especially with the efforts made in promoting public-private partnerships. This led to a rapid increase in project financing to private infrastructure firms.

The global financial crisis in 2008-09 again required the banks to take substantial further exposures in long-term loans as external loans taken by Indian corporates had dried up.

Till September 2015, the rise in Indian banks' bad loans every quarter was rather muted. It gained momentum from December 2015, when the RBI conducted the asset quality review (AQR), whereby the RBI's inspectors swooped down on banks, checked their books and forced them to come clean in 6 quarters by March 2017.

After a high credit growth rate regime during the expansionary phase of 2004-07, in tandem with India's high economic growth rate, the advances of PSBs between 2008 and 2018 have more than doubled, even though the rate of increase in advances has tapered in recent years.

The rise in advances, coupled with the stringent capital adequacy requirements imposed by RBI in the wake of the Basel III norms, high levels of NPAs and the poor performance of PSBs have led to significant capital erosion and requirements for further capital, both for replenishment of the base eroded by NPAs and fresh ones for giving loans.

The capital for PSBs can come either from the government of India or the capital market. Their underperformance and the pile of bad loans leading to low book value come in their 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 lower market values, compared with their book values. Hence, the government as the majority stakeholder needs to step in to rescue PSBs.

In October 2017, the Indian government had unveiled a plan to infuse INR 2.11 trillion capital into PSBs, which roughly have a 70% share of the assets of Indian banking industry. Of this, INR 1.45 trillion were to come from sale of recapitalisation bonds and the remaining INR 0.66 trillion were to come through budgetary allocation and fund-raising from the markets. Of the INR 1.45 trillion, bonds worth INR 0.8 trillion were issued last fiscal and bonds worth INR 0.65 trillion were planned to be issued for this fiscal. In December, the government enhanced bank recapitalisation outlay for this fiscal by an additional INR 0.41 trillion, from INR 0.65 trillion to INR 1.06 trillion.

In the period between 2008-09 and 2016-17, when the government infused cumulatively INR 1.19 trillion in PSBs, infusion was neither linked to banks' performance nor efficiency, but was ad hoc and without any accountable policy guidelines. The taxpayers' money was pumped in to keep PSBs alive.

This time, the government did not want to treat this as a dole, as was in the past. It seemed to be keen that banking reforms and recapitalisation must go hand in hand. Yet, the equity infusion was across the board. The government did not have much choice. It could not leave the banks under the prompt corrective action (PCA) framework to starve for capital as depositors needed to be reassured. But as a result of this, more efficient banks feel penalised despite conducting their business well, while the laggards still get capital. The government needs to look at ways in which it will tie future infusions to reforms.