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High NPAs at India's Public Sector Undertaking banks remain a pressing issue

by LU Chang

After a decade of excessive lending into power, infrastructure and steel, non-performing assets (NPAs) in Indian banks have been on the rise as many borrowers ran into financial difficulties and started to default on their bank loans. When businesses were booming in these industries, banks rushed to lend despite projects coming with considerable risks. This is especially so for the 24 Public Sector Undertaking (PSU) banks which had the social responsibility of priority lending to vulnerable industries as directed by the government. As a result, the gross NPAs across all banks in India mounted to INR 6.97tn as of December 2016, with 88.2% stemming from PSU banks. NPAs currently constitute 11% of gross advances in PSU banks. The amount of NPAs saw a significant jump in recent times as the Reserve Bank of India (RBI) forced banks to recognize losses and increase provisions for the NPAs on their balance sheet.

IDBI Bank, the 9th largest lender in India with total assets of INR 3.62tn, stood out among PSU banks after recognizing a loss of INR 31.99bn due to an 80% increase in NPAs. The RMI-CRI 1-Year Probability of Default (PD) for IDBI Bank soared to 692bps on May 23, the highest level in over a year (See Figure 1). The increase in 1-year PD coincides with the plunge of its market capitalization. However, not all Indian banks are in such a dire state. State Bank of India (SBI), India's largest lender, managed to double its profits in Q4 2016 driven by higher demand for loans. Unlike SBI, IDBI Bank's loan portfolio is narrowly focused on industrial financing, which failed to lift its net interest income during Q1 2017. As the RBI continues its reforms to improve asset quality, the financial health of banks has steadily recovered and the aggregate 1-year PD for 22 private banks has declined. However, the aggregate 1-year PD remains high for listed PSU banks.

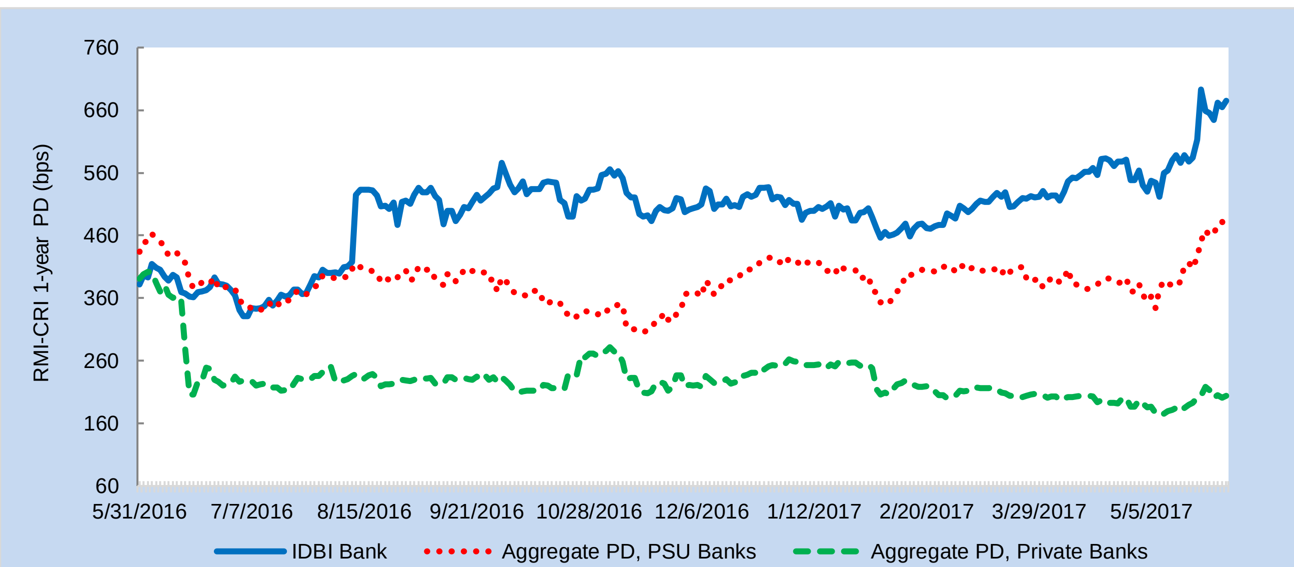

Figure 1: RMI-CRI 1-year PD for IDBI Bank and Indian banking sector. *Source: RMI-CRI*

Loose credit control and inadequate internal credit risk assessment within IDBI Bank are the main reasons for the rise of NPAs over the years. Though private banks face the problem of NPAs as well, they are nowhere as severe as that in PSU banks. Over the years, PSU banks such as IDBI Bank have tried to appease the government by inflating their balance sheet. Loans were granted easily and excessively with little regard for the credit worthiness of borrowers. One such example was the case of Kingfisher Airlines, where IDBI disbursed INR 9.5bn in loans even though Kingfisher Airlines was in financial distress. The airline subsequently went into a willful default and investigations are ongoing regarding the fraudulent practices of IDBI officials.

In addition, poor governance and lax underwriting standards in PSU banks worsened the problem. As the number of defaults increased, PSU banks attempted to cover up the problem by disguising NPAs as restructured loans. RBI audits revealed significant under-recognition of NPAs and the RBI intervened by enforcing new NPA provisioning norms on banks, resulting in the large spike in NPAs in recent quarters.

	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Q1 2017
Revenue (INR bn)	126.85	126.67	124.60	122.08	132.11
Amount of Gross NPAs (INR bn)	248.75	141.12	147.57	352.45	447.52
Net Profit (INR bn)	-17.35	1.35	1.19	-22.54	-31.99
Return on Assets (ROA, %)	-1.98	0.16	0.14	-2.32	-3.36

Table 1: Financial data of IDBI Bank. *Source: IDBI Bank Ltd company report*

Among PSU banks, IDBI Bank is one of the worst performers in terms of asset quality. Gross NPAs shot up significantly since Q4 2016 (See Table 1). The increased provisions for these NPAs have caused IDBI to post huge net losses in Q4 2016 and Q1 2017 despite growth in its revenue. The huge losses resulted in IDBI breaching the risk threshold set by the RBI and the bank was placed under Prompt Corrective Action (PCA).

Under the PCA framework, IDBI faces sanctions such as restrictions on dividend, branch expansion and executive compensation, which aim to prevent banks from collapsing in critical states. Profitability of the bank as reflected by ROA (See Table 1) has been on the decline. As a turnaround strategy, IDBI plans to cut wages to reduce costs and minimize losses. However, this move faced resistance from employees who threatened to go on strikes if any wage revision was to occur. The All India Bank Employees Association (AIBEA) will support the strike and one such strike already occurred in April 2017 with another planned on 16 June 2017. The outlook of IDBI remains bleak with NPAs expected to grow in the next few months as more loans mature. However, as a PSU bank, it is unlikely for IDBI to experience a complete collapse due to the implicit guarantee of a government bailout if necessary.

Despite the looming problem of NPAs, India is still one of the fastest-growing large economies in the world with a projected growth rate of 7.2% in 2017 and the overall outlook of the banking sector remaining stable. Economic expansion warrants a higher demand for credit and revenues of Indian banks are likely to grow. The key here is to maintain asset quality while banks extend more loans to companies.

Going forward, the RBI is expected to intensify its efforts on reforms to bring PSU banks back to health. The problem with NPAs is a left over one and will take time before it can be fully resolved. NPAs are expected to continue rising in the short run as banks have been consistently underreporting bad loans on their balance sheets. Going through reforms will be a painful process for banks as their profitability suffers under tightening regulations. However, this is necessary and positive for the robustness of Indian banks in the long run. As India's fiscal deficit continues to grow, it is not feasible to rely solely on government bailouts to relieve banks from all crises. Reforms to improve the credit structure of PSU banks may help solve the root problem. Apart from banking reforms, India is also modifying its bankruptcy laws to make it easier for banks to recover bad loans. With all these in place, PSU banks in India are on their way to recovery and investors will be waiting to see the progress.

Credit News

IMF warns US fiscal uncertainty, China's credit growth pose risk to Asia

Jun 4. The uncertainty associated with the size and composition of US fiscal stimulus and China's reliance on rapid domestic credit growth are amongst risks that affect Asia's economic outlook. In addition, IMF also noted that the faster-than-expected sequence of interest rate hikes by the Federal Reserve could trigger a "significant" dollar rise, raising the debt burden of Asian emerging economies with large dollar-denominated borrowings. (Reuters)

Spain's Banco Popular shares hit new low amid sale doubts

Jun 3. Banco Popular shares fell for more than a third of its value this week to a record low of EUR 0.41, due to investors' fears of Popular's larger rivals, such as BBVA and Bankia, pulling out of the auction process. The reason for the withdrawal is the uncertainty and the lack of data associated with the amount of capital and provisions that Popular would require. Currently, Banco Santander is considering to provide an offer to Popular only if a deal is reached and its hurdle rate of generating a return on its investment within three years is met. To date, Popular has yet to revise the market value of EUR 40bn in property on its balance sheet and it is uncertain about the amount of money to set aside for potential lawsuits from its investors who participated in its EUR 2.5bn share issue last year. If the auction process fails, Popular might require a financial restructure and at least EUR 4bn more capital, which is more than double of its market capitalization. (FT)

ECB split on stimulus dampens demand for long-dated euro zone bonds

Jun 2. Doubts on the sustainability of ECB's currently extraordinary stimulus measures have sent demand for long-dated EU government bonds tumbling following splitting views among euro zone policymakers on the need for further monetary injection. Analysts believed that this might be fueled by concerns revolving uncertainty in actions taken by the ECB which might cause undesirable losses on long-dated bonds. The impact started to materialize as the yield spread between Germany's 10 and 30-year bonds hit its widest in 18 months on Friday and that between Italy's 10 and 30-year bonds at 111 bps, a 2.5 month high. At the coming June 8 meeting, the ECB is expected to raise its assessment of risks to balanced or incorporate market sentiment through discussing a shift from its bias to ease policy. (Reuters)

Hertz pays premium for USD 1.25bn debt after fall in used car prices

Jun 1. The weakening market for used vehicles has made investors cautious about lending to Hertz, one of the largest US car rental groups. Hertz issued a USD 1.25bn of new debt at 7.625% interest on top its current USD 14bn debt load. The value of Hertz shares have dropped by more than half as of this year from a peak of USD 14bn in 2014. Car rental companies have also been under pressure as the auto market has cooled and it is also dependent on the resale value of the millions of car they own. Hertz has been selling vehicles at a loss due the weak market which has depressed margins. The company's bet on increasing its fleet by focusing on compact cars over trucks and SUVs has also caused it to lose market share. (FT)

China sovereign bonds decline in May amid deleveraging concerns

May 31. The Chinese sovereign bonds posted their second consecutive monthly decline amid the Chinese government's commitment to reduce the level of borrowing in China's debt market. The government's tough stance on the deleveraging drive remained unfazed even as Moody's downgraded its rating on China's sovereign debt, citing unforeseeable effect of the Chinese government's action. Based on data compiled by Bloomberg, the 10-year yield has advanced 17 bps so far in May to 3.65% compared to 18 bps in April. The effect could also be felt in China's money market where PBOC set the benchmark seven-day repurchase rate at 2.93% in May. (Bloomberg)

S&P upgrades Bulgaria's outlook to positive (Reuters)

Reliance Communications' debt downgraded amid default fears (FT)

Regulatory Updates

Stress test relief tops bank wish list ahead of Trump's rule review

Jun 2. US banks are pushing for an ease to the annual stress tests being conducted as the outcome determines how much capital banks must hold and how much left can be used. Banks are claiming that by reducing the complexity and frequency of the tests, man-hours can be saved and the effort can be used instead to stimulate more lending thus economic growth. Analysts have chipped in by estimating that JP Morgan could increase annual profits by about 10% under a more relaxed framework. However, regulators have opposed the idea of relaxing the stress tests too much. Regulators have stressed that strong capital regime have to be maintained and reckless practices in the banking industry might surface again if regulations are loosened. This comes as the Treasury Department is expected to release its first report on overhauling regulations early next week. (Reuters)

Moody's fined EUR 1.24mn over transparency failures

Jun 2. Moody's was fined by the EU's market watchdogs for failing to provide comprehensive descriptions of methodology for a series of rating decisions on the financial health of global institutions. The fine shows that the watchdogs are willing to take public enforcement actions, so as to maintain and enforce high standards of transparency, especially when the credit ratings by these agencies have significant impacts on the financial markets and investors' trust and confidence. (FT)

Asset managers step up performance disclosures (FT)

'Ghost collateral' haunts loans across China's debt-laden banking system (Reuters)

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