How Safe are India's Banks?

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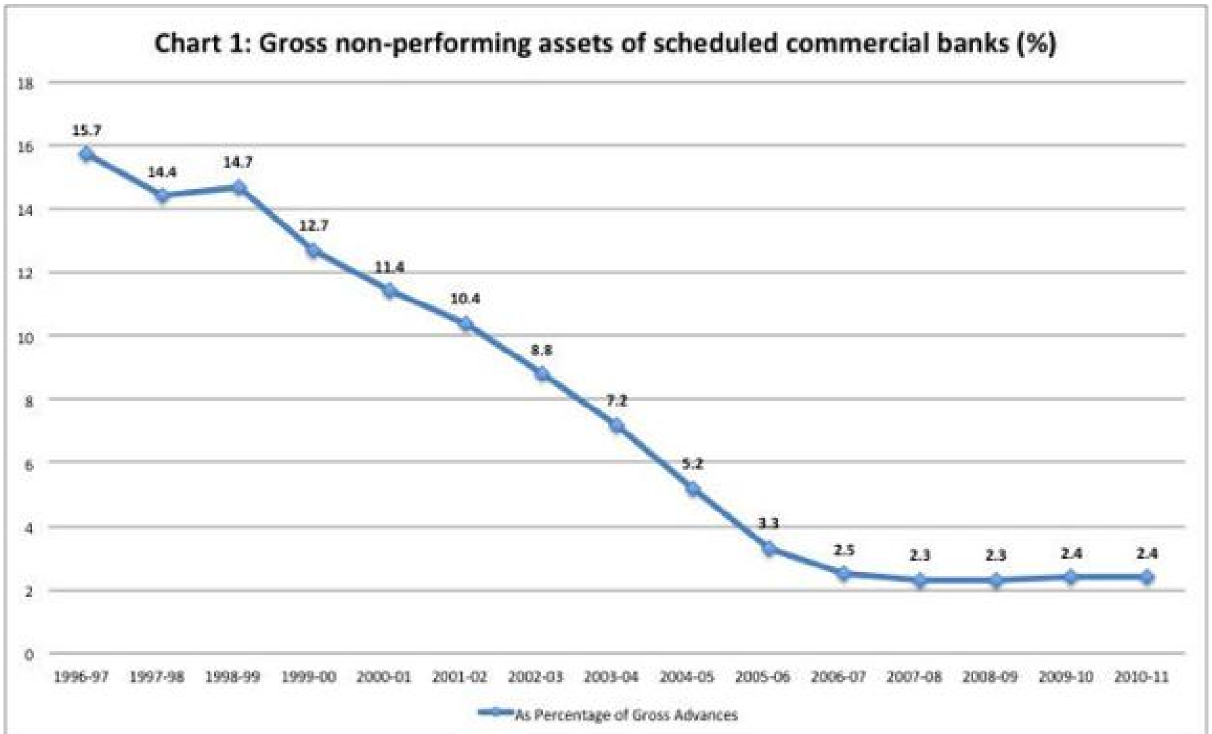
Ever since liberalisation opened up and deregulated the markets and institutions that constitute India's financial system, the positive effect that has had on India's banks has been a periodic refrain. One indicator regularly used to support that argument is the sharp fall in the share of non-performing loans to total, with the ratio of gross non-performing assets to gross advances falling from close to 16 per cent in the mid-1990s to as low as 2.5 per cent a decade later, where it has remained since (Chart 1).



However, the figures of loans on the books of the scheduled commercial banks that are non-performing seem to be gross underestimates. This is because the loans given to a number of large borrowers, who have been finding it difficult to meet the associated interest and amortisation commitments have been "restructured" in recent times. This allows troubled or even non-performing assets to be recorded as standard assets, concealing in the process the real state of affairs.

Such restructuring of debt favours the debtor at the expense of the creditor. The RBI's prudential guidelines define a restructured account as one where the bank, for economic or legal reasons relating to the borrower's financial difficulty, grants to the borrower concessions that the bank would not otherwise consider. Restructuring can involve some combination of changes in the terms of advances, such as alteration of the repayment period, reduction of the repayable amount, reduction in the rate of interest and conversion of debt to equity. It can also be accompanied by the provision of additional credit, despite the shortfall in meeting past commitments. The intent is to help the company recover. But, often that intent is not realised. The only benefit is that in return for the losses the creditor institution suffers, it is in a position to treat the asset (after providing for any write down) as a standard asset subject to conditions. But this may in fact provide the cover to abuse the restructuring route to bailout private investors at the expense of the banks. As Chart 2 shows the net result of this strategy has been that the troubled assets restructured by India's banks had by March 2011 exceeded the identified non-performing assets of the banking system.

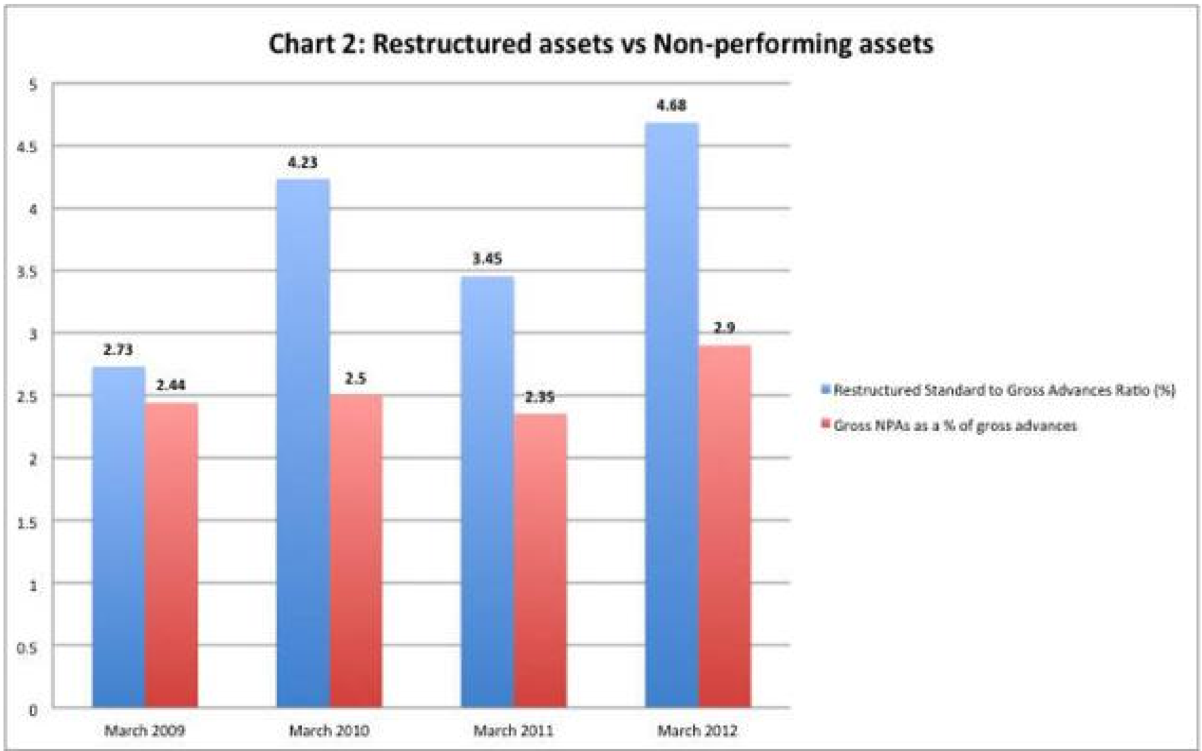


Chart 2: Restructured assets vs Non-performing assets

The dangers associated with restructuring was brought to public attention in the Kingfisher Airlines case, which is now facing the prospect of liquidation as a result of a combination of bad strategy, bad acquisitions, profligacy and obvious mismanagement. Unfortunately, it is not just the airline that is in a mess, but also the banks (including the venerable State Bank of India) that have lent to it. If they withdraw they invite default of the large volume of debt they have already provided. So they restructure debt, offer better terms, extend repayment periods, and provide more credit to keep the unit afloat. Thus, in 2010, the banks had under the Corporate Debt Restructuring (CDR) scheme of the RBI, restructured debt to the tune of Rs. 77 .2 billion owed by Kingfisher. Now, while the debt of the airline has increase by another Rs. 10 billion or so, the airline has been forced to suspend operations with no hope of repaying the banks unless the impossible happens.

What is disturbing is that it is now emerging that Kingfisher is no exception, but is the tip of a debt default iceberg that has been hidden by restructuring. The total volume of restructured loans as of the end of March 2012 was Rs. 2,18,068 crore, up from Rs. 75, 304 crore just four years back. Moreover, much of this is in the beleaguered infrastructure sector. Such credit rose sharply because of the government's decision to use the banking system as an instrument to further an aspect of its larger liberalisation agenda, which was the entry of the private sector into core infrastructural areas involving lumpy, capital intensive investments in power, telecommunications, roads and ports and sectors like civil aviation. Under normal circumstances banks are not expected to lend much to these areas as it involves a significant maturity and liquidity mismatch: banks draw deposits from savers in small volumes with the implicit promise of low income and capital risk and high liquidity. Infrastructural investments require large volumes of credit and do involve significant income and capital risk, besides substantial liquidity risk. So what is required for supporting infrastructural investment is increased equity flows from corporate or high net worth investors and the expansion of sources of long-term credit like a bond market. Neither of these, especially the latter, occurred in adequate measure. So the public banking system (besides a couple of private banks) became the main source of finance, possibly because of governmental pressure.

The share of infrastructural lending in the total advances of scheduled commercial banks to the industrial sector rose from less than 2 per cent at the end of March 1998 to 16.4 per cent at the end of March 2004 and as much as 31.5 per cent at the end of March 2012. Four sectors have been the most important here: power, roads and ports, and telecommunications, and a residual ‘other’ category more recently, reflecting in all probability the lending to civil aviation.

The largest chunk of bank debt to infrastructure (estimated at Rs. 269196 crore as of March 2011) is to the power sector. The problem in the power sector is that large capital investments, wrong technology choices, poor management, high power costs that the state distribution agencies are not able to bear given the tariffs they charge, and difficult and costly fuel supplies, have all ensured that most of the high profile private power projects are not viable. The government has sought to prop them up with concessions such as coal allocations without success. If this leads to failure, the bankruptcy of the private sector power companies can spill over onto the banks carrying their loans, much of which has already been restructured. That could make banks looks far less safe.

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