The Real Banking Problem*

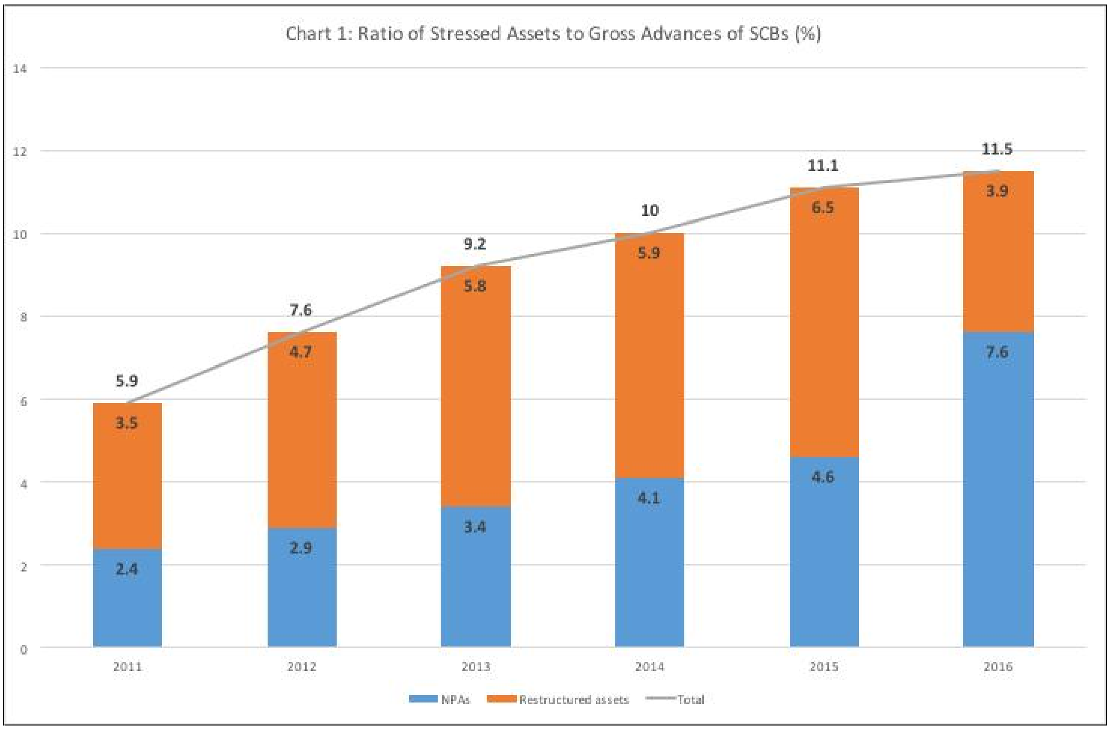
C.P. Chandrasekhar and Jayati Ghosh

While recognizing that risks to India's banking sector are rising due to deterioration in asset quality and low profitability, the government and RBI spokespersons periodically declare that there is no cause for alarm. But there is much evidence (for example in the RBI's Financial Stability Report of June 2016) that the problem is serious and the health of banks may deteriorate further, as changes in the nature of bank exposure in India in recent years have significantly increased systemic risk.

The indicator most often cited as reflecting the health of the banking system is the ratio of non-performing assets (NPAs) to total advances. The restructuring and recapitalization process associated with the post-1991 'reforms' had resulted in a sharp decline in the ratio of gross NPAs to gross advances from 15.7 per cent at the end of 1996-97 to 2.3 per cent at the end of 2008-09, the year of the global financial crisis. However, since then there has been a reversal in trend, with the ratio rising to 3.4 per cent in 2012-13, 4.6 per cent in 2014-15 and 7.6 per cent in 2015-16 (Chart 1). The Financial Stability Report of the RBI provides a number of explanations for this trend.

One is the possibility that "boom period credit disbursal was associated with less stringent credit appraisal." The other is accelerated credit growth, resulting from competitive credit disbursal encouraged by the sharp decline in the statutory liquidity ratio (SLR) from 30.5 per cent of total assets at end March 2005 to 22.6 per cent at end March 2008 and "the push for infrastructure projects, many of which later got into a logjam."

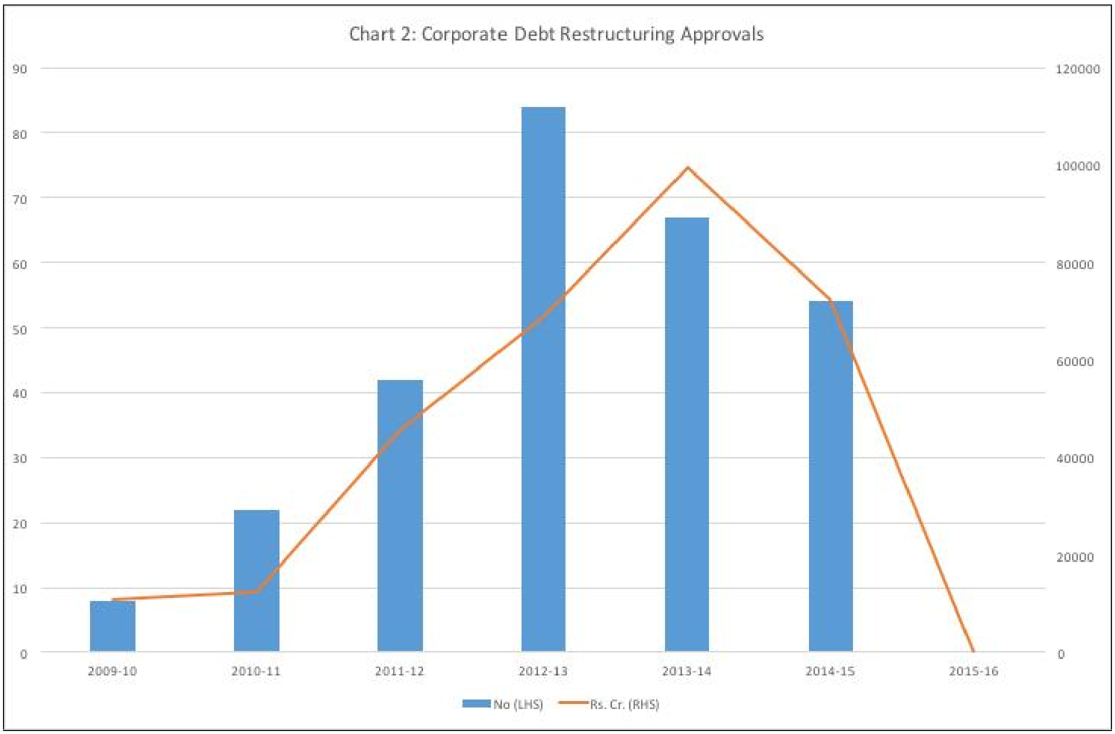
But these do not explain the sharp spike in the NPA ratio in 2015-16. Two other developments during the last decade are important. The first was the creation of a corporate debt restructuring mechanism, which enabled the revival of large loans that were under threat of default. The mechanism involved measures such as extending the maturity of the loan, reducing the interest rate charged, converting a part of the loan into equity, providing additional financing, or some combination of these. This was clearly intended to mitigate the risk of lending large sums, especially to capital intensive projects with long gestation lags, as in infrastructure. If banks had to make provisions for likely losses on such loans at the first sign of them turning non-performing, the impact this would have on their finances would dissuade them from undertaking such lending. Restructuring was a way of allaying the fears of bankers, who had in the past avoided lending to capital intensive projects for fear of being overexposed in long-maturing, illiquid loan assets. With the decline of development banks post liberalization, public commercial banks were required to take on this new role, in which they did indeed finance capital intensive projects with greater liquidity risks.



Secondly, in keeping with this policy inclination, in January 2009, to counter the adverse impact of the global financial crisis on the Indian economy, the RBI issued guidelines that allowed such restructured assets to be treated as standard assets. It hardly bears stating that restructuring is no guarantee that the asset concerned will 'perform' in future. Economic conditions that affected the repayment of the loan could deteriorate further, the project could prove to be structurally unviable for a host of reasons, or the borrower could just be a "willful defaulter". So keeping these assets out of the NPA basket made the NPA ratio an inadequate indicator of bank stress. If banks resorted more often to the restructuring option, the volume of stressed assets in the system would rise much faster than the NPA numbers suggested.

This is exactly what happened in India after 2008. Banks used the opportunity offered by these two policy initiatives to paper over the problems created by their new role as financiers of large projects. As a result, restructured assets as a percentage of gross advances rose from 3.5 per cent at the end of March 2011 to 6.5 per cent at the end of March 2015. This 3 percentage points rise was higher than the 2.2 percentage points rise in the gross NPA ratio.

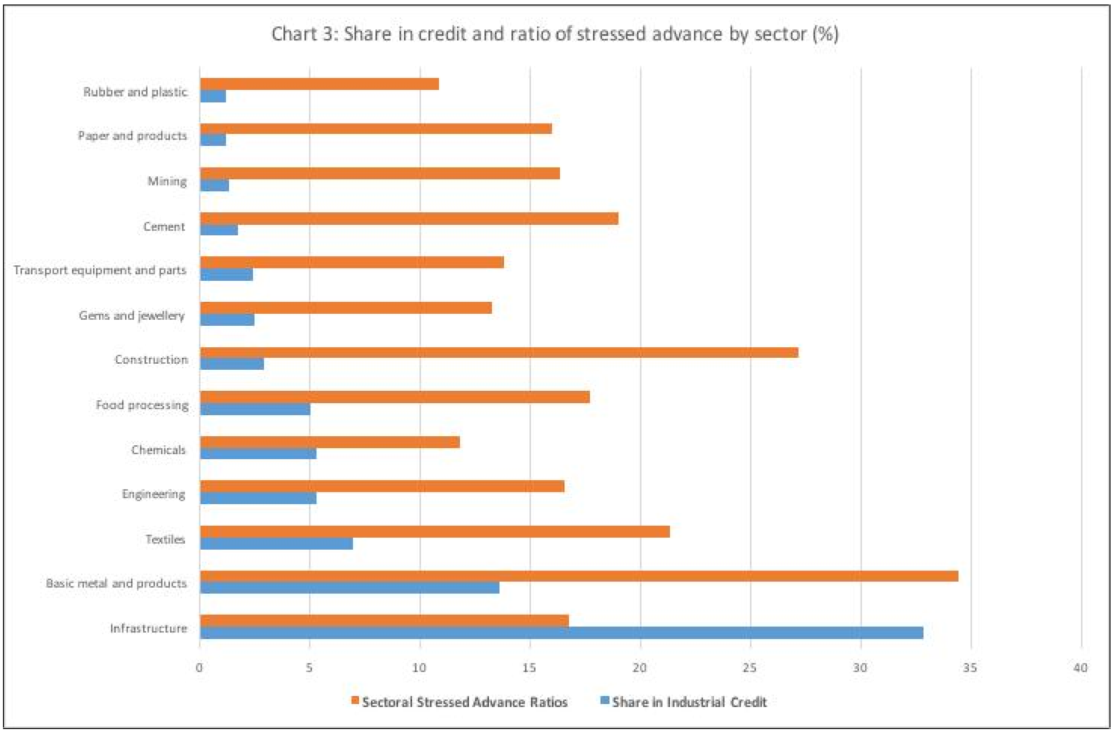
Realizing that postponing bad debt recognition in this manner could result in the accumulation of stressed assets in bank balance sheets sufficient to create a systemic problem, the Reserve Bank in 2015 instituted an asset quality review to reclassify assets and reverse the practice of treating all restructured assets as standard assets. As a result, many "restructured standard assets" were reclassified as non-performing. Simultaneously, the RBI seems to have put on hold the corporate debt restructuring process, with approvals of such restructuring initiatives falling to zero in 2015-16, as compared with 54 cases involving debt totaling Rs.72,560 crore in 2014-15 (Chart 2).



In the event, most restructured assets were reclassified as non-performing. The spike in the NPA ratio in from end March 2015 to end March 2016 is largely explained by the decline in the ratio of restructured assets to gross advances from 6.5 per cent to 3.9 per cent over that period. Overall stressed assets (including both NPAs and restructured assets) had increased from 5.9 per cent of gross advances at end March 2011to 11.1 per cent at end March 2015; but rose only marginally to 11.5 per cent by end March 2016. This is one reason the RBI is satisfied with the current position. In its view, once stressed assets are formally recognized as non-performing, the requisite provisions are set aside at the expense of short term profitability, and the banks are recapitalized, credit growth will see a revival, but within a more monitored framework.

This, however, sidesteps the problem of managing the role handed over to commercial banks, of providing the long term financing earlier undertaken by development banks. They are even required to make up for the shortfall in public capital formation within a low-tax and restricted fiscal deficit regime.

This has at least two implications. First, two sectors that account for high shares in total industrial credit advance, infrastructure (32.8 per cent) and basic metals and products (essentially iron and steel) (13.6 per cent), show very high ratios of stressed advances to gross advances (Chart 3). These are among the new areas into which neoliberal reform has taken the banks.



Second, as of March 2016, large borrowers (with liabilities of Rs. 5 crore and above) accounted for 58 per cent of scheduled commercial bank advances and 86.4 per cent of gross NPAs. Thus, NPAs were concentrated with these large borrowers. The top 100 borrowers accounted 16 per cent of total advances and 22.3 per cent of gross NPAs. Indeed, the gross NPA ratio of the top 100 borrowers rose from just 3.4 per cent in September 2015 to 22.3 per cent in March 2016, with the reclassification of restructured assets.

Thus, the fragility of the banking system is due to the large borrowers who have benefited from the restructuring route to concealing NPAs. If this proves to be unviable, growth itself is under threat. This provides the government with new grounds to adopt even more pro-business policies than it has in the past.

* **This article was originally published in the Business Line on July 4, 2016.**