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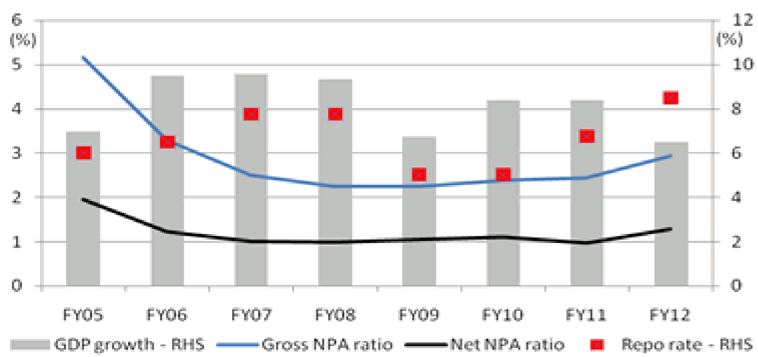
Bad loans add stress to India's banks

By Kunal Kumar Kundu

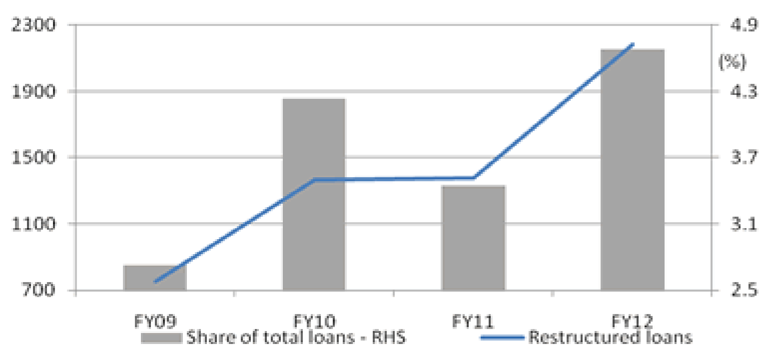
India's economic slowdown and high interest rates have started to impact the health of the country's banks in no uncertain terms, as is reflected by the rise in non-performing assets (NPAs) levels.



Source: RBI

As the Reserve Bank of India data shows, the gross NPAs of the Indian banking system (as a percentage of gross advance) during the fiscal year that ended in March 2012 (FY12) were the highest in the last six years.

An even bigger concern is the rising threat of loans getting restructured as high inflation and interest rates impact demand and reduce the pricing power of the corporates. FY12 saw a massive spurt in restructured loans, both at an absolute level and as a share total loan, as corporate cash flows have been affected drastically.



Source: RBI

Restructured loans refer to those that cannot be recovered or serviced as per their schedule and the lenders are, therefore, required to dilute the terms under which the loans were originally sanctioned, which may include lowering of interest rates, extension of tenure or both.

Under the so called Corporate Debt Restructuring (CDR) scheme, banks can restructure loans jointly. When interest payment becomes overdue for three consecutive months, the outstanding loan gets classified as an NPA.

From April 2012 onwards, Indian banks are required to report their NPAs in a computer-recognized / identified format. As per the available information, nearly 90% of all banks' loan portfolios are under the computerized system of NPA reporting or system-based reporting. With the discretion of bank managers in classifying assets according to their own judgment being removed, there is less probability of window dressing and hence, technically, the probability of a loan being classified is higher, or better-performing, than it is.

While it may lead to a spike in NPA numbers, this is a step in the right direction as it is likely to be more transparent (though this will not necessarily mean that all NPAs will get reported, as bank managers can collude with lenders and coax them to make payment for a month within the relevant three-month period and thereby prevent the loan from being classified as an NPA).

According to the International Monetary Fund Research Department's Corporate Vulnerability Utility database, debt-to-equity ratios now exceed 100% in Brazil, India, and South Korea (based on the capital-weighted mean of corporate debt-to-equity ratio - all sectors). High leverage and declining profitability raise the probability of corporate defaults in a downturn.

With the Indian economy continuing to slowdown (the gross domestic product growth for FY13 is widely expected to be sub-6%), NPAs are clearly on the rise.

As on June 30, the total amount of loans (on a cumulative basis) restructured by Indian banks under the corporate debt restructuring mechanism was close to 1.7 trillion rupees (US$24 billion) - an increase of 180 billion rupees during the quarter under consideration.

By July, the number of cases referred to CDR was even higher. According to a report by www.moneycontrol.com, in July alone there were additions of 19 cases amounting to an additional 115 billion rupees.

While not all restructured loans end up being NPA, the threat of rising NPAs is very real, as at least a quarter of restructured loans can end up being NPAs. The government-owned State Bank of India (SBI), the country's largest lender, has restructured loans worth about 330 billion rupees, out of which 70 billion rupees have turned into NPAs.

According to their chairman, Diwakar Gupta, SBI added 20 billion rupees of restructured loans in the March quarter, 5.64 billion rupees in the June quarter and expect to restructure another 50 billion rupees worth of loans during the remaining part of the current fiscal year.

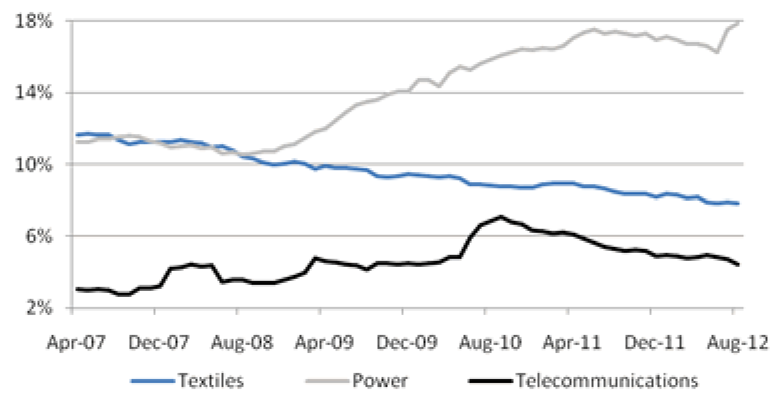
According to estimates made by India's leading credit rating agency, CRISIL, the volume of loans that will be restructured during FY13 may rise 71% to 2.05 trillion rupees from 1.2 trillion rupees during FY12. This means that approximately 5.7% of India's total bank loans will have been restructured over the two-year period.

More importantly, according to an RBI report, even with easier terms the borrowers have failed to make payments on 15% of these loans since 2009. The report further states that, the existing guidelines allow banks to restructure loans for debtors who don't have viable plans to bolster cash flow, thereby delaying the inevitable collapse.

As the economy slows, credit conditions worsen and companies struggle to raise cash from the stock markets, the probability of default can only be higher. From the point of view of the banks, restructuring will lead to an increased cost of credit as they will need to set aside a higher percentage of the original loan amount, unlike in the case of the original loan.

As of now, while the provisioning requirement for the original loan is around 0.4%, the requirement for a restructured loan goes up to 2%, and the RBI is planning to increase the provisioning requirement to 5%.

Most of the restructuring belongs to risky sectors such as power, telecoms, textiles etcetera. These three sectors alone account for 30% of total loans currently.



Source: RBI, author's calculation

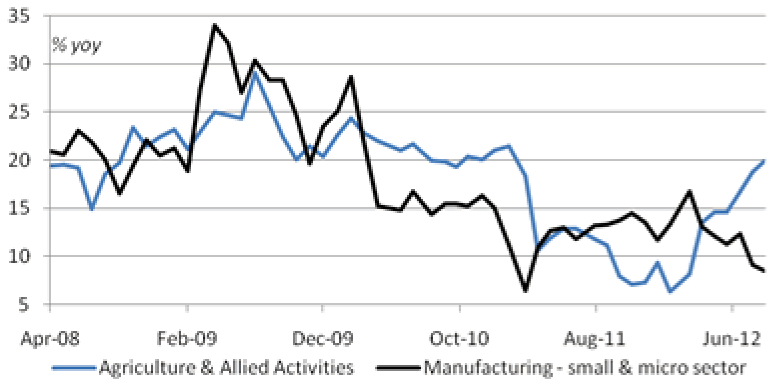
The problem is, most of the restructured loans belong to the state-owned banks. As per the estimates made by The Economist, 93% of restructured loans are part of loan portfolio of the state-owned banks.

India's commerce minister recently talked about restructuring loans to the textile sector to the tune of 350 billion rupees. Then there is debt restructuring of the ailing state electricity boards. And the story continues.

In fact, forced debt restructuring of many loss-making public-sector units is standard practice, which allows the bankers to classify their loans as standard, thereby increasing the risk of impairment of assets in the future.

Decisions by the policy makers to seek restructuring of loans as a solution to the problems faced by industries (unable as they are to address the basic concerns of the industry) can only come at the cost of the health of the banking sector, especially the state-owned banks, which are more prone to arm-twisting.

This is also evident from the fact that while India's small-scale industries are the worst affected due to credit lines drying up because of high rates and stricter lending norms, political pressure (with an eye toward various forthcoming elections) has resulted in priority lending to the agriculture sector increasing by leaps and bounds, even though this sector is suffering due to recent drought conditions.



Source: RBI, author's calculation

Clearly, rampant and politically motivated restructuring of loans induced by a slowing economy is increasing the vulnerability of India's banking sector even if, for the time being, it is not under imminent threat of collapse.

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