South Asia

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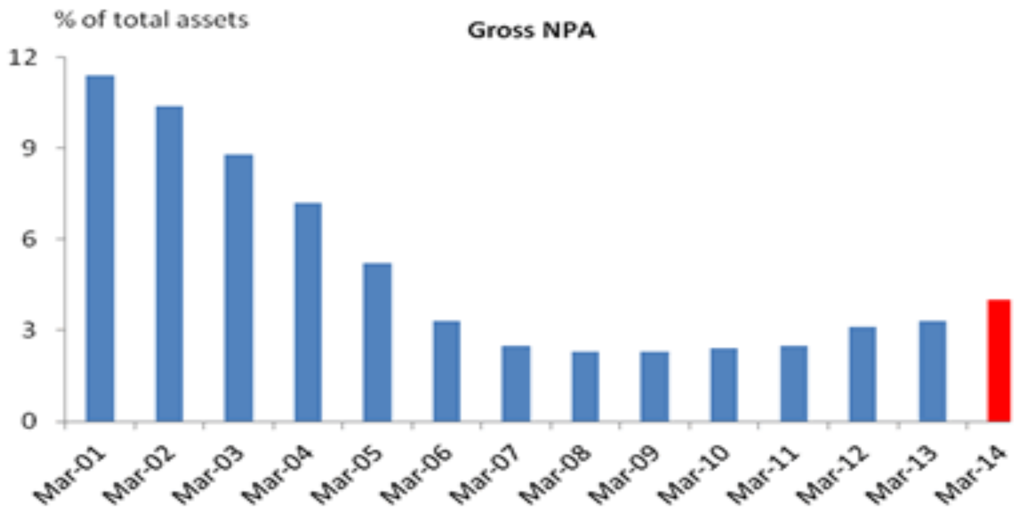
Indian banks trip on bad-loan hurdle

By Kunal Kumar Kundu

NEW DELHI - With Moody's recently downgrading by a notch the unsecured debt and local currency deposit rating of the State Bank of India, the country's largest lender, the focus is firmly back on the quality of assets of India's banks. A slowing economy, faltering corporate performance and stuck investments make for a debilitating concoction of headwinds that can stifle the banking sector, especially the public-sector lenders.

But first things first. The stress in the Indian banking sector is in any case visible through the prism of rising non-performing assets (NPAs). According to a Reserve Bank of India study, gross NPAs have more than trebled in the six years to March 2013. After declining from 700 billion rupees (US$11 billion) at the end March 2003 to 500 billion rupees at the end March 2007, NPAs shot up to 1.84 trillion at the end of March this year - an average growth of 24.7% over the past six years.



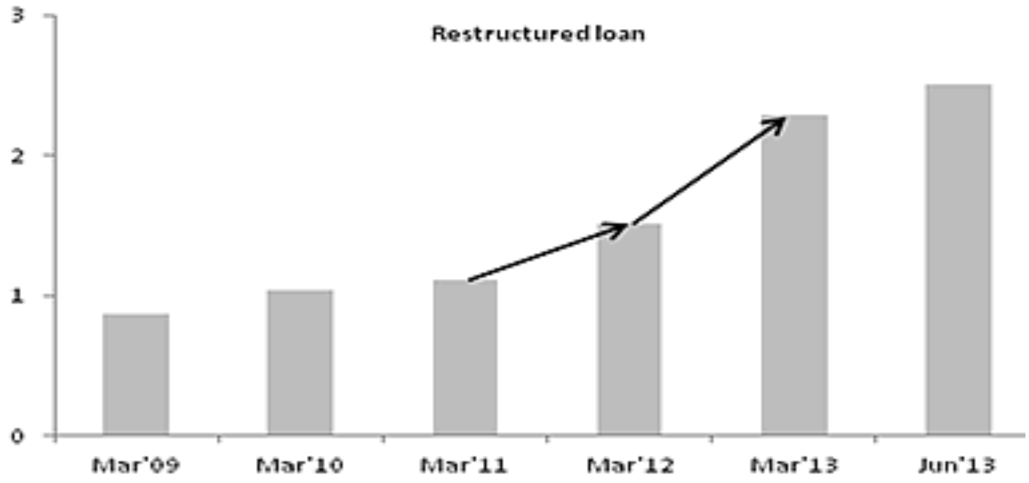
Note: Mar 14 - CRISIL estimate. Source: RBI, CRISIL

In percentage terms, the gross NPAs of Indian banks touched 3.3% as of March 2013, the highest since March 2005. CRISIL, India's leading credit rating company, expects it to touch 4% by March 2014.

It is not a surprise that NPAs would be on the rise, given that an increasingly large proportion of the loan portfolio of the banks is getting restructured. As of June 2013, a little more than 2.50 trillion rupees worth of loans have been restructured, which is nearly 50% more than what it was as of June'12 (1.68 trillion rupees).

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 interest rates, an extension of tenure or both.

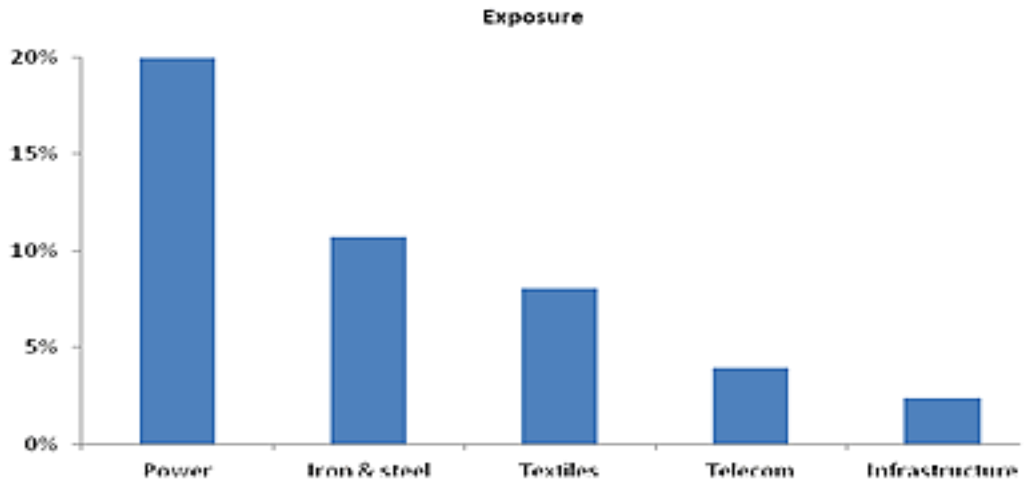
Under the so called Corporate Debt Restructuring (CDR) scheme, banks can restructure loans jointly. Debt can be restructured under the CDR facility only if 60% of the banks that have lent money and banks that have lent at least 75% of the total amount agree to the restructuring and both these conditions have to be met.



Source: CDR

According to the available information, during the three month period April to June this year, the first quarter of the present fiscal year, banks restructured the debt of 12 companies, aggregating 200 billion rupees. This included restructuring of debt worth 135 billion rupees of Gammon India Ltd (an engineering and construction firm). In this case, the banks concerned agreed to extend the loan repayment period to 10 years and to a moratorium of two years. This was coupled with a reduction in interest rate of between 1 and 2 percentage points. Another notable case was that of Arshiya International Ltd (a logistics company). In this case, debt worth 30 billion rupees was restructured.

According to the CDR, power, telecoms, iron and steel, textiles and construction sectors are undergoing plenty of stress and in the case of the banks, more than 45% of total loans outstanding are in these sectors.



Source: RBI, author's calculation

When interest payment becomes overdue for three consecutive months, the outstanding loan is classified as an NPA. According to the banking analysts, anything between a fifth and a fourth of such restructured debt ends up as NPA.

The banking sector stress is likely to increase even further due to the slowing economy, the weakening currency and its associated volatility, high inflation and faltering demand. More importantly, although the real interest rate appears to be low given the persistently high level of inflation, companies are finding it difficult to service their debts given that the absolute level of interest rates are high, especially given the falling demand.

Also, although the blue-chip corporate borrowers enjoy preferential rates, small and medium enterprises, which are hit even harder due to weak economic conditions, are forced to borrow at much higher rates, making them even more prone to default.

The weakening economy manifests itself on corporate balance sheets with a lag, and clearly the situation is worsening. According to CRISIL, more companies will be downgraded this year than they in the past year. During the year to March 2013, the rating agency downgraded ratings of as many as 1,073 firms while upgrading ratings on just 670.

According to India Ratings and Research, debt default by Indian firms rose to a 10-year high during 2012-13. Of the 716 issuers rated by the organization, (which included companies, banks, non-banking finance companies and infrastructure and project finance companies), about 32 defaulted on their debt obligations due to economic stress.

Clearly, the banks are in for a tough time. The problem will be more pronounced for state-owned banks that have to depend on periodic recapitalization by the government.

With the fiscal health of the government in dire straits, the desired level of recapitalization will not be forthcoming as the government needs to strike a fine balance between its ever-rising expenditure needs (especially as it gears up for the forthcoming election, due by next May) and falling revenue generation.

The recent refusal by the government to announce a one-time increase in retail prices of domestically sold diesel (despite raising expectations of announcing a one-time rise of 5 rupees per liter) shows that politics have once more out-maneuvered economics.

Despite a periodic increase in the diesel price by 50 paise (1 rupee equals 100 paise) per liter per month, the oil companies in India at present sell diesel at prices that are lower than the cost of production by 14.50 rupees per liter. What this means is that the burden of oil subsidy will rise, thereby further constricting the government's ability contain the deficit to reasonable levels.

To that extent, the downgrade of SBI by Moody's is not a surprise.

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