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Bad debts in public sector banks sour India's growth story

by Ker Wei Khaw

In March 2015, the International Monetary Fund's managing director Christine Lagarde lauded India as a bright spot in the cloudy global horizon during her visit to the country. India's economy is expected to surpass the economies of Japan and Germany combined by 2019, doubling up in size in just ten years from 2009. Already, data released in March 2015 showed that India's growth has edged above the growth of China, the world's fastest-growing economy, during the first quarter of the year. While there were doubts among economists regarding the validity of the data, China's declining growth rate is evident and it is not difficult to imagine how the plot will unfold. Indeed, at this point, the play has been set for India to take center stage and it all boils down to the government's will to do so – for it must first clean up and revitalize its weak banking sector.

India's banking sector is in a bad shape. The sector's gross non-performing asset (NPA) ratio, which is the value of non-performing loans divided by the total value of the loan portfolio, stood at 4.0% as of the end of 2014. In contrast, the emerging markets of Brazil and Indonesia only recorded an NPA of 2.9% and 2.1% respectively during the same period. Perhaps, the more troubling observation here is that the NPA in India has inflated to almost twice its size since 2010, while the same metric for its peers moved in the opposite direction. Just recently, the Reserve Bank of India (RBI), in its latest announcement, put the NPA figure for the banking sector at 4.45% as of March 2015.

When it comes to errant banks in India, it is not a case of one bad apple spoiling the barrel. Public sector banks (PSB) are the main sources of loan in the country, accounting for about 70% of the market. Unfortunately, it is also at these institutions where the NPA is surfacing at an alarming rate across the board. At the Bank of India, the fourth largest PSB by total assets, the gross NPA ballooned up by 87% during the financial year that concluded recently in March 2015. Similarly, the Punjab National Bank, third in the ranking of total assets, reported an increase of 36% in gross NPA during the period.

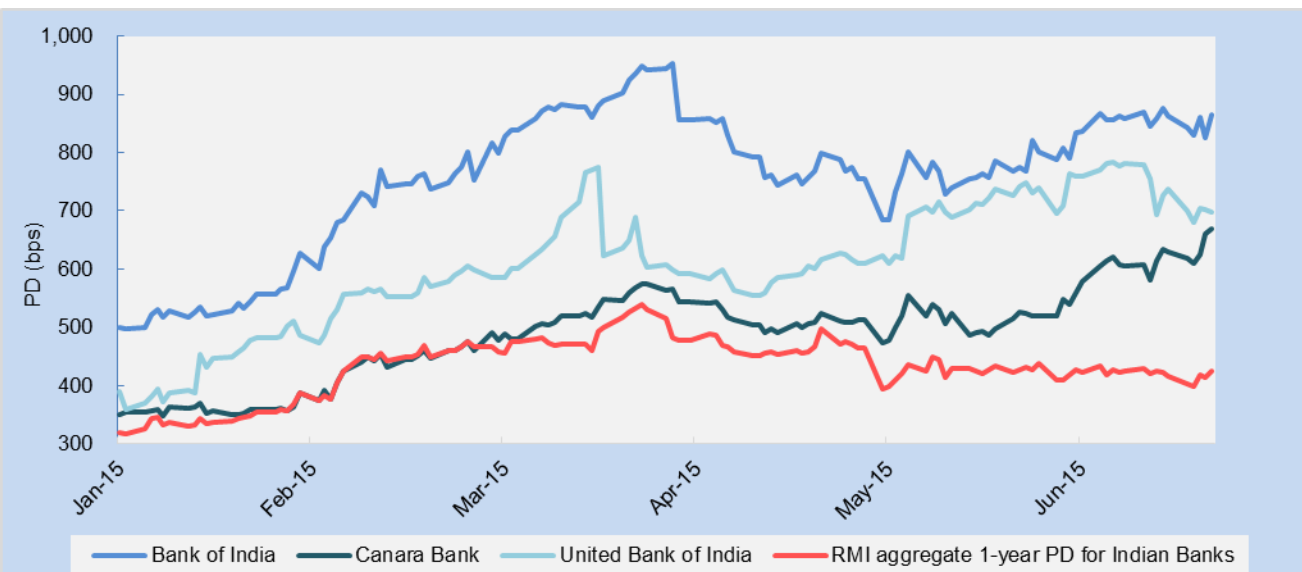

Figure 1: RMI 1-year PDs for Bank of India, Canara Bank, and United Bank of India and RMI aggregate 1-year PD for Indian public sector banks. *Source: Risk Management Institute*

In tandem with the rise in the NPA of these banks, the RMI 1-year probability of default (PD), as published by the Risk Management Institute, has also displayed an upward trend (see Figure 1). Since the beginning of 2015, the RMI aggregate 1-year PD for India's PSB (measured by the median value of PD for 19 PSBs in India) has climbed from 319bps to a peak of 531bps before settling at 424bps as of 26 June 2015. The PD for the riskiest bank by this measure, the Bank of India, stood at 864bps. The PDs for Canara Bank and the Union

Bank of India, also two of the big PSBs, were 669bps and 699bps, respectively. Collectively, these three banks hold about one fifth of the PSBs total assets.

The initial wave of NPA was largely generated by defaults in infrastructure companies. Now, the PSBs are bracing for a second wave of NPA propagated by the iron and steel industry. On 25 June 2015, the RBI issued a sharp warning noting that project delays have resulted in five out of the top ten private sector steel-producing companies coming under severe stress due to over-leveraged positions. The collapse in commodity prices has only made things worse. As recent as May 2015, India's fourth-largest steelmaker Essar Steel, had its account classified as an NPA by the Bank of India. As if the situation is not bad enough, the RBI further announced that seven state electricity boards, constituting a total exposure of INR 530bn (around USD 8.3bn), have a very high probability of turning into NPA in the quarter ending September 2015 – hinting that the problem could be more widespread.

The mounting NPA is a real cause for concern. It restricts the banks' ability to lend and the credit contraction, in turn, fuels a downward pressure on their profitability due to lower interest income. The Bank of India ended the latest financial quarter with a net loss of INR 561.4mn (USD 8.8mn) and for the full financial year, its net profit declined by 37.39% compared to the year before. As a result, by the end of May 2015, the bank's share price had lost one third of its value since it opened at INR 301.50 this year. The smaller market capitalization, as well as its shrinking trend, makes the bank more likely to default.

Recognizing the severity of the situation, the team led by Prime Minister Modi has introduced a series of guidelines since late last year to rein in the NPA issue before it has any chance of derailing the country's ambitions. The RBI had extended further flexibility to existing infrastructure projects to restructure and repay loans. Banks have also been empowered to convert their outstanding loans into majority stakes in companies that fail to meet their debt obligations. These new guidelines are expected to enhance the financial performance of the ailing PSBs in the near term. In response to the immediate need of the banks, the government has announced its intention of infusing the PSB with about INR 570bn (USD 9bn), to be disbursed sequentially in the current year and the next.

India knows that it has every potential to be the next economic superstar but it will have to polish that final act before it can delight the world audience in the limelight.

Credit News

Greece closing banks as expiring bailout spurs withdrawals

Jun 29. Following the European Central Bank's decision to suspend its liquidity assistance to Greek banks and breakdown in aid talks with the international creditors last Friday, Greece attempted to avoid the collapse of its financial system by imposing capital controls, as of Monday. Though holders of foreign bank accounts possessing credit and debit cards issued abroad may not be affected by such restrictions in capital movement, this measure will intensify Greece's recession and risk driving Greece out of the euro. Rapid outflow of cash from Greek banks occurred when Tsipras made the unexpected call for a referendum on the austerity demanded by the creditors, resulting in Greek bank deposits shrinking by EUR 30bn to EUR 129.9bn between January and May this year, according to the data released by Bank of Greece on its website on Thursday. (Bloomberg)

Aggressive property lending sparks fear of Australia banking crisis

Jun 25. Nearly nine years after the US subprime crisis, some analysts worry Australia could have a bank crisis of its own. Aggressive lending practices, including offering interest-only loans with little or no down payment, are starting to raise a red flag with credit-ratings firms, regulators and even Australia's central bank. Their concern is that frothy house prices, combined with a rising debt burden, may leave Australia's banks vulnerable to a housing-market correction as a long mining boom ends. Home loans now account for nearly two-thirds of new lending, up from 53% in 2008, while in the US and UK during the financial crisis, this figure was 38% and 13% respectively. (WSJ)

Brazilian banks' Q1 results show higher credit costs

Jun 25. Brazilian banks' asset quality generally worsened over Q1 2015, though many of these banks, demonstrated profit resilience. According to Fitch's report, which covered 21 banks in Brazil, loan loss provisions rose 34%, while annual loan growth in Q1 slowed to 12.9%, exceeding the accumulated inflation rate of 8.1% in the 12-month period ending March 2015. Brazil's larger banks generally demonstrated better profit resilience than the smaller or midsize Brazilian's banks, due to the larger banks' diversified product base. These banks were able to reduce the impact of asset quality pressures on returns through insurance and other fee-based services. With the expectations that the Brazil's economy will underperform, due to high inflation and weak GDP growth, as well as sovereign fiscal challenges, Fitch's outlook on the Brazilian banking sector remains negative. (Reuters)

Foreign reserves slip in emerging markets, raising risks

Jun 23. The emerging market countries' capacity to withstand potential shocks were being impeded, following the significant reduction of foreign-currency reserves at a highly rapid pace by the central banks in many emerging markets. Observers are still optimistic about the countries' capability to withstand external shocks in periods of stress, due to the record high total foreign reserves still being held by emerging countries. However, a number of countries are still facing increasing risks, due to their sluggish growth, lower reserves and weaker currencies. A further concern would be that some countries' reserves will be inadequate to withstand external shocks, especially with the widely expected interest rate hike by the US Federal Reserve. (WSJ)

Taiwanese banks' offshore strategies increase risks

Jun 23. According to the Fitch Ratings' report, more aggressive risk-taking and acquisitions will put Taiwanese banks' ratings under pressure, as the banks continued expansion in Asia, particularly in higher-risk emerging markets. The situation will be aggravated if additional risks are not adequately mitigated through higher risk buffers. Regional expansion will actually enable faster growth, margin expansion and potential diversification benefits. However, the limited success record of offshore operations in most Taiwanese banks along with the weaknesses in governance and transparency in many emerging Asian credit markets will challenge the sustainable regional franchise. (Reuters)

China market in focus after rate cut (Financial Times)

Japan industrial production slumps in May, denting recovery (Bloomberg)

Toshiba faces accounting scandal (Japan Times)

Regulatory Updates

China's auditor says state firms falsified revenue and profit

Jun 28. A number of China's biggest state firms were found to have fabricated revenue and profits. On Sunday, the National Audit Office stated on its website that fourteen state-owned companies, such as Cosco Group, to name a few, falsified CNY 29.8bn in revenue and CNY 19.4bn in profits. Additionally, violations were also found in the nation's financial industry when some state lenders distributed loans to unqualified borrowers. It was noted that more than 250 people had been penalized and CNY 4bn had been recovered from the state-owned companies. (Bloomberg)

BIS renews call for tougher fund rules amid "new risks"

Jun 28. Asset managers create new risks to financial stability, because they fuel bubbles and may amplify potential stress. In its annual report, the Bank for International Settlements (BIS) said that regulators should consider restricting asset managers' ability to shift investments quickly, capping leverage and introducing liquidity buffers, as well as limiting rapid redemptions. Regulators should also seek to restore the "vibrancy" of banks as the traditional source of credit. After global regulators abandoned a project to identify too-big-to-fail managers earlier this June, the BIS is now highlighting the risks created by the asset management industry. (Bloomberg)

Banks propose 90 "easy" fixes as regulators struggle to assess risk

Jun 25. A leading banking lobby group has submitted 90 proposals to regulators to improve consistency in how banks assess the riskiness of their loans. So-called "risk weightings" are applied to banks' assets, which should reflect how risky the asset is and determine how much capital must be held against it. Variations across countries and companies lead to big capital differences. Regulators are assessing and trying to harmonize the risk weightings calculated by standardized levels and by banks' past loan experience. Regulators are also expected to introduce more benchmarking to compare models and require banks to be more transparent in weightings they apply. (Reuters)

US authorities in crackdown on "rent-a-tribe" payday lenders (FT)

China proposing to scrap 75% loan to deposit rule (Bloomberg)

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