Credit Research Initiative
Risk Management Institute, National University of Singapore
NUS National University of Singapore | RMI Advancing Risk Management for Singapore and Beyond
transforming big data into smart data
Weekly Credit Brief Nov 21 - Nov 27

India's Public Sector Banks still at risk despite recapitalization plan

by Liu Hanlei

On 24 Oct after market hours, the India government announced a INR 2.11tn recapitalization plan for the country's Public Sector Banks (PSBs), by injecting INR 1.35tn of capital through recapitalization bonds over the next 2 years. The India government will issue bonds which will be bought by the PSBs. The money raised from the bond sales will then be used to subscribe to the equity of those same banks. An additional INR 181bn of direct support will come from the government budget and a further INR 580bn is to be raised from private investors. This recapitalization will most likely go to the biggest PSBs and will help to shore up their balance sheets which have been strained by the bulging bad loans problem.

Non-performing assets (NPAs) for the 38 listed banks (21 PSBs and 17 private banks) in India have been increasing as it crossed INR 8.4tn at the end of September quarter, an increase from INR 7.05tn a year ago. 87% of these NPAs are on the books of the 21 listed PSBs. NPAs have risen to 13.7% of PSBs' assets at the end of June as compared to about 4% of private banks' assets. The metals and infrastructure sectors are the biggest sources of stress for Indian banks as these sectors add up to 64% of total stressed assets. Over the past decade, PSBs have lent to companies involved with large-scale and long-term projects in steel, power, and infrastructure. However, these companies have difficulties servicing their loans, often due to project delays or cost overruns. 5 of the 12 heavily indebted companies that have recently been targeted by banks under India's new insolvency law are from the steel industry as the industry is plagued by falling steel prices over the past few years.

As NPAs increase, provisions for bad loans by PSBs have also increased by 44% as compared to a year ago. PSBs collectively reported a net loss of INR 42.84bn in the September quarter as compared to a INR 3.1bn profit a year ago. Given the PSBs' weak financial standing, the market cheered upon the announcement of the recapitalization plan. Stock prices of PSBs rose on the day after the announcement, 25 Oct 2017, as it is expected that the recapitalization plan will help to cover provisions on their bad loans and shore up their capital base to comply with Basel III rules by 2019. However, from a credit perspective, the default prospect of the PSBs is still considered substantial.

As seen in Figure 1, the rise in PSBs' stock prices caused a fall in the term structure of the RMI-CRI aggregate Forward 1-year Probability of Default (Forward PD) for the PSBs. The Forward PD represents the credit risk of a firm in a future period and works similarly to a forward interest rate. For instance, the 3-month Forward PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months. The recapitalization of PSBs may not be as effective as what the market expects as the probability of default remains elevated over the next 3 years. This trend is still evident one month later as seen in Figure 2. Based on market information on 24 Nov 2017, the credit profile of PSBs is unlikely to improve with the recapitalization plan in the near term.

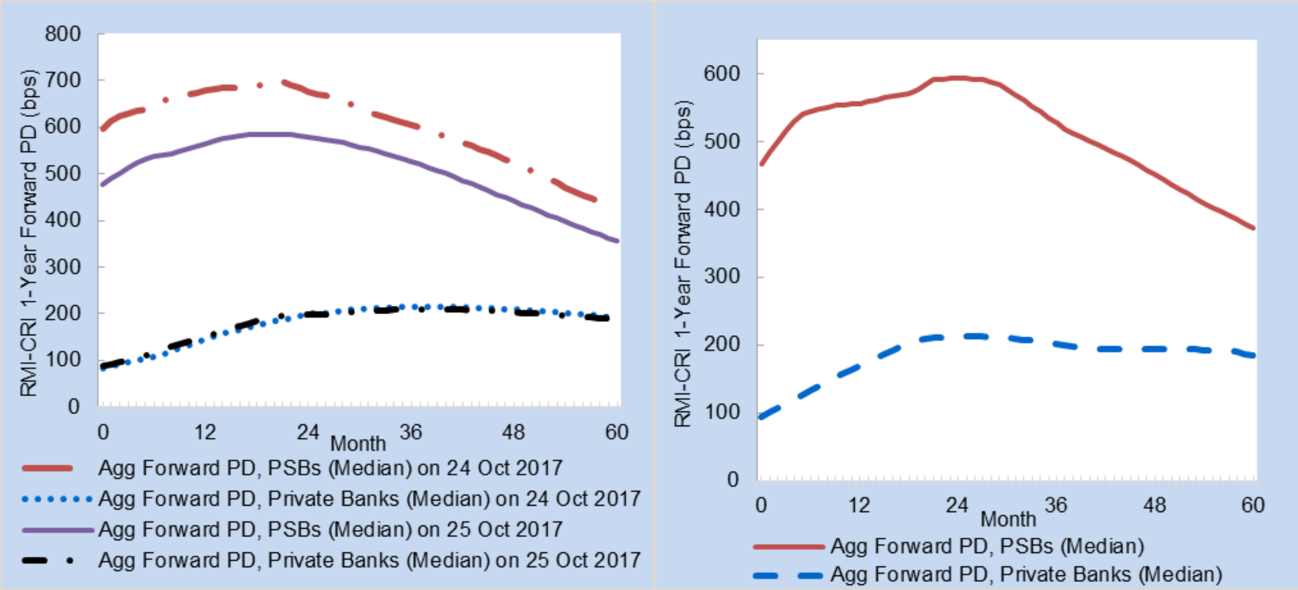

Figure 1 (LHS): RMI-CRI Aggregate Forward 1-year PD term structure for Indian PSBs (median) and private banks (median) on 24 & 25 Oct, 2017 & Figure 2 (RHS): RMI-CRI Aggregate Forward 1-year PD term structure for Indian PSBs (median) and private banks (median) on 24 Nov, 2017 *Source: RMI-CRI*

It is noteworthy that based on Figure 2, the market information as of 24 Nov, the forward PD for private banks shows an increase over the next 2 years, predicting a worsening credit profile, though significantly lower than that for the PSBs. Stock prices of some private banks fell after the announcement as the market is expecting private banks to now face stronger competition with the recapitalized PSBs. Although private banks have increased their market share marginally in the loans market from 27.8% to 29.3%, the PSBs still command a market share of 70%. Private banks are also not in good shape as they saw a 40% increase in the NPAs as compared to a year ago, doubling the PSBs' NPAs growth rate. Private banks have set aside 44% more provisions against bad loans as compared to the previous quarter but 14% lesser than a year ago period. The rise in NPAs could be due to new guidelines set by the central bank to improve the disclosure of NPAs and enforcing new NPA provisioning requirements on Indian banks but it still highlights the weak credit profile that private banks are in. Despite doing well over the past years, India's economy has slowed down as it lodged its lowest growth rate in 3 years at 5.7% for the second quarter of 2017. The slowing economy, the weak financial performance of the private banks together with the potential competition from recapitalized PSBs may explain private banks' deteriorating credit profile.

A similar exercise to recapitalize PSBs had been conducted in the 1990s and in the years after the global financial crisis to aid banks in solving their immediate funding crisis then. Even though the recently announced recapitalization plan is so far the largest, it may not imply that the PSBs will improve fundamentally. PSBs are directed by the government to support certain sectors such as infrastructure and steel. It is argued by the Finance Minister that PSBs play an important role in India's economy to help in implementation of government policies. One example quoted is the directing of capital to the infrastructure sector which private banks tend to avoid. Guidelines have also been set by the central bank to mandate 40% of all loans by PSBs to priority sectors such as agriculture, manufacturing and small businesses which PSBs are estimating more stressed debt forming from these sectors.

A fundamental reform of the PSBs may be necessary for the health of the banking sector in the long run. Reforms may have to be undertaken to reduce politician's influence in lending decisions and due diligence in credit approvals can be improved to avoid defaulters from getting access to new loans. Fortunately, policymakers have been acting on more reforms to aid resolving insolvency process in addition to PSBs' recapitalization plan. Bankruptcy laws have been amended to stop business owners, who default but have the ability to pay bank debts, from bidding for their own stressed assets being auctioned as part of insolvency proceedings. The central bank is also advising lenders to haul more companies to the National Company Law Tribunal for bankruptcy proceedings. Given the unique role the PSBs play in India's economy, the journey to a more robust banking sector may be a tough and painful one.

Credit News

Top 5 steel companies in bankruptcy process face INR 2.09tn claims

Nov 27. Five steel companies referred to the bankruptcy courts in the first batch faced more than INR 2.09tn of claims, with many coming from their group firms that have been suppliers to the defaulters. Lenders who are set to meet the resolution professionals of the respective companies are worried about how the resolution plan would work in the backdrop of sharp rise in claims, coupled with recent amendments in the Insolvency and Bankruptcy Code (IBC). While the recent amendments aim to prevent willful defaulters and other defaulters with one-year overdues from participating in the resolution, the amendments could potentially cause disruption to pending insolvency proceedings, as eligibility of all bidders will have to be ascertained before their bids are examined. In addition, finalization of credit resolutions will have to keep in mind interest of all stakeholders, particularly those of homebuyers in the case of Jaypee Infratech to prevent any negative repercussions. (Economic Times)

S&P cuts South Africa debt rating, Moody's issues warning

Nov 25. S&P Global Ratings downgraded South Africa's local-currency debt score on November 24 to BB+, one level below investment grade, while Moody's Investors Service also threatened to cut its ranking to the same level. S&P stated their opinion in a statement that the reduction reflects their concerns of further deterioration of South Africa's economic outlook and its public finances, "Economic decisions in recent years have largely focused on the distribution -- rather than the growth of -- national income. As a consequence, South Africa's economy has stagnated and external competitiveness has eroded." Absa Investment Management said the credit action would result in increased volatility going forward. Fitch Ratings on November 23 affirmed South Africa's foreign and local debt scores at its highest non-investment grade with a stable outlook. While the outcome of the ruling African National Congress's elective conference next month will be of interest to ratings companies, they'll also be watching the February budget for more information on the nation's debt trajectory. (Bloomberg)

China's USD 3.4tn corporate bond market faces rocky 2018

Nov 23. Higher yields, which come as Chinese government shows greater determination to shift the economy onto a more sustainable footing with less debt, will make 2018 a clearer test to let struggling companies fail. According to clearing house ChinaBond, yields on five-year top-rated local corporate notes have jumped about 33bps since the month began, to a three-year high of 5.3%. For the central bank warned further deleveraging was needed, government bonds had already moved last month. With more than USD 1tn of local bonds maturing in 2018-19, it will become increasingly expensive for Chinese companies to roll over financing. With broad expectations of a slowdown in economic growth closer to 6% than this year's 7%, challenges will be deepening. (Bloomberg)

Europe's debt collectors face own loan concerns

Nov 22. Since the financial crisis, Europe's debt collectors have served an important function of taking on the bad loans of mainstream lenders to recycle for as much cash as possible, a function that has proven to be a profitable job for the region's debt collectors. However, concerns about a consumer-led economic slowdown have begun to raise questions about valuations in the sector. On one hand, investors who are optimistic about the prospects of the industry believe that the presence of EUR 1 tn of non-performing loans in the European banking sector and economic woes should help debt collectors by opening up a ready supply of new problem loans. However, investors who are bearish on the sector argue that the risk is borrowers will start to miss regular repayments in hard times, affecting cash flow and putting debt under pressure. Furthermore, with more competition, the price that companies have to pay for loan portfolios has risen, affecting returns. To cope with rising prices in domestic markets, some debt collectors have ventured abroad, further increasing the risks for the industry. (FT)

US banks scale up long-term lending

Nov 22. US banks have scaled up the proportion of long-term, fixed-rate lending, which will generate higher interest income but may put them at greater risk if there is a sharp rise in rates. Figures released by Federal Deposit Insurance Corporation (FDIC)'s latest Quarterly Banking Report show that US banks are unable to change the terms on about US 6.1tn worth of loans and securities for at least three years, accounted for about 36% of total assets and was the biggest proportion since records. Those assets that do not mature or reprice for at least 15 years such as mortgage-backed securities accounted for the sharpest rise. Net interest margins across the industry rose from 3.18% a year ago to 3.3% in the third quarter this year after rising rates. However, a sudden or sharp rise in interest rates will force lenders to pay savers higher rates on deposits than the rates that borrowers pay them on loans, leading to a crisis. The FDIC indicated that smaller banks were "particularly vulnerable" to the interest rate risk. (FT)

S&P cuts outlook on Altice debt (FT)

Economic growth surges in Philippines despite political risk (FT)

Growth burst in Southeast Asia bolsters region as Fed hikes loom (Bloomberg)

Regulatory Updates

Singapore and Abu Dhabi sign deal to boost supervision of cross-border banking

Nov 23. The Monetary Authority of Singapore (MAS) and Abu Dhabi Global Market (ADGM) signed a Memorandum of Understanding (MoU) on November 23 to strengthen the supervision of cross border operations of banking institutions. The two countries have a long-standing cooperation in the securities field through. MAS indicated that the MoU would facilitate greater regulatory and supervisory cooperation between the two authorities. ADGM added that the partnership would create and facilitate more cross-border business, growth and investment opportunities between the two markets. (Straits Times)

Malaysia to enforce cryptocurrency regulation in 2018

Nov 22. Starting in 2018, individuals who convert cryptocurrencies into fiat currencies will be considered reporting institutions under the Anti-Money Laundering Anti-Terrorism Financing and Proceeds of Unlawful Activities Act. Malaysia's central bank has reported an increase of suspected transactions that may have financed terrorism activities this year. The new law will help prevent an abuse of the financial system for criminal activities and ensure the stability and integrity of the financial network. Financial intelligence units will also have a broader oversight about the roles of financial hubs in the regional and international terrorism financing structure. (Channel News Asia)

Cabinet approves amendments to India's insolvency and bankruptcy code (Reuters)

China to step up property market regulation to avoid bubble risk (Reuters)

Published weekly by Risk Management Institute, NUS | Disclaimer
Contributing Editor: Victor Liu