PSBs should look within for recapitalisation: MG Vaidyan, SBI DMD

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By Dr MG Vaidyan, DMD(SAMG), State Bank of India

Recapitalising public sector banks in the background of high level of NPAs is a matter of intense discussion these days.

Market capitalisation of PSBs has significantly fallen. Huge capital infusion is required in order to keep some of them complying with the capital adequacy requirements even at the existing level of business, leave alone the capital for future growth.

As per newspaper reports, out of the required fresh capital of Rs.1,80,000 crore for recapitalizing PSBs, government would have to provide Rs.70,000 crore. However, we should encourage banks themselves to find a solution for this issue.

As per RBI guidelines, banks periodically make provision against their problem loans. These provisions are made against profit of the bank and to that extent the capital of the bank is written down.

Due to aging of NPAs, approximately one-third of the total NPAs carry full provision. Similarly, Banks periodically write off loans for cleaning up of their balance sheets. Once loans are written off, they do not form part of the balance sheets of banks.

Borrowers of these written off loans are still liable to pay the entire dues to the Bank. Banks, therefore, continue the legal and other measures for recovery of NPAs and written off loans. Recoveries happen, albeit with some delay, due to legal process and other hurdles. In many cases, the entire dues are recovered. The level of recovery depends upon the value of security, availability of personal guarantees, etc.

Any amount recovered out of NPAs that are fully provided for, or written off, goes straightway to profit and gets added to capital of the Bank.

Recovery of bad loans is a lengthy and difficult process. RBI vide its Circular No.RBI/2005-06/54 - DBOD.NO.BP.BC.16/21.04.048/2005-06 dated 13th July 2005 has given a route for quickening the process of converting the hidden value in these written off accounts into capital. With a view to developing an active secondary market for non-performing assets, RBI has permitted sale and purchase of the NPAs among banks, ARCs and NBFCs.

RBI has also given clear guidelines for carrying out sale/purchase of NPAs through a policy which is approved by the Board of each bank. NPAs under multiple/consortium banking arrangement are also permitted to be purchased/sold. Sale/purchase of NPAs among banks has to be on 100% cash basis.

Such loan assets bought remain as Standard Asset in the books of the purchasing bank for 90 days. Thereafter, it will continue to remain standard asset subject to a minimum recovery of 5% in each half year. The total recovery has to happen normally in three years.

In order to encourage creation of secondary market for NPAs, RBI has also given incentive for trading by allowing spreading the loss, if any, incurred by the selling bank over a period of eight quarters.

Going by experience of sale to ARCs by banks, sale of NPAs and written off accounts happen at around 30 to 40% of the loan amount.

In the case of unsecured NPAs, the discount goes much higher and accordingly the purchase price comes down to even 5 to 10% of the loan outstanding. The sale value is calculated through a transparent mechanism based on present value of future recoveries out of execution of securities. The securities, mostly real estate, are valued on distress sale basis.

The security coverage in a typical deal is 150% to 200% of the purchase price. The minimum expected return on the funds deployed for purchasing the NPAs is generally around 20 to 25%.

This level of return on a loan asset is much higher than any other usual loan asset in the books of a bank. Capital requirement for carrying this loan is much lower, as the value of the NPA loan has been written down due to the heavy discount on acquisition.

Buying of NPAs of other banks thus makes a strong business case. The question then is why banks are already not doing this. The most obvious and easy answer given is that banks are already carrying huge level of NPAs and do not what to add more NPAs. This argument is not tenable.

The new NPA loan is bought at a huge discount. It will be treated as a standard asset like any other loan in the books of the purchasing bank. Security coverage is much better in the form of realisable value of real estate to the extent of 150 to 200% of the value of the new loan. The return could be very attractive at over 20 to 25% as compared to other bank loans.Another question is whether it amounts to 'evergreening'.

It need not be so due to various reasons, such as the NPA gets transferred to another bank at around 30% of the loan outstanding; the purchase consideration is based on present value of future recoveries; the purchase has to be done on 100% cash basis with 'no recourse' to the seller; the new NPA asset has to remain in the books of the purchasing bank for a minimum period of 15 months before it can be sold. The transaction, therefore, has to happen on the basis of realizable value of NPA asset.

Another pertinent question is the source from where banks will bring money for purchasing these NPAs. The answer is that there is no need for banks to bring any additional funds. They only have to, looking at the higher expected return, earmark a portion of their lendable funds for acquiring this loan portfolio.

PSBs have long experience and the necessary infrastructure for loan recoveries. This infrastructure can easily be leveraged for recovery of the new 'NPA loans' purchased from other banks for generating higher ROA. Banks have records of real estate security, title deed wise and valuations are updated periodically.

External auditors and RBI inspectors periodically verify the reasonableness of the valuation of the security. Hence, arriving at a reasonable price for sale/purchase need not be a lengthy process. Banks can also develop product/geography specialization based on own competencies and reach.

While banks start buying NPAs of other banks on ROA considerations, the selling bank also gets benefited simultaneously. In the case of written off accounts and fully provided NPAs, the entire selling price is added to profit. The table below gives the level of NPAs and written off accounts of scheduled commercial banks :

NPAs and Written-off Accounts

(Rs in Crores)

S No.	Bank	NPAs as on 31.03.2015	Written-off Accounts during 2011 to 2015
1	Public Sector Banks	278468	97232
2	Private Sector Banks	34106	23390
3	Foreign Banks	10771	3410
4	**ASCB**	**323345**	**124032**

(Source:RBI publication)

Taking one-third of the PSB NPAs as fully provided for, the capital that can be unlocked out of PSB NPAs and written off accounts would amount to approx. Rs.56,000 crore. at an estimated price realization of 30% of the NPA outstanding. Through this process, the Government can also generate significant revenue by way of Income Tax on the additional income generated by banks. PSBs, should therefore, look to their NPAs for recapitalization. Even if a fraction of this happens in reality, the Government's efforts to recapitalize Banks would receive a welcome boost.

(The author's views are personal)