

How healthy is your bank?

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Highly stressed	
Bank	Gross NPAs %
IOB	12.64
UCO Bank	10.98
Dena Bank	9.85
Bank of Baroda	9.68
United Bank	9.57
Bank of India	9.18
Central Bank	8.95
IDBI Bank	8.94
Punjab National Bank	8.47

Less stressed	
Bank	Gross NPAs %
Kotak Mahindra Bank	2.30
DCB Bank	1.98
Karur Vysya Bank	1.91
Lak. Vilas Bank	1.82
Axis Bank	1.68
HDFC Bank	0.97
IndusInd Bank	0.82
Yes Bank	0.66

As on December 2015

Capital starved	
Bank	Tier I capital %
Dena Bank	7.05
United Bank	7.12
IOB	7.16
Syndicate Bank	7.26
Allahabad Bank	7.40
Central Bank	7.63
UCO Bank	7.69
Union Bank	7.70
Vijaya Bank	7.80
Bank of India	7.88
Andhra Bank	7.90

Well capitalised	
Bank	Tier I capital %
Yes Bank	10.90
J & K Bank	11.15
ICICI Bank	11.79
Karur Vysya Bank	11.96
DCB Bank	12.33
Axis Bank	12.35
HDFC Bank	13.20
Federal Bank	13.74
Kotak Mahindra Bank	14.10
City Union Bank	14.17
IndusInd Bank	15.64

As on December 2015

At borderline

Bank	LCR %
Corporation Bank	54
IndusInd Bank	62
Dena Bank	64
Canara Bank	65
Vijaya Bank	67
Kotak Mahindra Bank	69
Punjab & Sind Bank	70

As per 2014-15 annual report

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Mounting bad loans and capital squeeze do not concern market pundits alone. Such issues have implications for you as a depositor as well. Here is how you can check your bank's health

If you are one of those who swear by safe bank deposits, reports of banks being in deep trouble due to bad loans might be leaving you sleepless at night.

Of course, depositors' interests have been watched over even in the worst of times. While many co-operative banks have failed, instances of commercial banks going belly up are rare in the Indian context. When a bank is in trouble, the RBI usually steps in and what follows is a merger or consolidation of the weak bank into a larger one. But that is not to say that depositors are unaffected by the deteriorating state of affairs at their banks. So, good health or no, be an alert investor. There are many indicators that tell you whether your bank is headed for trouble. By keeping a tab on metrics such as a bank's Tier I capital or Liquidity Coverage Ratio you can gauge its health.

But some basics first: Banks are in the business of lending and to do so they require funds. The liabilities side of a bank's balance sheet consists of capital — its own funds and borrowed funds — mainly deposits. Bank's assets include loans as well as other assets such as cash and liquid assets — mainly government bonds.

Unlike other businesses, a chunk of a bank's liabilities is funded by borrowed funds, typically in excess of 10 times its capital. Hence a bank relies heavily on large amounts of deposits for its lending activity. The loan book is usually many times a bank's capital and therefore it is the small sums of deposits that you and I entrust to the bank that help it run its operations.

Decoding bad loans

If you have been reading news reports lately, jargon like 'NPAs', 'AQR', and 'stressed assets' has flashed across too often to dismiss as high-flying bankers' gibberish. Each of these has far-reaching implications on the financial health of your bank.

Bad loans are loans where a borrower is unable to repay what he or she owes to the bank. Technically a bank classifies such loans as non-performing assets (NPAs), when borrowers have defaulted in their payments for 90 days or more. It is then required to set aside a portion of its earnings as provisions towards these loans to provide buffer in case of future losses. A sharp rise in NPAs can erode a bank's profits and hence the hullabaloo over the NPA issue.

Prolonged slowdown and weak corporate earnings have led to a steep rise in defaults over the last two to three years. In the last one year, NPAs for all banks (listed) have increased rapidly from 4.4 per cent of the loan book in December 2014 to 6.1 per cent by December 2015 (nearly Rs 4.5 lakh crore). For PSU banks, NPAs stand at 7.2 per cent.

The latest December quarter was one of the worst for the banking sector, where the RBI's drive to clean up banks' balance sheet led to a sharp rise in bad loans. Known as Asset Quality Review, the activity forced banks to recognise certain loans as NPAs even if these loans are not delinquent. This has led to a spike in NPAs and provisions for most banks, taking a toll on their earnings.

For instance, PNB's bad loans increased to 8.5 per cent of loans in the December quarter from 5.9 per cent last year. Provisions for NPAs more than doubled from last year, while the profit for the quarter came in less than one-tenth of that reported during the same quarter last year. For Bank of India, a near tripling of bad loan provisions over last year led to the bank reporting losses for the quarter.

But these official NPA numbers do not fully capture the extent of the bad loan problem. Hence, you also hear a lot about stressed assets of banks. Aside from NPAs, banks also carry loans that have been restructured — where borrowers have sought more lenient terms. While the RBI closed the restructuring window (technically) for banks last year, it allowed them to extend a 'lifeline' to businesses under Strategic Debt Restructuring and the 5:25 scheme. Under the former, banks have the right to convert their loans into a majority equity stake if they feel that a change in ownership can help turnaround the borrower's business. Under the 5:25 scheme, banks can fix longer repayment schedule for, say, 25 years, for loans to infrastructure projects. All such restructured loans are not classified as bad loans and carry only a marginal provision. This throws open the possibility of sharp increase in provisioning in future, if losses arise on these accounts.

How they fare

Thus depositors need to watch out for a combination of NPAs and other restructured assets. Banks having one of the highest NPAs as a proportion of their loans include IOB (12.6 per cent), UCO Bank (10.9 per cent), Dena Bank (9.8 per cent), Bank of Baroda (9.6 per cent), United Bank (9.5 per cent) and Bank of India (9.1 per cent), Central Bank of India (8.9 per cent), IDBI Bank (8.9 per cent), and PNB (8.5 per cent). Most of these banks also have a large quantum of restructured loans. IOB, Dena Bank, United Bank and Central Bank have stressed assets (NPA+ restructured) of about 20 per cent of total loans. For a few banks, loans under SDR and 5:25 constitute 2-4 per cent of loans.

But rising bad loans and restructured assets need not necessarily spell doom. It is when banks carry insufficient capital to absorb sudden losses on account of increase in bad loan provisioning that you should worry.

Capital cushion

This brings us to the most critical parameter you need to understand and assess to ascertain the financial health of your bank. As mentioned earlier, banks usually supplement their capital with large amounts of deposits which they use for their lending activities. It is imperative that a bank carries sufficient amount of capital to remain viable. It is because of this that the capital infused into PSU banks by the government (largest shareholder) is so keenly watched.

But why is capital so important for a bank?

The key aspect of a bank's capital is its ability to absorb losses in the normal course of operations. While it is true that much of the bank's activities are funded by deposits and other borrowings, these have to be repaid at a future date. Hence, if a bank's fund base only consists of such borrowed funds (no capital), then in case of a loss on account of defaults by its borrowers, it would not be able to honour the demands from its depositors.

Let us understand this better with a simple example.

Suppose a bank has ₹100 crore of loans, which has been funded with ₹4 crore of capital and ₹96 crore of deposits. If ₹3 crore of loans turn bad, then the bank's capital can absorb this loss. The bank will continue to remain solvent because its assets (₹97 crore) are still greater than its liabilities (₹96 crore). But if, say, ₹6 crore of loans turn bad, then the

bank's liabilities will be greater than its assets. This would mean that the bank will not be able to repay to depositors — it would essentially become insolvent.

So how do you run a litmus test to determine whether your bank has sufficient capital? Thankfully, regulatory efforts around capital adequacy ratio (CAR) make it easy for you to assess a bank's capital position.

According to internationally agreed standards (Basel III), banks must fund risk-weighted assets with at least a certain amount of capital. Regulations require Indian banks to have total capital amounting to 9 per cent of their risk-weighted assets, which is termed as the CAR. To ensure that every bank holds capital that is commensurate with the risk it carries, the RBI has assigned different 'risk weights' to each type of loan based on the possible risk of default. For instance, loans to the Central government have a zero per cent risk weight while exposure to commercial real estate has a 100 per cent weight. Hence the riskier a bank's loans, the more capital it needs.

The CAR is further divided into 'Tier I' and 'Tier 2'. Tier I capital essentially includes share capital, share premium and other reserves (45 per cent of revaluation reserves). It is Tier I capital that you need to look up, to assess your bank's financial health. This is because Tier I capital is the one that is always available to absorb losses, without the bank having to cease operations—'going-concern capital'. Tier II, on the other hand, is a supplementary capital which includes debt capital instruments issued by the banks and provisions or loan-loss reserves freely available to meet losses. It absorbs losses only in the event of a winding-up of a bank (gone-concern capital), and so provides a lower level of protection for depositors.

As per Basel III norms, banks need to maintain Tier I capital of 7 per cent of risk-weighted assets, apart from a total capital (CAR) of 9 per cent. A combination of weak capital and rising bad loans can serve as early warning signals.

How they fare

While all banks currently have Tier I capital above the statutory 7 per cent requirement, there are many who are just about meeting it. Dena Bank (Tier I of 7.05 per cent), United Bank (7.12 per cent), IOB (7.16 per cent), Syndicate Bank (7.26 per cent), Allahabad Bank (7.4 per cent), Central Bank of India (7.6 per cent) and UCO Bank (7.69 per cent) are some banks whose ratios are below the 8 per cent comfort level. These banks also have higher stressed assets and a rapid rise in NPAs can push them to the brink.

Liquidity matters too

So far we have looked at one type of risk that banks can face — credit risk — that of a borrower being unable to pay his dues to the bank. There is yet another risk that a bank faces — when it does not have sufficient funds to repay its depositors. A bank 'run'— where hoards of depositors flock to banks to withdraw their savings — is an extreme example of a liquidity crisis.

In practice, banks run into liquidity issues mainly because of asset-liability mismatches (ALM). That is, their loans and deposits do not come up for payment at the same time. For instance, if a bank funds a five-year loan with a one-year deposit, it will find it difficult to repay the deposit when it comes up for repayment.

Hence, if a bank has a large amount of short-term deposits when compared to its liquid assets such as cash or government securities, and a large number of depositors seek to withdraw their savings at the same time, then the bank's liquid assets can be quickly depleted, leaving it with insufficient funds to repay all its depositors.

As a depositor, however, it will be difficult for you to gauge the extent of liquidity problems at a bank. Here again, regulatory checks come to the rescue.

From January 2015, banks are required to meet the guidelines on the minimum liquidity coverage ratio (LCR) set out by the Basel III that helps to quantify a bank's liquidity risk. The main objective of LCR is to ensure that banks maintain sufficient liquid assets to meet obligations in a 30-day stress scenario. Banks that do not have a stable deposit base or run high ALM mismatches in the short term are, by design, compelled to keep a high proportion of highly liquid assets to meet the LCR requirement.

The LCR requires that the stock of liquid assets should at least equal 70 per cent (60 per cent in 2015) of total net cash outflows over 30 days. This will be gradually increased to 100 per cent by January 2019. Banks are required to make LCR disclosures in their annual report. A higher LCR over and above the mandated requirement is indicative of a prudent liquidity risk management policy.

As a depositor, you can keep a tab on two things. One, the bank's reported LCR vis-à-vis the mandated level. Two, the LCR disclosures carry a detailed break-up of a bank's funding base that also provides insightful information. It reveals the extent to which a bank relies on flighty deposits such as short-term wholesale funding rather than more stable funding sources such as retail deposits.

How they fare

As of March 2015, many banks had LCR in excess of 100 per cent. Few banks were just about meeting the 60 per cent requirement. Corporation Bank reported LCR of 54 per cent lower than the mandated level. A few large banks such as HDFC Bank and SBI have lesser dependence on short-term wholesale funding while YES Bank and Axis Bank have a higher wholesale deposit base.

However, remember that banks have several means to raise quick cash. Pre-emptive measures by the RBI such as cash reserve ratio (CRR) and statutory liquidity ratio (SLR) help banks to meet any shortfall. Banks have to set aside 4 per cent of their deposits in cash, which is parked with the Reserve Bank of India. SLR is the portion of deposits that banks need to hold in the form of government securities that is highly liquid and can be easily sold to raise money. Currently banks have to hold 21.5 per cent of deposits as SLR.

While these prudent measures are comforting, it would still be wise to keep a watch on the above mentioned parameters from time to time to check your bank's financial health.

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