

Banks, and the elephant in the room

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Despite the many safety nets that are in place, depositors need to take stock of the huge NPA burden and its financial impact

The proposals put forward by Reserve Bank of India deputy governor, Viral Acharya, to resolve stressed assets have been widely discussed. But another important but understated issue that Acharya has called attention to has failed to trigger as much debate. Should weak and undercapitalised banks be shown some ‘tough love’ by restraining them from taking on fresh deposits? Should depositors take cues from the market to assess the growth potential of banks and stay clear of weak banks? Acharya believes this will restore market discipline in deposit migration — away from the weakest to healthier public sector banks (PSBs).

In a country where PSBs hold the lion’s share of public deposits, and depositors repose their faith and pledge their undying loyalty to state-owned banks, it may seem alarmist to even suggest such a radical move. A freeze on incremental lending or deposits, even temporary, can cause a run on the bank.

But given the sharp deterioration of finances of state-owned banks in the last couple of years, Acharya’s call for tough corrective action cannot be dismissed for fear of a major shake-out alone. While depositors’ interests have been watched over like a hawk even in the worst of times, they are nonetheless affected by the deteriorating state of affairs at their banks. It’s time for depositors to wise up and bite the bullet.

How it matters

If you were an investor in PSB stocks, the stark under-performance of these banks in the last couple of years would have cost you dear. Over the last five years, investors have lost over Rs. 1 lakh crore. If, as depositors, you have been

unaffected, it is only because of the various regulatory checks and the Centre's backing at all times. That isn't the same as saying that banks' weak performance does not matter to depositors at all.

The much widely talked about bad loans aka NPAs and stressed assets actually have far-fetching implications on depositors; a sharp rise in NPAs erode banks' profits and hence capital. In the last one to two years, NPAs in PSBs have increased rapidly, and now touch a perilous Rs. 6-lakh crore mark. Many banks are grappling with the issue of insufficient capital to absorb sudden losses on account of increase in bad loan provisioning.

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, 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. Regulatory efforts around Capital Adequacy Ratio (CAR) ensures that banks fund risk-weighted assets with at least a certain amount of capital.

Many state-owned banks have been stretching themselves thin on capital. Gross NPAs have gone up from about 5 per cent of loans two years back, to over 11 per cent now. What has made matters worse is that the core earnings of most of these banks have grossly fallen short of the requirement for bad loan provisioning. For many PSBs, bad loan provisioning forms 90 per cent to over 100 per cent of their operating profit.

Safety nets

In India, thankfully, instances of commercial banks going kaput are very rare. The biggest backing has come from the Centre which has been infusing capital into PSBs year after year. In the last five years, even as the market value of PSBs plummeted, the Centre infused over Rs. 75,000 crore.

In the past, some bigger banks such as the Palai Central Bank failed due to a poor level of reserves and high percentage of unsecured advances. The public and parliamentary outcry that followed speeded up the move towards a legislation to tackle bank failures. Subsequently, the RBI was granted powers in the early 1960s for consolidation, compulsory amalgamation and liquidation of small banks. Since the reforms in 1993, 13-odd forced mergers have taken place in India.

In 2003, Punjab National Bank took over Nedungadi Bank, the oldest private sector bank, after the bank's net worth was completely wiped out due to accumulated losses. Take the case of Global Trust Bank. After various financial discrepancies came to light, the RBI forced a merger of the bank with Oriental Bank of Commerce.

Aside from this, deposits are insured under the Deposit Insurance and Credit Guarantee Corporation of India (DICGC), a wholly owned subsidiary of the RBI. Each depositor is insured up to Rs. 1 lakh for both principal and interest.

But these safety nets should not detract depositors from the need to take stock of the health of their banks. Consider deposit insurance. Only less than a third of bank deposits in value terms are insured by the DICGC.

Before drawing comfort from the Centre's tacit support, depositors should realise that the Government is after all throwing good taxpayers' money after bad. Depositors are essentially fending for the banks in which they have put in their money for safe-keeping!

Need more efficiency

Over the last two years, while PSBs have struggled to grow their loan book, garnering deposits has not been as challenging. Deposits (without demonetisation) have managed to grow by 11 per cent annually over the last two years. The higher rates that many PSBs offer are a big draw for depositors. So is their strong presence in certain regions. But the often lopsided flow of money into weaker PSBs deprive the healthier ones of precious funds that can be deployed more efficiently. Just as there is a need for the Centre to pare its stake in weaker banks to be able to generate enough funds to take care of the needs of some of the stronger banks, deposit flows into weak banks may need monitoring. This will ensure systemic stability and mitigate risk for depositors in the long run.

But before the Centre and the regulator tread this path, they will have to create a level playing field for weak banks to compete effectively. It is also important to educate depositors well before embarking on the road less travelled, to ensure that they don't end up pushing the panic button and causing a run on the bank.

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