High leverage, weak returns trouble PSBs

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Sharp rise in NPAs has accentuated the problem over the past year

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Muted growth in assets, steep losses and erosion in capital have led to the build-up of high leverage (ratio of assets to capital) in the banking system, particularly for public sector banks (PSBs).

The problem with high leverage is that it magnifies profits when the returns from assets are healthy, but it also blows up the losses in case of abysmal returns.

Punjab National Bank, which reported a loss of around ₹12,200 crore in 2017-18, has a high leverage of 18.6 times, up from an already high 17 times last year.

Allahabad Bank, too, which reported significant losses for the 2018 fiscal, has seen a sharp rise in leverage to about 21 times. Oriental Bank of Commerce, Canara Bank, and Union Bank are some of the other PSU banks that have declared their full-year results, sporting high leverage.

What’s of concern?

It is usually not enough to gauge the performance of a bank by the size of its balance sheet alone. It is more important to see how the banks’ assets have been financed.

Banks that use more of its own capital to fund its assets in relation to its borrowed funds (deposits) are said to have a high leverage.

Excessive leverage by banks came to light at the helm of the global financial crisis, when many lenders undertook aggressive lending without raising additional capital. The RBI, under the Basel III regulatory framework, revised its guidelines on the leverage ratio for banks coming into effect from April 1, 2015.

The leverage ratio is defined as their capital measure divided by their exposure measure, with this ratio expressed as a percentage. Capital measure for the leverage ratio is the Tier-1 capital, and exposure measure is the sum of on-balance sheet exposures; derivative exposures; securities financing transaction exposures; and off-balance sheet items.

As a simplistic approach, one could also look at the total bank leverage (ratio of assets to capital) to assess the extent of leverage.

Most PSBs have always had high leverage of upwards of 16 per cent. The key issue with this is that the muted return on equity (ROE) for these banks does not justify the risk.

ROEs for PSU banks have been negative to modest single-digits in the past two to three years.

Most private sector banks, on the other hand, have low leverage of 9-12 per cent, but have a relatively higher ROE of 15-16 per cent (barring ICICI Bank and Axis Bank whose earnings have been impacted by rise in bad loans).

The RBI's revised framework on resolving stressed accounts has seen a sharp rise in bad loans in 2017-18. So much so that the bad loan provisioning has eaten into earnings and capital, further accentuating the problem of leverage for PSU banks.

Oriental Bank of Commerce has seen its leverage go up from about 18 per cent in 2016-17 to nearly 20 per cent in 2017-18, while its ROE remains negative, owing to losses on account of rising loan defaults.

The bank's net NPAs (gross NPAs less provisions) are around 121 per cent of its net worth.

Canara Bank, Union Bank, Allahabad Bank and PNB are others with high leverage and negative ROE. For these banks too, their net NPAs are 80-120 per cent of their net worth.

According to the RBI, an underlying cause of the global financial crisis was the build-up of excessive on- and off-balance sheet leverage in the banking system.

During the most severe part of the crisis, the banking sector was forced by the market to reduce its leverage in a manner that amplified downward pressure on asset prices. This deleveraging process exacerbated the falling bank capital and contraction in credit availability.

As a backstop to the risk-based capital measure, the RBI had introduced the leverage ratio (capital measure [Tier I capital] / exposure measure), prescribing a benchmark of 4.5 per cent (minimum).

The RBI stipulates a minimum of 4 per cent Tier I leverage ratio to avoid falling under the PCA.

With limited scope of improvement in earnings, at least over the next year or so, existing high leverage could inhibit lending.

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