Banking reform: Fragile financial sector needs credible corrective action

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The woes of the banking sector do not seem to be ending anytime soon. While everyone would like to see a turnaround, what we see, instead, is a steady deterioration of the sector in successive quarters. Yet, RBI's Financial Stability Report released last week asserts, "India's financial system remains stable". This seems to be more a statement of hope rather than a reasoned assurance for much of RBI's own analysis points to the contrary.

Of course, the Centre has all along been in a state of denial and hasn't found a credible way to deal with the problem besides promising to infuse more taxpayers' money for recapitalisation.There has been complete policy inaction on reforming the governance of the banking system to distance it from politics. Asking LIC to bail out IDBI bank shows that the government simply wants to "fix" the problem through temporary palliatives. It does not care about the policy holders' interest and will not hesitate to drag down their returns. Now, LIC will have the additional job of
running the banks!

RBI, despite its assertion that the financial system remains stable, can perhaps take satisfaction from the fact that its analysis has adequately demonstrated the seriousness of the problem. Barring credit growth, every other performance parameter of the banking sector has deteriorated in March 2018 as compared to September 2017. The gross non-performing asset (GNPA) of the Scheduled Commercial Banks (SCBs) has deteriorated from 10.4% in September 2017 to 11.6% in March 2018. The deterioration with regards to public sector banks is even sharper: from 13.7% to 15.6%.

RBI has rightly disallowed ever-greening of loans and has forced the banks to show their real NPA, but, the deterioration is not entirely due to the stricter norms of recognition. The capital to risk weighted assets ratio (CRAR) for all SCBs remained constant at 13.8%, but, in public sector banks, it declined from 12% to 11.7%. There is a sharp decline in the after-tax profits of the SCBs and this cannot be entirely due to increased provisioning.

In fact, all the PSBs, barring two, made losses in 2017-18 and the combined loss in 2017-18 is estimated at `85,166 crore which is more than the profits made in the last five years. The report warns, “profitability of weak banks (14 banks with return on assets in the bottom of the quartile), on an average, has been worsening since September 2016 and more efforts will be needed to improve their resilience”.

The stress tests done by RBI bring out the intensity of the problem. Even in the base line scenario, with the assumption of constant macroeconomic conditions, the GNPA of the SCBs is set to increase from 11.6% in March 2018 to 12.2% in March 2019, and under moderate and severe macroeconomic conditions, the GNPA is estimated at 12.7% and 13.3% respectively. The deterioration in the GNPA in PSBs under baseline scenario is from 15.6% in March 2018 to 17.3% in March 2019, and under moderate and severe macroeconomic deterioration, it is estimated at 16.7% and 17.7% respectively.

The macro-stress tests suggest that the GNPAs of the PSUs subject to prompt corrective action (PCA) framework is likely to deteriorate from 21% in 2018 to 22.3% in March 2019. Even under a baseline scenario, six PCA-PSBs are likely to have their CRAR at less than 9% and, if the macroeconomic conditions deteriorate, ten banks may record CRAR below 9%. Indeed, placing the PSBs under PCA is tantamount to putting the patient in the ICU. Now, their survival will crucially depend upon the ventilator in the form of recapitalisation using taxpayers' money. Not surprisingly, the report states that deteriorating profitability and asset quality pose elevated risks to banking sector stability.

The industry-wise build-up of GNPA

and stressed advances shows that it is not entirely due to cyclical factors. The GNPA for the industry sector rose from 19.4% in September 2017 to 22.8% in March 2018, and the stressed advances by banks to the sector increased from 23.9% to 24.8% during the period. Of course, the stressed asset ratios remain very high in basic metals and metal products (46.8%), engineering (34.4%), mining and quarrying (26.8%), gems and jewellery (25.4%), and infrastructure (22.6%). This underlines the urgency of policy reform to ensure that the SCBs, and particularly the PSBs with short term liabilities, are not made to lend for long-term investments.

This also points towards the need to build capacity in the PSBs to evaluate lendable projects and more importantly, there is an urgent need for freeing them from political interference.
The simple fact is that the fortunes of the banking sector and more importantly, those of the PSBs, are not likely to improve any time soon. The Modi, Chokshi and Kothari cases came to light only in February and there are possibilities of more such surprises in the future. With oil prices rising, we may not have the macroeconomic comfort of controlling the fiscal deficit, current account deficit and inflation, particularly in an election year.

Subjecting the banks to PCA is not likely to solve the deep rooted problem and much more needs to be done. The resolution of the Bhushan Steel case holds some hope, but, that is the only big case that has been resolved and the application of insolvency and bankruptcy code is still a work in progress. Again, the problems in sectors like power, which are not likely to see much of demand revival, are not easy to be resolved. The Committee of Lenders are not likely to agree to big haircuts in the given environment where the senior past and present executives of the banks have been put in the dock.

One interesting fact that keeps emerging in these episodes is the lack of accountability of the government and RBI nominees in the PSBs. The idea of “bad bank”, which keeps coming up from time to time, will not find favours. What is needed is a comprehensive approach to improve the capacity and governance of the PSBs. Decisive and urgent actions on this are necessary for not merely ensuring the stability of the banking system, but also to create conditions for sustained accelerated growth.

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