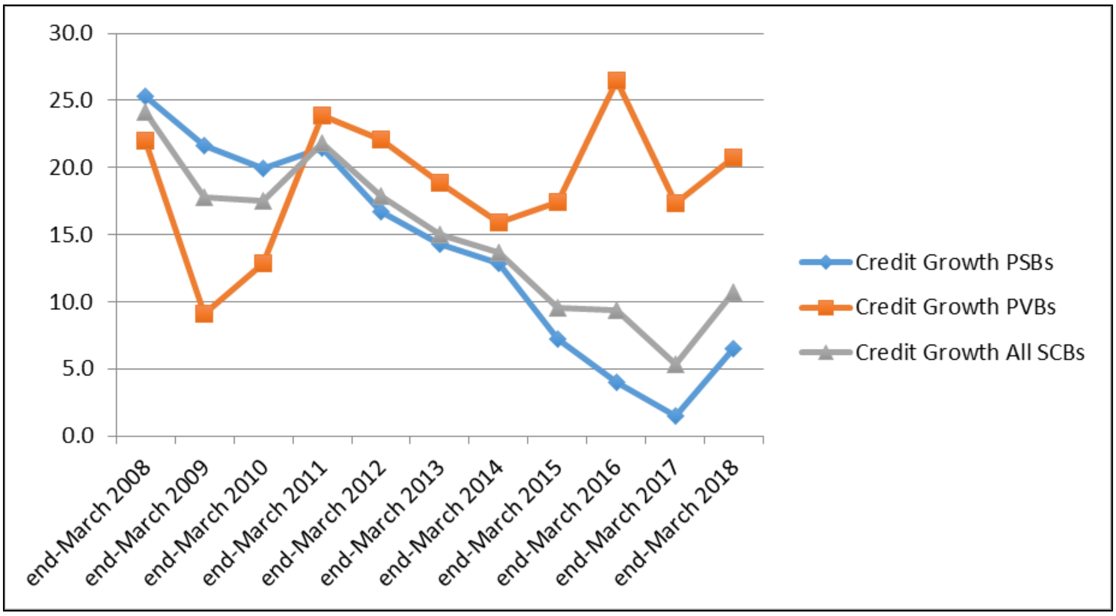
Is the Banking Sector out of the Woods yet?*

Prasenjit Bose and Zico Dasgupta

The Reserve Bank of India's annual banking report and the latest financial stability report, both of which were released in end-December 2018, suggest that a banking sector recovery is already underway. The reports see "signs of improvement" in credit growth and asset quality in the recent period and assert that the RBI's revised Prompt Corrective Action (PCA) framework along with the resolution process under the Insolvency and Bankruptcy Code (IBC) are paving the way for "a stronger and more resilient trajectory of balance sheet expansion" for the banks. So, are the Indian banks out of woods or do these reports paint a rosier-than-reality picture?

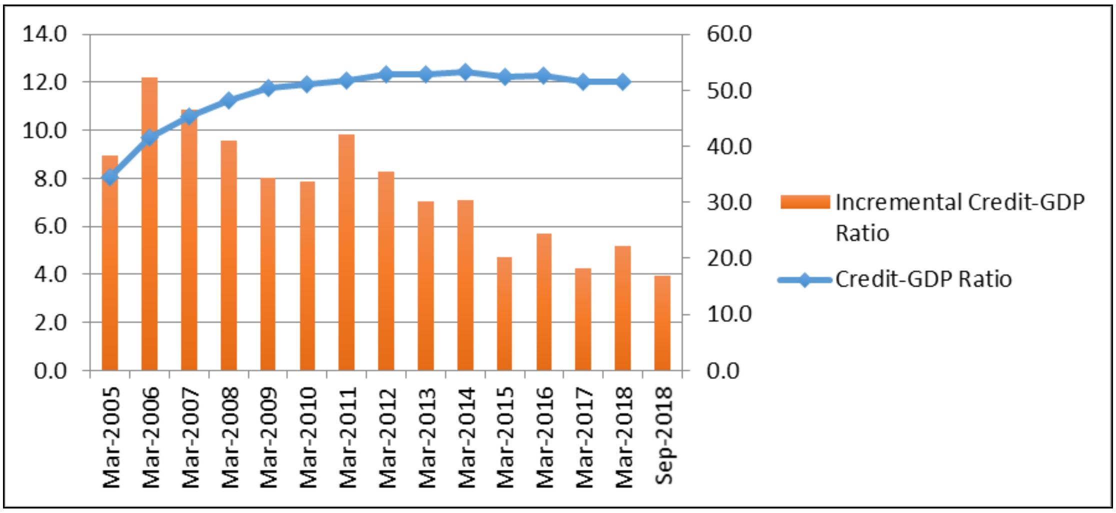
Data from the basic statistical returns of the scheduled commercial banks show a very modest revival of annual credit growth in 2017-18 to around 10%, after declining continuously for six consecutive years, from almost 18% in 2011-12 to 5% only in 2016-17. It is noteworthy that this credit recovery is driven by over 20% credit growth of the private sector banks in the last three years in contrast to that of the public sector banks at 4% only. The widely divergent credit growth trajectories reflect more of market share gains by the private sector banks at the cost of the PSBs, rather than an across-the-board revival of the banking sector. In terms of the credit to GDP ratio, the situation remains grim (See Chart 1a & 1b).

Chart 1.a - Credit Growth of SCBs, PSBs & PVBs: 2007-08 to 2017-18



Source: Basic Statistical Returns of SCBs in India

Chart 1.b: Credit-GDP Ratio



Source: Basic Statistical Returns of the SCBs and Monthly Bulletin, RBI & National Account Statistics, CSO, MoSPI

The outstanding credit-GDP ratio has fallen from 53.4% in end-March 2014 to 51.4% by end-March 2018. The incremental credit-GDP ratio (which measures the annual flow of credit) fell from an average 8% of GDP from 2009-2010 to 2013-14, to around 5% of GDP in the four years 2014-15 to 2017-18. In the first half of 2018-19, incremental credit-GDP was only 4%. It is clear that the very large lending space being vacated by the PSBs owing to their deteriorating financials, is not being occupied fully by the private sector banks, despite aggressive lending on their part. Given the 63% share of the PSBs in outstanding credit, there cannot be any credit revival in the economy without reviving the PSBs.

It is here that the problems with the banking sector policies under the Modi-Jaitley regime become apparent. NPA recovery through various channels in the last four years increased modestly to Rs. 4.2 trillion from Rs. 3.2 trillion in the previous five years, in the backdrop of fresh NPAs rising from Rs 5.7 trillion to Rs. 16.7 trillion. In contrast NPA write-offs have increased very sharply from Rs. 550 billion under UPA-II to over Rs. 4 trillion under the present regime. Out of this, Rs. 3.2 trillion worth of NPAs were written-off by the PSBs alone (See Table 1). By writing off the bad loans owed to the large corporate groups, those losses were absorbed into the banks' balance sheets through 100% NPA provisioning.

Table 1 - NPA Recovery vs Write Offs: 2004-05 to 2018-18

(in Rs. Billion)

	All SCBs			**PSBs**		
	Fresh NPAs	NPA Recoveries	NPA Write Offs	Fresh NPAs	NPA Recoveries	NPA Write Offs
2004-05 to 2008-09	1553.2	1394.5	85.0	1078.9	1119.0	21.6
2009-10 to 2013-14	5758.3	3241.9	550.0	4799.2	2642.6	321.1
2014-15 to 2017-18	16709.1	4252.8	4032.5	13795.9	3237.7	3219.2

Source: Statistical Tables Relating to Banks in India, RBI
https://dbie.rbi.org.in

The other major contributors to the mounting losses of the PSBs are the bank frauds, whose instances have significantly increased under the current regime. The fraud committed by Nirav Modi and Mehul Choksey on the Punjab National Bank (PNB) contributed to a jump in the total amount involved in bank frauds from Rs. 239 billion in 2016-17 to Rs. 411 billion in 2017-18. Moreover, while this particular fraud was an "off-balance sheet" operation, credit related frauds (or loan frauds) have emerged as the dominant category of bank frauds (Table 2).

Table 2 - Bank Frauds in India: 2014-15 to 2018-19

(Amount involved larger than Rs. 10 lakh)

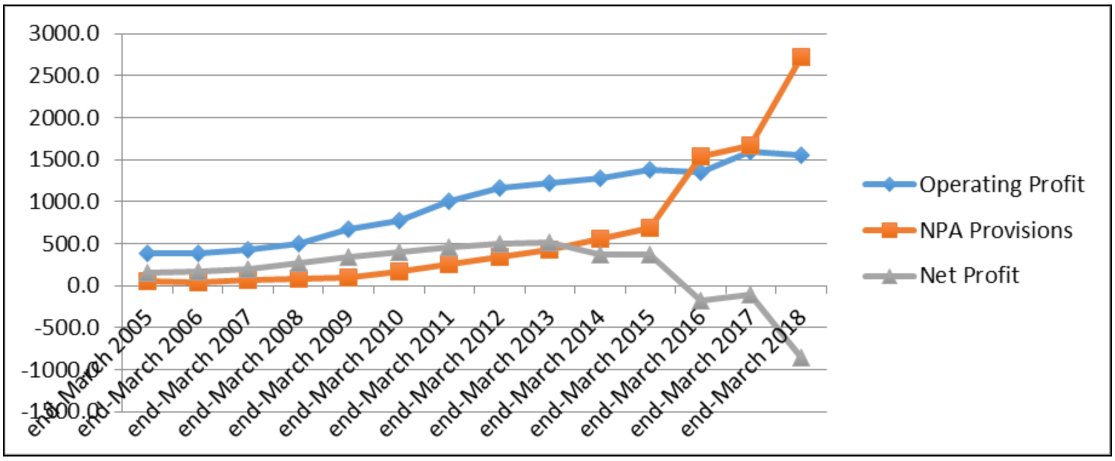
	Cases of Bank Frauds		Amount Involved (in Rs. Billion)	
	Total Number	Number of Credit related Frauds	Total Bank Frauds	Credit related Frauds
2014-15	4639	2251	194.6	171.2
2015-16	4693	2125	187.0	173.7
2016-17	5076	2322	239.3	205.6
2017-18	5917	2526	411.7	225.6
H1: 2018-19	3416	1792	304.2	287.5
Total under NDA regime	23741	11016	1336.8	1063.6

Source: December 2018 Financial Stability Report, RBI

Overall, Rs. 1.33 trillion have been ripped off the banking system by the fraudsters under the NDA rule. There has been a further increase in loan frauds in the first half of 2018-19, with Rs. 304 billion already lost by the banks in six months.

The sharp rise in NPA write-offs combined with increasing instances of bank frauds have led to the declining net profitability of the banks, despite rising operating profits. The 21 PSBs taken together made net losses in the last three financial years (2015-16 to 2017-18) because NPA provisions in each of these years surpassed their operating profits (Chart 2).

Chart 2: Net Profit of Public Sector Banks: 2004-05 to 2017-18



Source: Statistical Tables Relating to Banks in India, RBI

In 2017-18, despite posting operating profits of Rs. 1.5 trillion, the PSBs made record aggregate losses of Rs. 853 billion, on account of NPA provisioning worth Rs. 2.7 trillion. Moreover, the total net losses made by the PSBs in the last three years amounted to Rs. 1.14 trillion, which is less than the total amount lost by the PSBs through bank frauds, Rs. 1.2 trillion.

Even after the massive NPA write-offs in the last four years, the total stock of NPAs stood at Rs. 10.4 trillion in end-March 2018, out of which the PSBs accounted for around Rs. 9 trillion. Over 85% of these bad loans are owed to large borrowers, whose credit exposure exceeds Rs. 5 crore. The latest Financial Stability Report projects the NPA ratio of the PSBs to decline marginally from 14.8% in September 2018 to 14.6% in March 2019 and 14.3% in September 2019. Thus, the PSBs are not being expected to clean up their balance sheets in the foreseeable future.

The efficacy of the Insolvency and Bankruptcy Code (IBC) and the revised Prompt Corrective Action (PCA) framework becomes questionable in this backdrop. Under the IBC, the National Company Law Tribunals have been able to resolve only 50 odd NPA cases till September 2018, involving admitted claims of Rs. 1.25 trillion. Data provided in the IBBI quarterly newsletter shows that 7 high-value cases out of the 52 resolved cases till September 2018, involved total claims of over Rs. 1 trillion. The average realization by the creditors stood at only around 45% only (See Table 3). Given the current stock of NPAs worth over Rs. 10 trillion, the present realization rate under the IBC is likely to inflict another Rs. 5 trillion loss on the banks over the next few years.

Table 3 - Corporate Debt Resolution under IBC: Realization of Financial Claims
(Cases involving Claims over Rs. 50 Billion upto September 2018)

Name of Corporate Debtor	Admitted Claims of Financial Creditors	Realization by Financial Creditors	% of Claims Realized
Bhushan Steel Ltd.	560.2	355.7	63.5
ElectroSteels Steel Ltd.	131.8	53.2	40.4
Amtek Auto Ltd.	126.1	43.3	34.4
Monnet Ispat and Energy Ltd.	110.1	28.9	26.3
Orissa Manganese & Minerals Ltd.	53.9	3.1	5.8
Adhunik Metaliks Ltd.	53.7	4.1	7.6
Zion Steel Ltd.	53.7	0.2	0.3
Total	1089.4	488.5	44.8

Source: Quarterly Newsletter of the Insolvency and Bankruptcy Board of India, Various Issues

As far as the RBI's revised PCA framework is concerned, 11 out of the 21 PSBs have so far been brought under it since April 2017, imposing stringent restrictions on their lending, branch and staff expansion, capital expenditure etc. RBI's latest Report on Trend and Progress of Banking reveals that not only have the profitability ratios and regulatory capital positions (CRAR and CET1 ratios) deteriorated for the PCA-PSBs till September 2018, credit and deposit growth have also lagged behind the non-PCA PSBs leading to a rise in the NPA ratios. By further restricting the core operations of the already stressed PSBs, the PCA framework has been pushing them further into the red.

Capital infusion into the PSBs by the government was to the tune of Rs. 900 billion in 2017-18 and over Rs. 515 billion in 2018-19 (end-December), as reported by the Finance Minister in parliament (Loksabha starred question # 342, answered on 04.01.2019). Despite such recapitalisation, the CRAR of the PSBs progressively deteriorated from 12.1% in end-March 2017 to 11.7% in end-March 2018 and further to 11.3% in September 2018. This erosion of the PSB's capital funds have occurred because of their mounting financial losses on account of NPA provisioning. The latest Financial Stability Report has projected that 8 out of the 11 PCA-PSBs may have CRAR below the 9% benchmark set by the RBI, by March 2019.

With the continuing deterioration of the PCA-PSBs' profitability, capital funds would continue to erode. Bank recapitalisation in the absence of effective NPA recovery is nothing but a taxpayer funded bailout. The point is to arrest the source of capital erosion of the PSBs rather than keep throwing money into a black hole.

The assertions of a turnaround in the banking sector made in the latest RBI reports are not in keeping with the state of the PSBs, which continue to bleed heavily on account of bad loans and bank frauds. The policies under the present regime have failed to reverse the trend.

*** A shorter version of the article was published in The Hindu Businessline.**