Burdening Public Banks with Private Losses*

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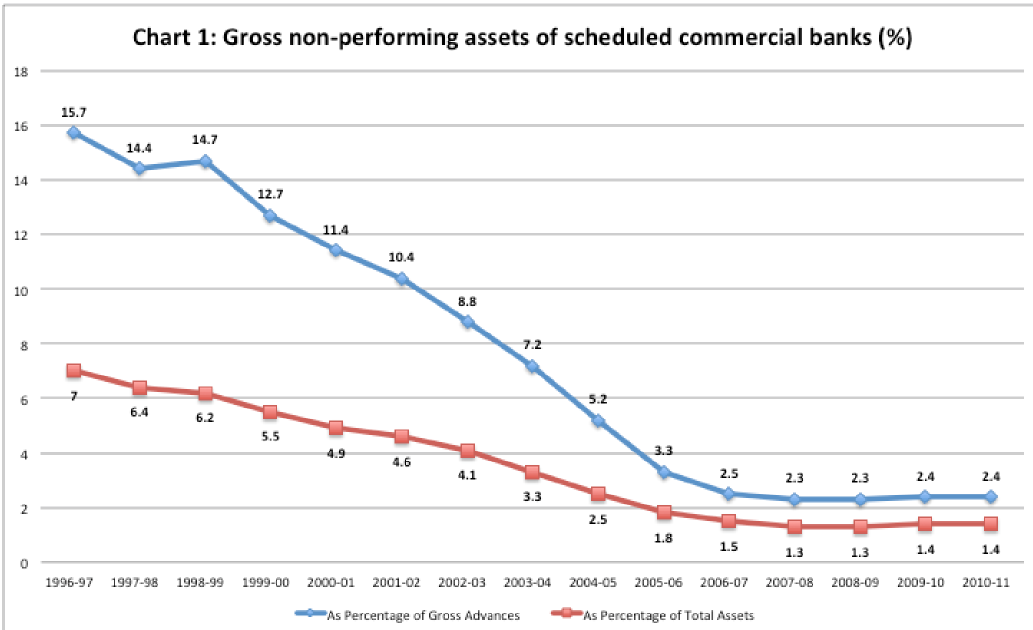
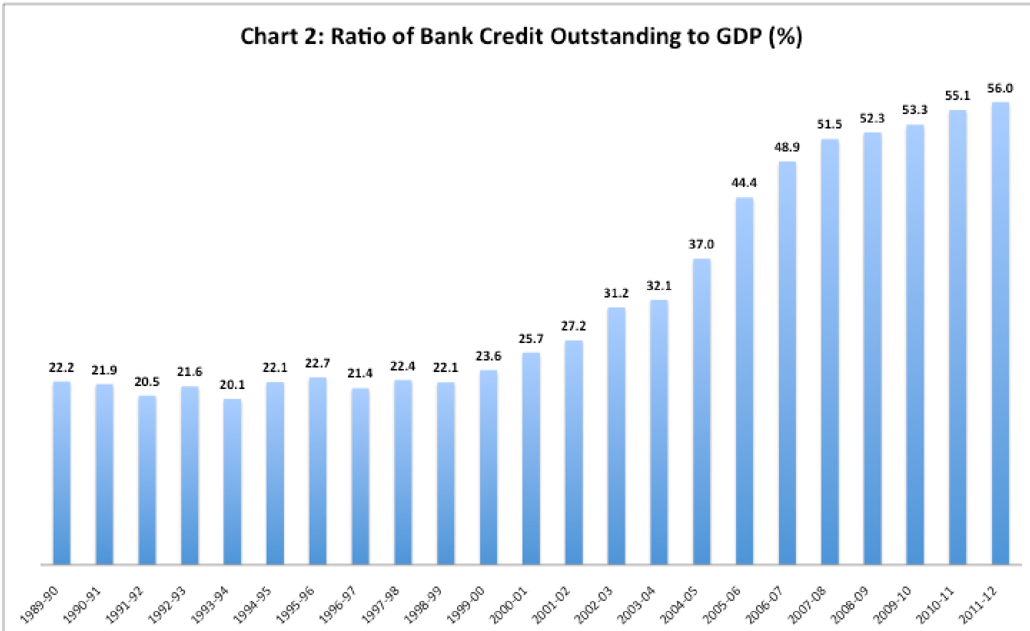
Ever since liberalisation opened up and deregulated the markets and institutions that constitute India's financial system, the positive effect that has had on India's banks has been a periodic refrain. Two sets of indicators are used to support that argument. The first is the sharp fall in the share of non-performing loans to total, with the ratio of gross non-performing assets to gross advance falling from close to 16 per cent in the mid-1990s to as low as 2.5 per cent a decade later, where it has remained since. As a ratio of total assets too those NPAs have fallen from 7 per cent to less than 1.5 per cent (Chart 1).



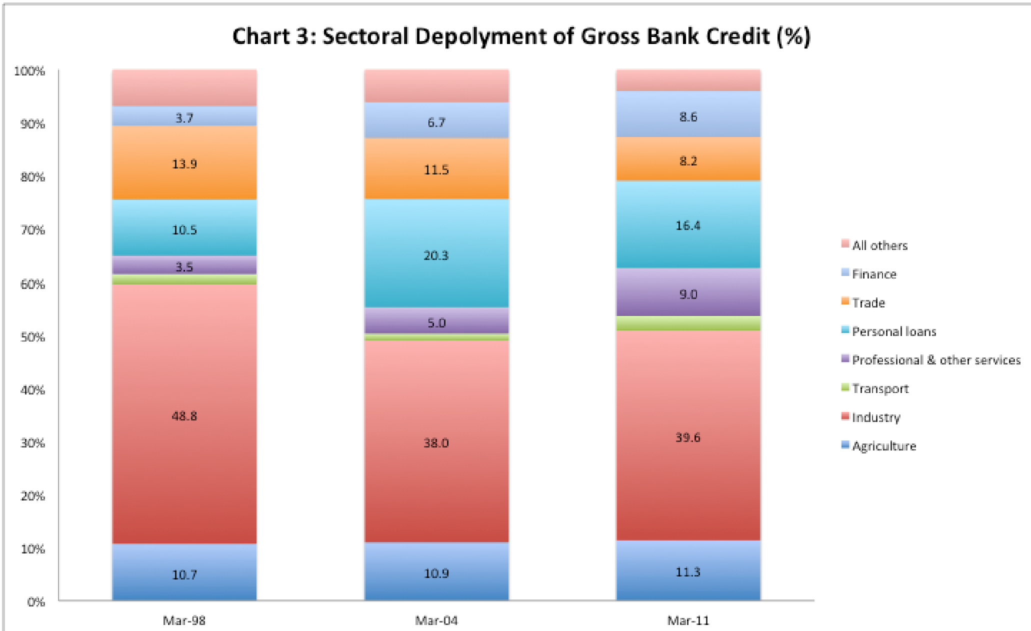
The second set of indicators point to the successful adoption by India of Basel norms in both their first and second versions, with the capital to risk-weighted assets ratio being well above 12 per cent in the case of almost all scheduled commercial banks. With the major banks stripped of their non-performing assets and extremely well capitalised, India's banking system seems a model to hold up to the rest of the world. Those who had predicted that liberalisation would increase the fragility of the banking system had been shown to be wrong, it is therefore argued.

This performance was particularly creditable because the system was displaying enhanced robustness in the midst of a sharp increase in credit advanced by the banking sector. Thus the ratio of credit outstanding to GDP, which stood at around 22 per cent just prior to liberalisation and remained around that level till the end of the 1990s, rose sharply in a period of rapid growth to reach 52 per cent in 2007-08 and 56 per cent in 2011-12 (Chart 2).



There was, of course, some cause for concern as a result of a couple of post-liberalisation developments to which even the central bank as the principal regulator had on occasion drawn attention. Significant among these was a shift in lending by the banking system away from the productive sectors to the retail sector, with personal loans accounting for a rising share of the total. As Chart 3 shows, between the end of the 1990s (1998 March) and March 2011, the share of industry in total advances (which, as mentioned, was rapidly rising) fell from 49 per cent in 1998 to 38 per cent in 2004 and remained around that level till 2011. On the other hand the share of personal loans rose from 10.5 per cent in March 1998, to 20.3 per cent, though it stood at a lower 16.4 per cent in 2011 as a part of the slow down that had begun to affect the economy. . Much of the retail lending was to the housing sector, with automobile and educational loans being quite significant too.

As in the case of the subprime market elsewhere in the world, this expansion of retail lending had brought into the universe of borrowers a set of households that did not have secure employment, could not offer much collateral and often had borrowed more than they should. This could, when economic circumstances change, lead to default rates that would be difficult to provide for and cover, and pointed to an increase in potential fragility It was such expansion in retail lending that prompted an erstwhile central banker (S. S. Tarapore) to call for caution with regard to India's own version of the subprime problem.



It is now becoming clear that such signs of potential fragility have been accompanied by another form of increased fragility resulting from changed lending behaviour and liberalised regulatory practices. The source of this fragility was the government's decision to use the banking system as an instrument to further an aspect of its larger liberalisation agenda, which was the entry of the private sector into core infrastructural areas involving lumpy capital intensive investments in power, telecommunications, roads and ports and sectors like civil aviation. Under normal circumstances banks are not expected to lend much to these areas as it involves a significant maturity and liquidity mismatch: banks draw depositors from savers in small volumes with the implicit promise of low income and capital risk and high liquidity. Infrastructural investments require large volumes of credit and do involve significant income and capital risk, besides substantial liquidity risk. So what is required for supporting infrastructural investment is increased equity flows from corporate or high net worth investors and the expansion of sources of long-term credit like a bond market.

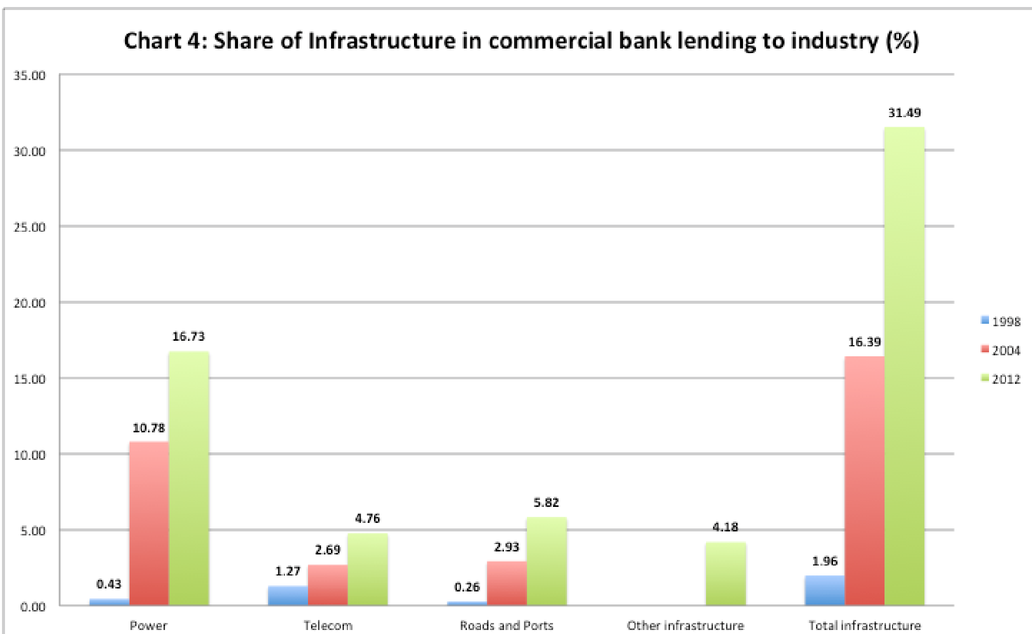
Neither of these, especially the latter, occurred in adequate measure. Rather, the development financial institutions with special access to lower cost financial resources, which were created as providers of long term-finance, had been shut down as part of liberalisation. Hence, besides recourse to external commercial borrowing, many infrastructural projects had to turn to the banking system. As is to be expected, private banks have been unwilling to commit much to this risky business. So it is the public banking system (besides a couple of private banks) that has moved into this area, possibly under government pressure.

The figures are dramatic. The share of infrastructural lending in the total advances of scheduled commercial banks to the industrial sector rose sharply, from less than 2 per cent at the end of March 1998 to 16.4 per cent at the end of March 2004 and as much as 31.5 per cent at the end of March 2012 (Chart 4). That is, while the share (though not volume) of lending to industry in the total advances of the banking system has fallen, the importance of lending to infrastructure within industry has increased hugely. Four sectors have been the most important here: power, roads and ports, and telecommunications, and more recently a residual 'other' category, reflecting in all probability the lending to civil aviation.

Unfortunately, as the exposure of the banks to these sectors has increased, the folly of "dragging" the private sector into infrastructure with concessions and cheap credit is becoming clear. The shake out has begun in civil aviation with possibly only one airline able to show profit after many years of liberalisation. Of the ones that were surviving until recently, the worst case is Kingfisher Airlines, which added to the effects of an erroneous policy through its own follies: bad strategy, bad acquisitions, profligacy and obvious mismanagement.

The result is that the banks that lent to Kingfisher have found themselves in a mess. If they withdraw, they invite default of the large volume of debt they have already provided. So they restructure debt, offer better terms, extend repayment periods, and provide more credit to keep the unit afloat. But they are doing so with the knowledge that unless the government uses taxpayers' money in some form to bail out the unit, this is merely sending good money after bad.

Thus, in 2010, the banks had got together and under the Corporate Debt Restructuring (CDR) scheme of the RBI, restructured debt to the tune of Rs. 77 .2 billion owed by Kingfisher. Now, with the debt of the airline having increased by another Rs. 10 billion or so, the airline has been forced to suspend operations with no hope of repaying the banks unless the impossible happens.



Such restructuring of debt as is being implemented in India's infrastructural sector clearly favours the debtor at the expense of the creditor. The RBI's prudential guidelines define a restructured account as one where the bank, for economic or legal reasons relating to the borrower's financial difficulty, grants to the borrower concessions that the bank would not otherwise consider. Restructuring can involve some combination of changes in the terms of advances, such as alteration of the repayment period, reduction of the repayable amount, reduction in the rate of interest and conversion of debt to equity. It can also be accompanied by the provision of additional credit, despite the shortfall in meeting past commitments. The intent is to help the company recover. But, often that intent is not realised. The only benefit is that in return for the losses the creditor institution suffers, it is in a position to treat the asset (after providing for any write down) as a standard asset subject to conditions. But this may in fact provide the cover to abuse the restructuring route to bail-out private investors at the expense of the banks. As Table 1 shows the net result of this strategy has been that the troubled assets restructured by India's banks had by March 2011 exceeded the identified Non-performing assets of the banking system.

Table 1: Trends in Restructuring

	Mar-09	Mar-10	Mar-11	Mar-12
Gross Advances (Rs. Crore)	27,53,365	32,27,287	39,82,954	46,55,271
Restructured Standard Advances (Rs. Crore)	75,304	1,36,426	1,37,602	2,18,068
Restructured Standard to Gross Advances Ratio (%)	2.73	4.23	3.45	4.68
Gross NPAs as a % of gross advances	2.44	2.5	2.35	2.9

The reason is that Kingfisher is no exception, but is the tip of a debt default iceberg that has been hidden by restructuring. The largest chunk of bank debt to infrastructure (estimated at Rs. 269196 crore as of March 2011) was in the power sector. The problem in the power sector is that large capital investments, wrong technology choices, poor management, high power costs that the state distribution agencies are not able to bear given the tariffs they charge, and difficult and costly fuel supplies, have all ensured that most of the high profile private power projects are not viable. The government has sought to prop them up with concessions such as coal allocations without success. If this leads to failure, the bankruptcy of the private sector power companies can spill over onto the banks carrying their loans, much of which has already been restructured. According to an estimate by Credit Suisse reported in the media, 36 private thermal power projects carrying a debt of Rs 209,000 crore are now facing potential stress.

A chunk of bank exposure to power consists of credit to finance the losses incurred by the power distribution companies, most of which are state owned, though privatisation has brought in non-state players. That exposure is estimated at Rs 1,50,000-1,70,000 crore as on March 2012, which is around half of total power credit. In theory, the state inspired restructuring has conditions attached to it that are expected to ensure that the units involved would turn their backs on losses and become commercially viable. But the feasibility and viability of these liberalization-inspired schemes are in serious doubt.

As noted earlier the burden of financing the losses has fallen disproportionately on the public sector banks, which have seen the volume of restructured assets grow at a compound rate of 47.9 per cent during 2009-12, when credit grew at 19.6 per cent. The comparable figures for the private banks were 8.1 and 19.9 and for foreign banks -25.5 and 11 per cent respectively. Clearly liberalisation has not reduced but rather increased the misuse by the state of the public banking system to shore up private capital.

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