Bank Book 2017

World Economy

The cyclical recovery helped the upward revision in global growth projections by IMF for 2017–18. World Economy is anticipated to grow by 3.5% in 2017 (earlier estimation was 3.2%) and 3.6% in 2018. According to Bank for International Settlements' 87th Annual report, the global economy's cyclical upswing has strengthened considerably. By early 2017, virtually all major economies were expanding, with a favourable short-term outlook. Many Emerging Market Economies (EMEs) benefited from increasing commodity prices, while Advanced Economies (AEs) began to show recovery, especially in the labour market. Consumption growth was one of the key drivers of demand, with business investments also showing signs of a rebound. Some green shoots have started to appear in the trade horizon with world trade growth projected at 3.8% and 3.9% in 2017 and 2018. Overall, the near-term economic outlook has brightened substantially, and financial headwinds have turned into tailwinds in many AEs. However, policy and political risks continue to cloud the outlook of the AEs.

Economic activity has gained momentum so far. The US economy has expanded at a faster pace in Q2 after a weak Q1, supported by steadily improving labour market conditions, increasing consumer spending, upbeat consumer confidence helped by softer than expected inflation, and improving industrial production. The US Federal Reserve quickened its pace of policy rate normalisation and raised short-term interest rates in June 2017, while the Bank of Japan and European Central Bank maintained their expansionary stances. Inflation in AEs remains subdued and generally below targets; it has also been declining in several EMEs. In the Euro area, the recovery has broadened across constituent economies on the back of falling unemployment and a pickup in private consumption coupled with sense of political stability. In Japan, a modest but steady expansion has been taking hold, underpinned by strengthening exports and accelerating industrial production. Emerging and developing economies are projected to see a sustained pickup in economic activity. However, escalating geopolitical pressures compounded amidst tension between US and North Korea, a ripple effect has been experienced across Asian markets in the recent period. There is a need for EMEs to address domestic imbalances to enhance their resilience to external shocks.

Domestic Economy

Economic Survey 2016-17 Volume 2 released by GOI notices a rekindled optimism based on structural reforms in Indian economy. Various factors such as launch of the GST, positive impacts of demonetization, decision in principle to privatise Air India, further rationalisation of energy subsidies and actions taken to address the Twin Balance Sheet challenges. However, achieving the high end of the 6.75-7.5% growth projected earlier may be difficult due to appreciation of rupee, farm loan waivers and transitionary challenges from implementing GST. GDP, IIP, credit, investment and capacity utilisation, point to a deceleration in real activity so far in 2017. Industrial growth as per IIP new series of 2011-12 shows overall growth at 5% in 2016-17 as compared to 3.4% last year. The Index of Eight Core Industries growth during 2016-17 was 4.8% as compared to 3.0% in 2015-16. The latest available information also reveals slowdown in growth. India's services sector growth, which was highly resilient even during the global financial crisis, has been showing moderation in recent times.

The year 2017 continued to witness significant moderation in CPI inflation. CPI Inflation fell to a series low of 1.5% in June 2017. The decline was broad based with the most significant being the fall in food inflation on the back of a normal monsoon. The softening trend in inflation helped the RBI to cut the policy rate in August 2017. The RBI cut the policy rate by 50 bps during 2016-17 and 25 bps in 2017-18 so far. It could be noted that RBI shifted its monetary policy stance to neutral from accommodative in February 2017. As of August 2017, Repo rate stood at 6.00% and reverse repo rate at 5.75%.

Demonetisation impacted various financial intermediaries differently. Monetary aggregates decelerated significantly following the withdrawal of legal tender status of specified bank notes on November 9, 2016. As of 31st March 2017 the currency in circulation contracted by 19.7%. The total currency in circulation as on 28th July 2017 is Rs.15.41 trillion which is about 86% of amount in circulation as reported by RBI on 4th November 2016.

Demonetisation resulted in a significant increase in bank deposits, which if sustained, could have favourable impact on financial savings and their channelisation to capital markets. Consolidated balance sheet of Scheduled Commercial Banks experienced 'excess' deposit growth in the post-demonetisation period. Non-banking financial intermediaries, such as, debt/equity oriented mutual funds and insurance companies also gained and the aggregate balance sheet of the NBFC sector expanded by 14.5% during 2016-17. Sluggish growth and increasing indebtedness in some sectors of the economy have impacted the asset quality of banks and is a cause for concern. The gross non-performing advances (GNPAs) ratio of SCBs rose from 9.2%in September 2016 to 9.5% in March 2017.

During 2016-17, gross bank credit outstanding grew at around 7% on an average. The average gross bank credit to industry contracted by 0.2% in the same period. Credit off-take from banks has not picked up much and evident from the 4.8% increase in non-food bank credit growth in June 2017 compared to an increase of 7.9% in June 2016. Low credit demand combined with falling interest rates amidst abundant liquidity in the banking system, would lower bank earnings, particularly for smaller, deposit-funded, and less diversified institutions.

Reflecting the world economic situation, India's exports turned positive at 12.3% in 2016-17 after an interregnum of two years. The current account deficit (CAD) narrowed down progressively to 0.7% of GDP in 2016-17 from 1.1% of GDP in 2015-16 led by sharp contraction in trade deficit which more than outweighed a decline in net invisibles earnings. India's balance of payments situation improved in 2016-17, as a result of low and falling trade and current account deficits and moderate and rising capital inflows, resulting in further accretion of foreign exchange reserves. Net capital inflows were slightly lower at US$ 36.8 billion (1.6% of GDP) in 2016-17 as compared to US$ 40.1 billion (1.9% of GDP) in the previous year. Gross FDI inflows to India increased significantly to US$ 60.2 billion in 2016-17 from US$ 55.6 billion in 2015-16. The measures taken by the Government has resulted in FDI equity inflow of US$ 43.4 Billion in 2016-17, is the highest ever FDI Equity inflows.

Most of the external debt indicators of India also improved at end-March 2017 compared to end-March, 2016. India's aggregate external debt stock at end-March 2017 stood at US$ 471.9 billion registering a decline of US$ 13.1 billion (2.7%) over end-March 2016. The ratio of external debt to GDP fell to 20.2% from 23.5%, while foreign exchange reserves provided a cover of 78.4% to external debt compared to 74.3% in the previous year.

The India growth story remains strong as seen in the improvement in the rankings of doing business in India, enabling start-ups, active Insolvency and Bankruptcy mechanism and the smooth roll-out of GST. Increased focus on infrastructure like affordable housing and urban infrastructure development propel capital flows and boost investments. India's economy grew slower in 2016-17, compared to last two fiscal years. However, the expectation of better agricultural produce in 2017-18 would help healthier rural growth and support & offset the weakness from other sectors, in addition to government's concerted efforts to restore the economic activity

It is in this context that we should discuss future road-map for the Indian Banking Industry. A couple of ideas that are being discussed at Government level are: (a) Consolidation of Public Sector Banks; merger process of SBI and its subsidiaries is already in progress, and expected to be completed before 31st March 2017; (b) Strengthening top management of PSBs by bringing in fresh blood from private sector; (c) Providing comfort to the Management of PSBs in taking decisions relating to OTS, waivers, etc., by making them go through a small Committee set up by GOI.

Bank Book 2016 discusses these issues in detail, in the later pages.

Indian Banking

While the Financial Year 2015-16 was a bad year for Indian Banking – with as many as 14 out of 26 Public Sector Banks (PSBs) declaring losses, it was expected that the worst would be over by the 2nd quarter of 2016-17, and the full year would be much better. Then came the Demonetisation announcement in November 2016, which upset certain businesses/sectors, and operations of the Banking industry itself was thrown out of gear. For nearly 3 months, the focus of every bank branch was to take care of opening new accounts and meeting currency requirements of customers. Hence, the much needed attention towards monitoring & follow-up of loan accounts, as also improving collections went to a background. Banks did register a good growth in deposits with more cash moving from house-holds and businesses to Savings and Current Accounts. However, most sectoral problems remained, and for all practical purposes, there was no growth in credit or there was shrinkage in PSBs. Considering increasing provisioning cost and benefits of falling interest rate scenario, some PSBs moved from red to green. Overall the situation continued to be grim, with 9 PSBs out of 21 declaring losses in FY17.

Private Sector Banks (PvSBs) on the other hand, made use of this opportunity to grow, and many large NBFCs also registered good growth, in products like loans to SMEs and LAP (Loans against Property). PvSBs also came out with asset quality issues with two large banks registering much higher NPAs than their peers, and some of them restating their NPA figures for FY16 post RBI's Audit. Overall, it was still a comfortable position, with decent profits.

In this scenario, it was inevitable that the discussion is around PSBs' ability to maintain mandatory capital adequacy levels. Government of India, in its budget for FY18 had announced only Rs. 20,000 Crs towards recapitalisation of banks, and this was woefully short of the requirements – despite low or no growth in the assets. This was due to increase in risk weighted assets as a consequence of ageing of NPAs, and also losses or low profits. Estimates for capital requirements (including Additional Tier I capital) as at FY19 (by when Basel III guidelines will be fully implemented) varied between Rs. 1,00,000 to 1,90,000 Crores.

Not much progress happened on consolidation of PSBs; it was a difficult process anyway, but was considered essential to reduce costs and manage man-power issues plaguing the PSBs. However, there is an expectation that this would move a few steps in H2FY18. This, to an extent, has become urgent with the Capital Adequacy level of a few banks falling quite low, and their ability to service coupon on higher risk instruments now getting threatened.

First quarter results of FY18 indicate slight improvement, and there is lot of activity happening in terms of referring large defaulters under Bankruptcy Code. BWR believes that while this is the right approach to resolve NPAs with productive assets weighed down by large debt, this is likely to take time to settle down through the legal system and effectiveness of the Insolvency Resolution Professionals getting demonstrated.

Performance of Banks in FY17

Stunted Business Growth

Business growth was quite uneven among the banks. While the larger PvSBs registered growth in deposits between 14% and 36%, those in the PSBs were in the range of 3% and 18%. There was no enthusiasm to grow deposits while their focus was on containing the NPAs, and hence no or low credit growth. However, the Demonetisation was an unexpected bonanza with lot of deposits flowing into Savings and Current Accounts post November 2016. This resulted in significant growth in CASA deposits, with almost all the banks registering a significant increase in CASA%. In particular, CASA% of 5 PSBs around 45% or more was quite impressive. Deposit interest rates also were brought down by almost 100 bps over the 12 month period.

J & K Bank	**51.7%**
Axis Bank	51.4%
ICICI Bank	50.4%
HDFC Bank	48.0%
United Bank of India	47.3%
Punjab National Bank	46.0%
Allahabad Bank	45.8%
State Bank of India	45.6%
Bank of Maharashtra	44.9%
Kotak Mahindra Bank	44.0%

Top 10 Banks with high CASA%

Among the PSBs as many as 8 banks registered negative growth in credit, 5 banks were more or less flat and the rest registered a single digit growth. As expected, most of the fall happened in corporate credit, either due to recoveries, write-offs or sale to ARCs.

Notwithstanding the expertise PSBs have for SME credit, growth here was marginal, and Agri loans grew faster. Given the fact that repayment of Agri loans is uneven, particularly in an environment of 'Farm Loan waivers' as a political issue, this growth can only be termed ominous. Anyway, banks had their Priority Sector targets to fulfil.

Central Bank of India	**-19.5%**
IDBI Bank	-11.6%
Dena Bank	-9.6%
Indian Overseas Bank	-9.2%
Bank of Maharashtra	-8.7%

Top 5 PSBs registering negative growth in credit

Indian Bank
Bank of Baroda
Corporation Bank
Allahabad Bank
Syndicate Bank

PSBs registering flat growth in credit

This situation was taken advantage of by the more aggressive private players, with HDFC, Kotak Mahindra, IndusInd and Yes Bank registering high growth in credit, and this was not confined to only Retail advances. Incidentally, among the country's Top 5 banks, three were from public sector and two were from private sector.

State Bank of India	**21.1%**
HDFC Bank	6.9%
Punjab National Bank	6.0%
Bank of Baroda	5.7%
ICICI Bank	5.5%

Top 5 banks with their market share of business

MCLRs of all the banks came down by 50 – 75 bps during the period, due to RBI guidelines wherein the MCLR is linked to the ROI offered for incremental deposits. It may be noted that in the 12 months period, Repo Rate had come down by only 25 bps, but the banks were anyway lagging behind in effecting rate cuts.

	Banks	MCLR (Overnight to 1 year) effective from 01 Aug 2017
1	State Bank of India	7.75% to 8.00%
2	Punjab National Bank	8.00% to 8.35%
3	Bank of Baroda	8.10% to 8.35%
4	Bank of India	8.00% to 8.40%
5	Canara Bank	8.05%to 8.40%
6	Union Bank of India	7.90% to 8.40%
7	HDFC Bank	7.85% to 8.15%
8	ICICI Bank	7.85% to 8.20%
9	Axis Bank	7.85% to 8.20%
10	Kotak Mahindra Bank	7.75% to 8.65%

MCLRs of 10 major banks

Continued Asset Quality Issues

Asset quality issue of banks was more an economic and sectoral problem than a problem within the banks per se. With sectors like Steel and Power Generation continuing to have challenges, no meaningful recovery in the NPAs in these sectors could happen. Though all banks had special teams dealing with large NPA accounts, they could only do so much. The previous tools used for rehabilitation or recovery like CDR, 5/25, etc., gave way for SDR and S4A. With the Bankruptcy Law coming into effect, RBI empowered to give directions to the Banks and functioning of NCLTs, one can see a flurry of activity. This has certainly given a jolt to the Corporate Sector, which had previously not taken the issue of bank loan repayment seriously. It has made some large groups to seriously look at selling down some of their assets, reducing debt, and consequently helping banks to reduce delinquencies. The efficacy of all these steps will be felt over the next 12 months, ie., by September 2018.

Among the PSBs, Indian Overseas Bank, IDBI Bank, Central Bank of India and UCO Bank showed high GNPA%, with only 4 banks (including SBI) having this ratio in single digit. If we looked at Stressed Assets (GNPA + Standard Restructured Assets), Dena Bank and United Bank of India also figured prominently. Among PvSBs, ICICI Bank and Axis Bank showed some stress in their industrial credit, and some banks were asked by RBI to restate their NPAs for FY16 on account of improper classification. Stress in Agri loans was not much visible in FY17, but Q1FY18 results of some banks started showing negative trends.

Indian Overseas Bank	**22.39%**
IDBI Bank	21.25%
Central Bank of India	17.81%
UCO Bank	17.12%
ICICI Bank	7.89%
Axis Bank	5.00%

GNPA of select banks

BWR has deemed it fit to discuss the problem of NPAs in general, and means of avoiding similar pitfalls in the future, later in this write-up.

Profitability and Capital Adequacy

With increasing provisioning cost, it was only natural for most banks to show lower profits. Majority of PSBs showed lower provisions in FY17, as many of them had made very high provisions in Q3 and Q4 of FY16. Banks having persistent NPA problems since 3 years, and also those who had escaped with lower provisions in FY16, had to bear the brunt of higher costs in FY17. 9 out of 21 PSBs (SBI subsidiaries are ignored, as the merger took place effective from 1st Apr 2018) suffered losses, apart from J&K Bank, which also registered a large loss. The situation would have been more acute but for a fairly significant increase in Non-interest income booked by many banks. This was mostly the Treasury income arising out of profit booking in a falling interest rate scenario. Q1FY18 results also more or less indicate the same trend.

As a consequence of losses and inability to raise AT1 bonds due to market perceptions, CRAR of many banks is adversely affected. As of Q1FY18, at least half a dozen banks are below the minimum CRAR required by March 2018. Government's budget provisions for capital infusion are totally inadequate, and it is interesting to see how the Government of India will tackle this serious challenge.

Prompt Corrective Action

RBI issued revised guidelines in April 2017 on criteria for identifying banks for introduction of 'Prompt Corrective Action' (PCA), with effect from 1st April 2017. At the end of Q1FY18, among the PSBs, 13 banks were seen failing in at least one parameter, most of them in NNPA% and the loss making ones in respect of ROA. 3 banks had threshold-3 breach, and going forward, some of them are likely to show a breach on the third parameter, viz., CRAR. This is a fairly serious situation, threatening the capacity of the banks to raise any capital in the market. Probably, these are the banks that are likely to get merged, but it would not be easy for the acquirer also to digest the problems, without affecting their own health. Government's direct capital injection is an option.

Threshold 1				
CRAR	CET-1	NNPA	ROA	Leverage
10.25%	6.75%	>=6.00% and <9.00%	(-)ve for 2 yrs	<=4.0% to =3.5%
Threshold 2				
CRAR	CET-1	NNPA	ROA	Leverage
7.75%	5.13%	>=9.00% and < 12.00%	(-)ve for 3 yrs	<3.5 %
Threshold 3				
CRAR	CET-1	NNPA	ROA	
6.25%	3.65%	>=12.00%	(-)ve for 4 yrs	

RBI Circular dated April 13, 2017 on Revised PCA framework

One fall-outs of the PCA tool is the impact that will be there on the bank's ability to attract any profitable business, as many analysts and economic journals have put this information in public domain. Today, the public still deals with these banks on account of GOI ownership, but it is quite possible, one day, their good customers (both borrowers and depositors) could move out to other banks, seriously affecting the steps being taken to strengthen them. Hence while PCA is a regulatory tool for focussed monitoring, it could have the effect of adversely impacting the concerned banks.

Asset Quality Issues – Who is to blame?

Since mounting NPAs and consequent provisioning requirement is the root cause of the problems being faced by a majority of the banks, it is appropriate to look at the issue of Banking Credit Appraisal and monitoring system more holistically. This is also important from another angle, as there is lot of public scepticism about the banking industry's ability to handle large project loans; in fact many senior bankers with decades of experience are facing charges of gross negligence or incompetence in handling these loans.

Basically, the large NPAs have occurred in the following sectors:

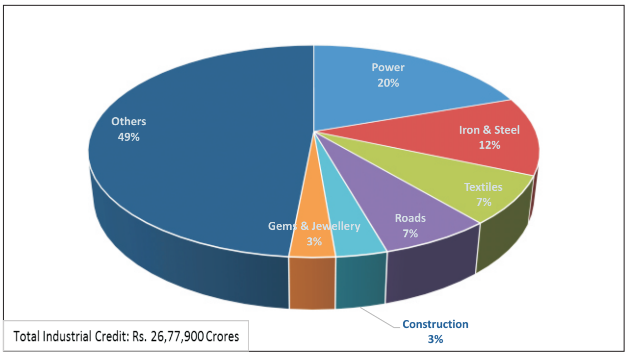
• Iron & Steel

• Power Generation (coal or gas based and hydro)

• Roads & Highways &

• EPC Contractors

Though there are also NPAs in some Real Estate projects, Textiles or Gems & Jewellery segments, these do not appear to be sectoral problems, but individual issues, with reasons ranging from diversion of funds to outright frauds.



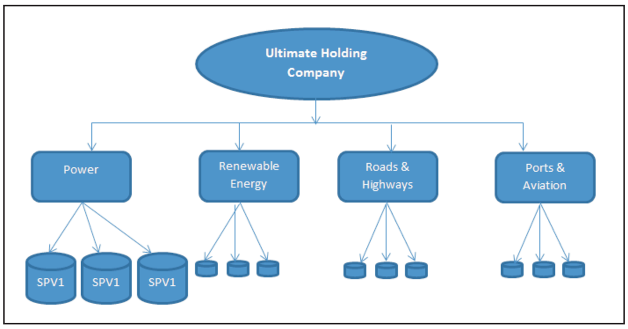
Source: RBI

So, looking at the four sectors where maximum NPAs are to be seen, it is clear that there were many reasons outside the control of the borrowers or bankers, because of which the companies in these sectors failed. The general principle which a bank looks at is the Ownership & Management, and whether they have competence to gauge the demand & supply gaps, availability of raw materials and other inputs, and a profitable market. Most of the numbers required for this purpose are taken by both the promoters and bankers from Planning Commission or other Ministry documents, where there are projections. Nobody assumes all these projections to materialise in full, but take a calculated risk. Second point is the project execution capability, which was inferred by a Group's diversified activities. It is in this context that lot of investment went into steel manufacturing and power generation over the last decade or more. Both these sectors are highly capital intensive, require inputs like iron ore, coal, coke, gas, etc., and logistics related to their transport or transmission. In hind-sight we now note that excessive capacities are created in both these sectors, as the consumption has not picked up as projected. In the case of Steel, the companies faced enormous problems in supply of iron ore or coal being taken away due to mining policy related litigations, dumping of steel from China, Ukraine or other countries, and consequent non-viability of running the mills. Thermal power similarly faced problems of coal, unviable tariffs, litigations relating to PPAs, transmission bottle-necks, etc. It is to be noted that in all these cases, valuable assets created by the entrepreneurs are very much there, but the capacity utilisation is low, and below the break-even level. In fact, many coal or gas based plants are virtually shut or having PLF in single digit.

Similarly in the roads & highways business, there were serious challenges in land acquisition, environmental clearance, etc., whereby the projects suffered both cost and time escalation. Even after the projects were completed, the projected traffic did not materialise for a host of reasons, including economic slow-down, ban on mining (and hence no movement of iron ore, sand, etc), resistance by public to pay toll, etc. Currently there is a discussion on the debt levels and viability of Telecom operators, precisely for comparable reasons.

From all this, the lessons the lenders have learnt the hard way is that all projections need to be viewed sceptically (professional scepticism should be a hall-mark of an appraiser, anyway), scenario analysis should be rigorous, and project viability to be established in the worst case scenario. In particular, higher the riskiness of the project, higher contribution from the promoters and lower Debt : Equity should be the norm. All projects which are EBIDTA positive can be made viable by tweaking the debt and equity components, or by suitable moratorium and repayment schedule, and in some special cases by Viability Gap Funding. Bankers should also cultivate the habit of saying no, or enforcing strict covenants. In fact, some of the large PvSBs simply did not take exposures to Infrastructure sector, and are now spared of the problems.

This brings us to the question of Promoters' equity in the projects. If we have a look at the Top-50 NPAs of banks, a couple of disturbing aspects come to the fore. Firstly, these are large groups which have almost simultaneously embarked upon multiple projects. So they have a structure of Ultimate Holding Company, Sectoral Holding Company and Operating Company or SPVs. Technically, it is the Operating company which is raising loans, and which is being appraised. The promoters show an equity, which is in fact, raised as a debt at the next higher level. A careful analysis will show that the promoters have brought very limited equity at the Ultimate Holding company level, and most of the equity at all other levels is in fact debt disguised as equity. It is only at a consolidated level that some reality comes, but lender at each SPV level cannot be expected to do



this. Further, whatever equity is there in the SPV or other operating companies is also pledged in many cases. Thus, in effect, there is very low level of promoters' skin in the business. Hence, when there is continuous loss for 2 or 3 years, promoters' stake totally vanishes; this explains why the promoters of such companies are willing to let their assets go, if the bank wants to take any coercive action.

The lesson learnt from the above is: (a) Bankers' need to enhance their project appraisal skills, by setting up specific sectoral desks; (b) All projects need to be rigorously stress tested, as most government estimates happen to be optimistic; (c) They must ensure that promoters have much higher stake in the business, and the standard D:E Ratios of 2:1, etc., need to be junked; (d) Payment moratorium and repayment schedule should be of sufficient length so that it accommodates unexpected or unplanned delays.

Is S4A a panacea for NPA resolution?

One of the events being keenly watched is the efficacy of NPA resolution process post introduction of S4A scheme and the new Bankruptcy Code.

As long as there are valuable assets in the defaulting company, and there is a market for the product that can be produced, it is possible to find a resolution to the NPA problem. Severity of the problem depends upon how big is the debt vis-à-vis value of productive assets. Hence, assuming that the entire Networth of the borrowing company is wiped out due to losses, and the liabilities are far in excess of the value of assets, the unit can't be made viable by simply rescheduling the debt or extending the overall repayment period. This explains the failure of many resolution plans under CDR or 5/25 schemes. Now, under S4A, technically, the debt gets pared by the lenders taking a hair-cut. So, if you now have a balance sheet with liabilities more or less matching the value of productive assets, it is possible to run this company in a viable manner by a new investor coming in with additional capital infusion, and rescheduling of the sustainable debt.

What is important is that while the NCLT process of accepting references from financial creditors and taking a call to appoint a Bankruptcy Resolution professional is happening fairly fast, developments since then, including the resolution process (including debt haircuts) getting quickly implemented, changes in ownership/ management, if any, getting effected, etc., are to be seen. It is early days, and it is only hoped that this last weapon used by the Government, RBI and the Banks will succeed.