Global Economy

Though some of the advanced economies' (AEs) lost some momentum, the US is expected to grow at 2.9% for 2018 up from 2.2% in 2017 outpacing AEs growth rate of 2.4%. US monetary and fiscal policy, escalating trade conflicts, geopolitical tensions, crude price volatility with supply disruptions have clouded the near term outlook. US federal funds rate increased to 2 - 2.5% from 1 - 1.25% from a year ago. Growth projections have been revised down for Europe. Asian countries are also projected to experience weaker growth in 2019 in the aftermath of the recently announced trade measures. The growth prospects of many energy exporters have been lifted by higher oil prices, but moderated in some importers. Crude oil prices surged by 24% in the current year so far on geopolitical tensions relating to expected US sanctions on Iran. Supply disruptions in Venezuela, Libya and a robust demand for crude are expected to exacerbate the situation. Despite the pressures, global economic growth is projected at 3.7% for 2018 and 2019 as projected by IMF.

Domestic Economy

Global trade uncertainty, rising energy prices and strengthening US dollar have impacted our economy as well. But, due to reasonably sound domestic fundamentals relative to its peers, the economic activity has continued to exhibit resilience and stability. RBI expects real GDP growth to improve from 6.7% in 2017-18 to 7.4% in 2018-19, despite unfavorable conditions. The medium-term growth prospects remain strong, with expansion in manufacturing activity, better agricultural growth and 3.5% higher food grain production for 2017-18 compared to last year.

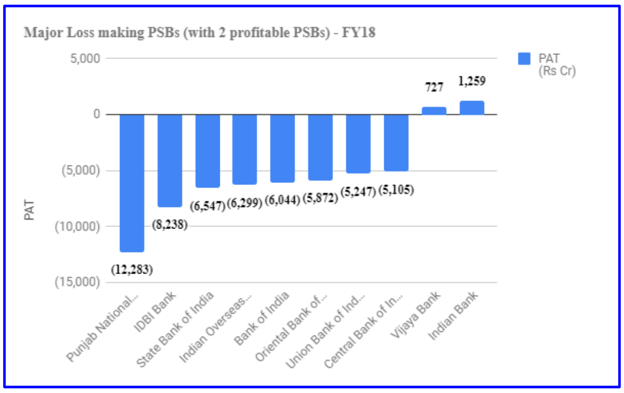
IIP accelerated to 4.3% in August 2018 on a y-o- basis, and 5.2% in the fiscal year so far on a cumulative basis. Consumer durables, Capital goods, infrastructure and construction sector continued to show good growth paving way for better prospects for overall industrial growth. RBI's MPC effected two policy rate hikes in June and August. September inflation at 3.77% was below the RBI's target rate of 4.0%. The food price inflation in the recent few months has been benign. Inflation is, expected to rise on account of spike in global crude oil prices. Strong demand for dollar, rising energy bills have exerted pressure on rupee; thus, building inflationary pressures.

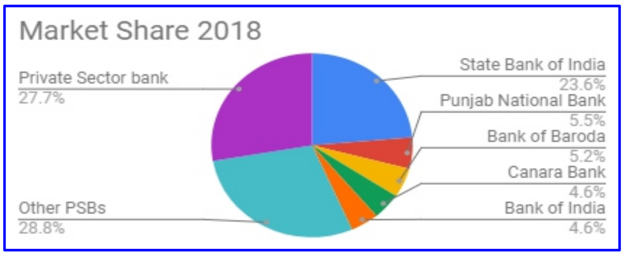
The systemic liquidity is in surplus mode due to increased government spending. Advance tax outflows and RBI forex interventions had created a deficit recently. Total credit growth - September 2018 grew by 12.5% to Rs 89.8 trillion. Credit flows from banks gathered momentum, and broad-based even as banks increased lending rates. Improving credit offtake, the process of recapitalization of public sector banks and resolution of distressed assets under the resolution framework of RBI and IBC gives adequate support for the system to be resilient.

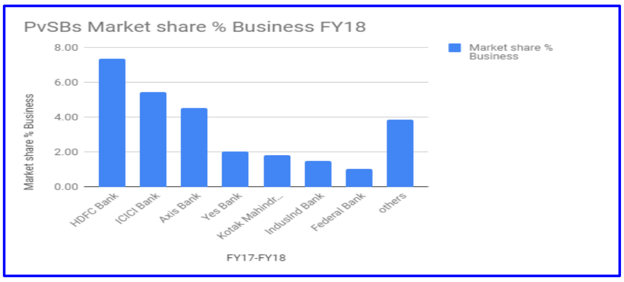
Indian Banking

Profitability

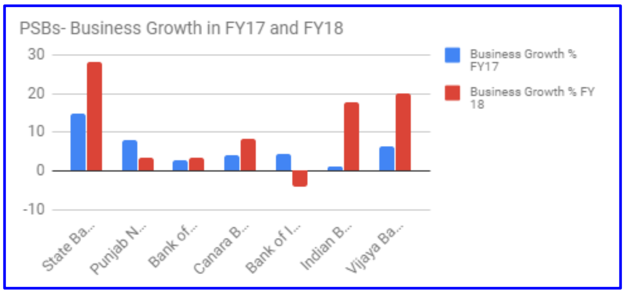
FY 2018 continued to be a stressful year for Indian Banking, with the expected near to medium term recovery of Public Sector Banks (PSBs) not materializing. Due to asset quality woes, combined with a major fraud in Punjab National Bank (~Rs. 13923 Cr), only two banks were able to declare profits (Indian Bank of Rs.1259 Cr and Vijaya Bank of Rs.727 Cr). The combined loss of 19 PSBs was a staggering Rs. 87,715 Crores, with PNB and IDBI Bank heading the table.



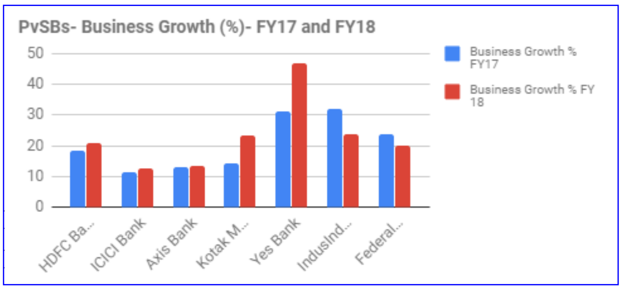




Market Share of PSBs in total business (Deposits + Advances) continued to slide and was at 72.28% (73.53 % PY) compared to 27.72% (26.47% PY) in FY 2018 for PvSBs in FY 2018 . While the slide was just around 138 basis points year-on-year, the PvSBs were seen growing at rates about 2 times that of PSBs, in both deposits and advances. Among PSBs only the two profit making banks grew at double digits, with 8 others actually shrinking.



Among PvSBs, Yes Bank grew at a phenomenal 47%, while a large bank like HDFC Bank, the second largest bank in the country, growing grew at a respectable 20.8%. This trend of PSBs ceding space for PvSBs, is likely to continue in FY 2019 as well. The new type of banks like Small Finance Banks of the Payment Banks did not make much impact on the overall scenario.



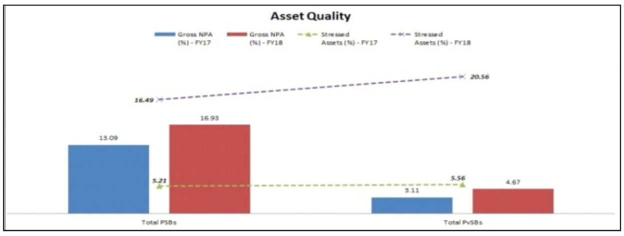
Companies, which registered growth of 21.2% and 22.9% respectively. These companies were dominant players in extending Commercial Vehicles/Auto Loans, Home Loans, Construction Finance for Real Estate Developers, and Business Loans for SMEs and mid-sized business segments through mortgaged based products (like Loans against Rental Discounting, LAP or other similar products). So it is clear that the credit space vacated by PSBs due to problems of their own, was occupied partly by PvSBs and partly by NBFC/HFC sectors. While some of the PvSBs also started showing signs of stress (both among new and older private banks) due to asset quality issues, non-banking financial sector has not shown any signs of problems so far. Loans to Real Estate Developers and SME loans provided more on security cover and less on business viability, are areas to watch.

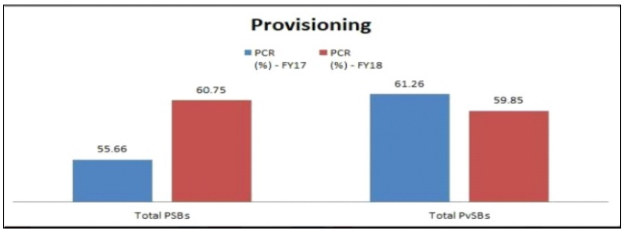
Ultimately, a bank's ability to grow business is significantly influenced by Capital Adequacy Ratios (CRAR, with all its components), and this came under stress for many PSBs, despite infusion of additional capital by many banks. Another interesting development was about the servicing capability of the AT1 Bonds which these banks had raised, and suddenly, in Q4 FY18 many weak banks hurriedly announced full redemption of AT1 Bonds. More discussion on this topic later.

Asset Quality

Total Gross NPAs of Scheduled Commercial Banks touched the figure of Rs.9.73 lac Crores as of FY18 (Rs. 7.90 lac Crores in FY17), accounting for 11.5% (10.4% in FY17) of Gross Advances of Rs.84.79 lac crores in FY18. (FY17: Rs.76.05 lac Crores). As in the past, most of these were in credit to Infrastructure (Power, Roads & Highways and Telecom), Metals, EPC Contractors, Textiles and other manufacturing sectors. (Gems & Jewellery sector also figured prominently, more due to the fraud perpetrated by two groups to several banks, most notably Punjab National Bank). The Banks had previously tried tools like CDR, 5/25 scheme, SDR and S4A, and apparently, none of these were found to be effective. Reasons are not too far to seek. In most of these schemes, the quantum of debt was not getting altered much, vis-à-vis either the asset values or the potential EBITDA.

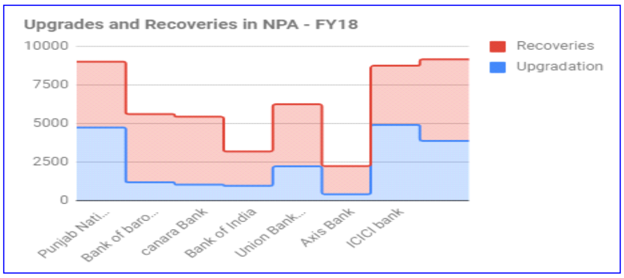
The February 12, 2018 circular of RBI came as a bolt from the blue to most large defaulters, where all the previous unimplemented schemes or failed restructurings got abolished, and a viable 'Resolution Plan' was to be implemented within a specified time-line. Such plans essentially involved in realigning the sustainable debt to asset value and/or potential EBITDA, and thus was more likely to succeed. RBI also mandated an external vetting – by insisting on an independent TEV Report, besides a Resolution Plan Rating by External Credit Rating Agencies. While these guidelines were well intentioned and quite practical, it resulted in the banks unable to restructure any debt in Q4 FY18; thus most banks declared bad results for the quarter, which also influenced income and profits/losses for the full year.





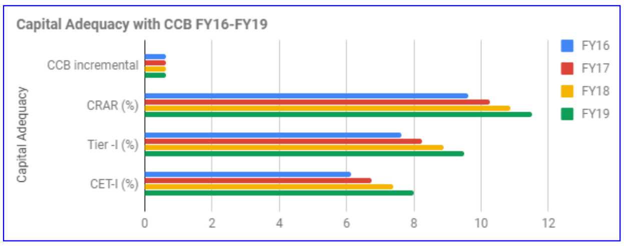
In this connection, it is worthwhile to look at the success or otherwise of the Resolution Plans under the Insolvency & Bankruptcy Code, which had started from November 2017. Some of the successful resolutions were in heavy industries like Steel and Cement, where there were productive assets, and the markets had improved. Quite a few cases are under various stages of resolution, and we can expect them to be finalized before end of FY19, including the big case of Essar Steel Ltd. While the Road segment is going through the route indicated by NHAI like surrendering concessions, the whole process of Arbitration and payment is slow and not providing relief to the borrowers or banks. This needs speeding up. Similarly, a large number of Power Assets without coal linkages or PPAs are languishing, despite banks working out some plans; they are not passing the benchmarks put up the Rating Agencies. It is suggested that large State Power Utilities, including the likes of NTPC, NHPC, GUVNL, etc., have a role to play. Most EPC contractors, who have no meaningful assets to back their liabilities, are getting simply liquidated.

Apart from recovery through Resolution Plans, many banks have sold their assets, generally after making good provisions, to Asset Reconstruction Companies. As of June 30, 2018, SCBs subscribed to Security Receipts amounting to Rs. 57,951 Crs. It is also observed that many ARCs are successful in selling underlying assets or working out OTS schemes, and redeem the SRs early. Not much success was visible in Resolution plans based on revival of manufacturing industries.



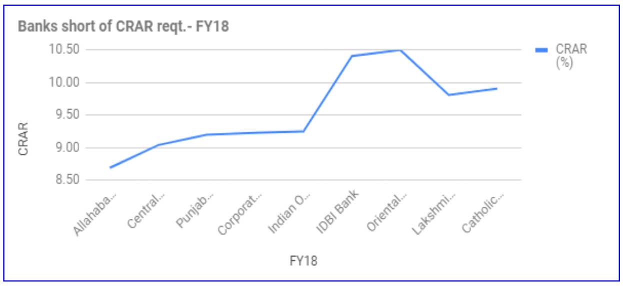
This takes us to the topic of low credit growth in PSBs. As many as 11 PSBs are under Prompt Corrective Action frame-work, and have issued very strict guidelines for extending fresh credit or enhanced facilities to their existing borrowers. As a consequence, better borrowers are shifting to other banks, and what would remain with them would be weak borrowers. A concentration of weak borrowers will further exacerbate their problems. As allowing a PSB to fail is not an option, these stringent guidelines for credit growth needs a review.

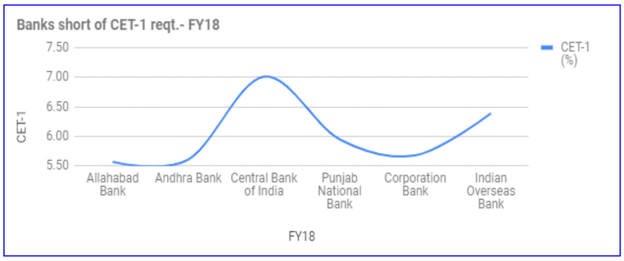
Capitalisation



This is presently a serious issue for many PSBs, with as many as 7 below the minimum CRAR level as of FY18. 6 PSBs were below CET1 requirement. Government of India had pumped a total of Rs. 88,100 Crores as equity, and in addition the banks had raised AT1 bonds to the extent of Rs. 60,385

Crores. The 11 PCA banks account for Rs 21,000 crore of AT-I bonds. However, the utility of AT1 bond as a component of CET1 for weak banks got exposed in Q4 FY18. Many banks were not eligible to service the coupon on the AT1 bonds, as they were not generating profits, did not have surplus from previous years, and hence, were required to skip the payment. That would not be a default as per terms of AT1 paper. However, sensing distress in the markets if such a thing were to happen, and considering need for such papers in future, Govt of India subscribed to additional capital, and with special permission of RBI, allowed these banks to fully redeem these papers prematurely, citing 'regulatory call option'. Thus, Bank of India, Corporation Bank, United Bank of India and UCO Bank paid off the AT1 bonds during the March – May 18 period.





For FY19, the Govt of India may still have to pump in significant capital, despite plans to merge some banks and rationalize the capital requirement.

Fraud in Punjab National Bank

One of the stunning incidents in FY18 was the Rs. 13,929 Cr fraud perpetrated by Nirav Modi and Geetanjali group (Mehul Choksi) companies on Punjab National Bank, through the 'Letter of Undertaking' route. It is reported that large LOUs were issued on behalf of PNB, without actually accounting for them in PNB's books, and based on such LOUs, various Indian Banks operating abroad provided funds to Nirav Modi or Geetanjali group companies, and thus syphoned off the money. Apart from the amount itself being a staggering figure, the fact that this was going on for several years without being found out through internal checks and audits, was shocking. Later the root cause was traced to SWIFT and CBS (Core Banking) Issues), apart from human failure.

This brings us to the broad subject of mastery of PSBs over technology. PSBs, which were rather slow in adopting technology for their operations, introduced Core Banking System, some-time in the mid-90s or around the year 2000. Top managements of the PSBs, which had come up during no technology or low technology eras, did not have the vision to assimilate the technology and make the best use of it. They simply used it to reduce customer facing staff, without fully appreciating the new Operational Risks, back-office problems and even normal customer service issues. Private Banks managed it much better. Thus, in PSBs, they are still struggling with ATM frauds, unauthorized transactions, poor internet banking experience, etc. Moving away from branch banking to centralized operations, they were unable to handle shifting of risks outside their traditional locations, and did not introduce a differentiated control system. Their Internal Audit System, which is supposed to be a combination of Risk-based audit, concurrent audit and credit audit – has not been as effective as it is required. A fresh Enterprise wide Risk Management approach is called for.

Merger of Banks

Govt of India, with rotating Secretaries of Financial Services, has not come out with any 'out of box' strategies in managing the problems.

While lot of debate had happened previously on reduction in the number of PSBs, the only action visible was the merger of Subsidiaries of SBI with itself, which came into effect from 1st April 2018. LIC getting control of IDBI Bank was an important development. The next announcement has happened in September 2018, proposing merger of Dena Bank and Vijaya Bank with Bank of Baroda. At a broad level, this merger appears well thought out, and basically rescue Dena Bank. The combined entity will also have better foot-hold in the South. The business numbers of the 3 banks is given below:

Parameters	Baroda Bank	Vijaya Bank	Dena Bank	Merged Entity
Total Business(Rs cr)	1029810	279575	172940	1782325
Deposits (Rs cr)	581485	157325	103020	841830
Gross Advances (Rs cr)	448330	122350	69920	640600
Employees	56360	15875	13440	85675
Branch (Domestic)	5502	2130	1858	9490
Deposite/Branch (Rs cr)	106	74	55	89
Advances/Branches (Rs cr)	81	57	38	68
RoA(%)	0.29	0.32	-2.43	-0.02
CET-1 Capital Ratio (%)	9.27	10.35	8.15	9.32
CRAR Capital Ratio (%)	12.13	13.91	10	12.25
NetNPA (%)	5.4	4.1	11.04	5.71
CASA Ratio (%)	35.52	24.91	39.8	34.06

Management

Brickwork Ratings firmly believes that leadership plays an important role in management of banks, especially in times of stress. While PvSB chiefs have stayed in their position for long periods, the tenor of PSB chiefs has been, on an average, less than 3 years. The Executive Directors (who are full time members of the Board as well) is even less, at around 2 years. This has unsettling effect on decision making, including business strategies, turnaround plans, investments/disinvestments, etc. Added to this is the challenge posed by vigilance enquiries, consequent coercive action, suspension, etc. There has been a hue and cry on this topic for many years and even the Finance Minister has spoken about it, but nothing concrete has happened on the ground. For a person to become a PSB chief, he would already be there in the system for more than 30 years, and his track record is open to all the relevant agencies. Having become the CEO at the last stage of his career, and later being accused of either incompetence, corruption or gross negligence – is rather surprising. There is an urgent need to resolve this issue. Professional judgement issues should not be a matter of criminal investigation, and only corruption or collusion with an errant borrower can attract such a provision. Otherwise, nobody will take any decisions, and the whole system will get paralysed. Further, ; more than anything else, the CEOs should have a tenue of at least 5 years, so that there is stability in managing affairs of the banks.

PvSBS				
No	Bank	MD & CEO	Since	To
1	ICICI Bank	Ms.Chanda Kochhar	2009	2018
2	Axis Bank	Ms.Shikha Sharma	2013	till date
3	HDFC Bank	Mr.Aditya Puri	1993	till date
4	Kotak Bank	Mr.Uday Kotak	1995	till date
5	Yes Bank	Mr.Rana Kapoor	2003	till date
6	Federal Bank	Mr.Shyam Srinivasan	2010	till date

PvSBS				
No	Bank	MD & CEO	Since	To
1	State Bank of India	Ms.Arundhati Bhattacharya	2013	2017
2	Bank of India	Mr. Melwyn Rego	2015	2017
3	Bank of Baroda	Mr.S Jayakumar	2013	till date
4	Union Bank of India	Mr.Arun Tewari	2013	2017
5	Canara Bank	Mr.Rakesh Sharma	2015	2018
6	Punjab National Bank	Ms.Usha Ananthasubramanian	2015	2017
7	Indian Overseas Bank	Mr. R Koteeswaran	Dec 2014	June 2016

Conclusion

While the situation definitely seems gloomy, there are ways of managing the situation. After all most of the PSBs are centuries old, have witnessed the two World Wars, four major wars of India with its neighbors, seen a melt-down of India's forex reserves, faced the ripple effects of 1997-98 South East Asian financial crisis or 2008 crisis in US and European banks. While it is true that their institutional culture is not the same as was the case 20 years age, still they do have a reasonably knowledgeable and hardworking work-force and a management eager to salvage their reputation. So, let us start.

Firstly, the Bank boards are to be strengthened – currently, that is the weakest part of a PSB. All the executive members (whether Chairman, Managing Director or Executive Directors) should be from within the same bank, with some exceptions. This was the case for almost 25 years post nationalization, and is the system that prevails in State Bank of India, even today. So, let all the PSBs have top executives from within, so that they bring in the institutional memory of borrowers, employees, systems and challenges. Other non-executive members of the Board should be professionals of high integrity, coming from regulatory, legal, accountancy, capital market or other similar background. It would be best to allow the Bank boards themselves to decide on this. This will also help in insulating the banks from political interference in credit decisions, or other day-to-day management issues.

Second, Corporate Lending of Long Term variety should be significantly reduced, as the Private Sector Banks have done. Either Long Term lending institutions should come in or the bond market should be made attractive. Whatever Project Loans the PSBs give, should be on the condition that Debt : Equity Ratio for these projects is brought down steeply from current levels. If the project risks are high, then the promoters' skin in the game should also be more. Total Interest Bearing Debt (including working capital) to Tangible Networth Ratio should be capped at a conservative level. Any indicator solely linking the quantum of loans to future profitability should be viewed skeptically. Promoters will cry hoarse over this, but tough luck! They should approach Venture Capitalists or Private Equity investors, and not bankers for this.

Third, Risk Management should be the mantra in the banks, and a fresh Enterprise Wide Risk Management study should be conducted, especially focused on technology, application software being used, their integration, centralization, controls and audits. Every bank should have two Senior Risk Officers, one for handling Credit and Market Risk, and another for all other risks, including Technology & Operational Risk.

And finally, RBI as a regulator, should deal with all PSBs the same way as it deals with private banks. Amendments required for this purpose should be immediately introduced. After all, oversight can't fall in the gap between RBI and the Finance Ministry!