Public Sector Banks under siege - The Road Ahead

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It is not the best of times for Public Sector Banks (PSBs) or Public Sector bankers. Every report that is published, be it the Financial Stability Report (FSR) of RBI, the CRISIL or CARE report, the Credit Suisse report, or the numerous articles appearing with increasing regularity, paint a grim picture.

The FSR foresees the banks' gross non-performing assets (GNPA) ratio ballooning to 12.2% in March'19 from 11.6% in March'18. Once stressed assets are added this could rise to 14.3% of total loans. Roughly 90% are in the books of the PSBs. 11 of the 21 PSBs are under RBI's Prompt Corrective Action and all but 2 reported losses during the last financial year. There is a danger of some PSBs' capital adequacy ratio deteriorating below regulatory norms.

The reasons cited for the current situation are many - slowdown in the economy adversely impacting highly leveraged corporate balance sheets, diversion of funds, stuck infrastructure projects due to lack of environmental clearances, timely non-availability of land from Govt., directed lending, external factors, coal block cancellations, lack of risk assessment and credit skills in banks, etc. All of these have some element of truth. However, this situation did not develop over a year or two but has been building up. It is our collective inability to recognize and take timely corrective action that has brought us to the current sad impasse.

The task of cleaning up the banks' books is no doubt herculean. The quicker we are able to resolve the situation the faster would be the path to economic revival.

Given the magnitude of the problem, where stressed assets comprise around 10% of the country's GDP, there can be no simple solution. The solutions implemented elsewhere in the world will not be appropriate as each country differs in its level of development, NPAs to GDP ratio and other macro-economic indicators. The Government, the Regulator and the banks are working together to find solutions. However, it has to be recognized that there will be a negative impact on the GDP in the short term before the position normalises.

This Government has shown the will and the determination to take hard decisions and implement them in a time bound manner. It has passed the Insolvency and Bankruptcy Bill (IBC) in a record time of 13 months, which will prove the single most effective vehicle for resolution of NPAs in banks. Shortly thereafter, RBI directed banks (in June 2017) to refer 12 largest NPAs, comprising almost 25% of GNPAs, to National Company Law Tribunal (NCLT). A few of these already stand resolved and in many instances the resolution did not involve liquidation of assets with consequent loss of value and jobs. In Dec.'17 RBI issued a 2nd list of 28 accounts, with approximate exposure of Rs 1.82 lakh crores. With this, nearly Rs 4 lakh crores in bad loans would be referred to NCLT under RBI directions. For the first time pressure is on defaulting promoters to either clear their dues or lose their assets. At the same time banks will have to make substantial sacrifices while moving on to more disciplined lending practices.

The tough stand taken by RBI, vide their circular of 12th February 2018, has to be appreciated as all existing guidelines for dealing with stressed assets, including various schemes of restructuring, were substituted with a simplified generic framework .The guidelines require banks to report all default accounts of Rs 5 crores and above to a Central Repository of Information on Large Credits (CRILC) at weekly intervals, which will bring in greater transparency and full dissemination of information. It also requires banks to resolve overdue accounts within 180 days, after which a reference has to be made under IBC, with a maximum period of 270 days for implementation of a plan. The fact that the resolution plan for larger accounts needs an opinion from a Credit Rating Agency approved by RBI, for the residual debt, makes the process transparent and gives confidence to bankers. All NPAs over Rs 2000 crores have to be resolved in this manner even if they are under any existing restructuring scheme. For far too long corporates had flouted financial discipline and had used the restructuring routes for camouflaging toxic assets, at times abetted by the bankers and under an umbrella of apparent regulatory forebearance. It will also enable banks to transit smoothly to IND AS under which they will have to provide for entire "expected credit loss" as soon as an asset is stressed.

The seriousness with which the Government is addressing the issue can be gauged by the speed with which they accepted the recommendations of the Mehta Committee (Project Sashakt). Financial institutions are currently in the process of signing a legal inter-creditor agreement to authorize the lead bank to implement a resolution plan within 180 days for all stressed assets between Rs 50-500 crores. Due to predefined terms this is expected to expedite the process, especially as it covers all lenders, both public and private sector. This should also ease the pressure on NCLTs.

For stressed loans over Rs 500 crores (estimated at Rs 3.1 lakh crores spread over 200 or so accounts) the Committee has suggested setting up an Asset Management Company(AMC), backed by Alternate Investment Fund(s),(AIFs) which will buy stressed assets. The AIFs would raise funds from the banks as well as from Institutional Investors. The AMC is expected to focus more on turnarounds rather than on asset stripping and liquidation. It will be able to hire skilled personnel from the market, which is important, as investment banking skills are generally not available with the PSBs.

The banks will have to move speedily to operationalize the AMC/AIFs. It would enable them to clean up their balance sheets and also to participate in any upside in the future. Going forward, there is a need to establish a vibrant secondary market for stressed assets. This will enable market driven price discovery.

Resolution of stressed assets alone will not be sufficient for the PSBs to come out of the current morass. They require substantial capital infusion .While the Government has announced a package, it is likely to fall short of requirements and other avenues have to be found. Till they emerge stronger PSBs may have to tweak their business strategies to focus on products and services which require less capital or those which are capital accretive.

The current dismal valuations do not make privatization a viable option at the moment. Once the balance sheets have been cleaned up the Government may consider the matter. The ownership structure of PSBs has led to several inefficiencies, particularly lack of leadership development and HR planning, disempowered boards, little incentive to top management for innovation, lack of credit and risk management skills and decision paralysis due to the vigilance machinery foisting unrestricted culpability on any credit delivery process. Building an arms length relationship between ownership and management is desirable, not only in the financial sector but in all sectors.

To safeguard against a recurrence of the current situation and to build long term sustainability the PSBs need to go back to the basics of banking and to:

- Strengthen risk and credit appraisal skills and credit monitoring skills. Expose staff to skill upgradation programs at periodic intervals.
- Build more robust concurrent and internal audit processes. Audit departments are commonly staffed with demotivated employees. Managements have to consciously work to reverse this. Auditors should be trained to identify red flags of incipient sickness and potential frauds, at initial stages itself, so that timely remediation can prevent losses.
- Recruit laterally, if necessary, for specialized skills like risk management and new technologies.
- Digitalize to remain relevant in an age where competition is not only from banks, NBFCs or other financial services companies, but also from fintechs,, P2P platforms and on-line payment providers. Besides reducing costs this will lead to robust data analytics and improved customer relationship management capabilities. Safeguarding against cyber attacks and skilling employees on the new technologies would be two key challenges.

Most important of all is that the banks need to build a healthy and credible leadership pipeline.