ASSET QUALITY OF INDIAN BANKS IN 2013-2014 - A BIG CHALLENGE

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Abstract: *As per RBI norms, loans on advances given by the Banks become non-performing when interest and/on installment of principal remains unpaid on overdue for more than 90 days. Loans on advances which do not generate any income and which are doubtful of recovery badly affect the health of the Bank and also hampers the very vital function of Banks viz. mobilization of savings, deposits, bonds etc. and providing loans/facilities of Borrowers. No country in the world can have a healthy economy if the quality of Banking assets is weak and Bad. The asset quality the Banks become weak and Bad due to its non-performance and unable to generate income. Deterioration in asset quality continues to be the major factor impacting profitability of banks in the near future. It is estimated that the overall Gross NPA ratio for the banks under study would be around 4.5% by March 31, 2014 with higher proportion coming from PSBs whose Gross NPA ratio is estimated to rise to around 5%. Further, banks will have to provide more for restructured assets as per the RBI's guidelines. Indian banks would require capital infusion at regular intervals to maintain their credit growth as well to maintain adequate cushion to withstand asset quality pressures and comply with Basel III norms. This coupled with the sharp rise in NPAs necessitates the Government of India (GOI) to infuse capital in PSU banks. The continuing pressures on asset quality and profitability are the major challenges faced by the Indian banking sector.*

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INTRODUCTION

The non-performing Assets hit banking sectors in several ways. Not only banks lose income on these advances but they also have to incur heavy recurring expenditure by way of provisions to maintain them in their Banks as per RBI guidelines. Banks have to ensure adequate capital, maintain reserve requirements, pay interest on deposits on time and demand liabilities, incur legal and other expenses, make provisions on loan losses and above all maintain an image as if nothing has gone wrong with the inherent strength and fundaments of Bank.

High NPAs and limited ability to raise capital due to falling valuations and the Govt's inability to put in money pose serious problems to Indian Public Sector Banks. Meanwhile, the problem of bad loans is rapidly increasing. Gross non-performing assets (GNPA) of 26 PSBs stood at ₹ 1.64 lakh crore at the end of March 2013 which was equivalent to 43 per cent of the PSBs net worth. At the end of December 2013, the GNPAs had soared a whopping 38 percent to ₹ 2.28 lakh crore. That's an increase of about ₹ 64,000 crore.

This Adam Samith quote sums up the role of the banking sector in the economy. "It is not by augmenting the capital of the country, but by rendering a greater part of that capital active and productive than would otherwise be so, that the most judicious operations of banking can increase the industry of the country".

Using Public Sector Banks (PSB) to promote the government's agenda might be considered acceptable, but the government should be able to recapitalize them, too. In a recent report, Moody's estimates that recapitalisation for the year 2015 would be at ₹ 22,500-36,000 crore, against the allocated ₹ 11,200 crore in the interim Budget. Senior bankers estimate that the required recapitalization in the next three years would be more than ₹ 2 lakh crore. Unfortunately, by earmarking substantially low amounts, the government is clearly telling PSBs that it is incapable of recapitalizing them.

"In August, 2013 the Reserve Bank of India (RBI) had estimated Indian banks, both public and private, would need equity capital of ₹ 1.65 lakhs crore of which ₹ 1.43 lakh crore would be required by PSBs. To maintain its current shareholding in PSBs, the government will have to contribute ₹ 90,000 crore to their equity capital and about ₹ 66,000 crore for 51 per cent shareholding.

Any rational government will have to decide to reduce its stake to contribute to capital-raising and bring about professional managements, something they are quote afraid of for obvious reasons. Clearly, bad loans are impacting capital-raising. Recently, a qualified institutional placement (QIP) by State Bank of India, barely managed to sail through. Following this, other PSBs that had lined up QIPs to boost capital adequacy postponed these offerings. Alpesh Mehta, banking analyst at Motilal Oswal, pointed out that "Raising money through QIPs is not going to be easy, as there is no appetite for PSB stocks. Investors are not sure how much longer the bad loan problem will last". .

MEANING OF ASSET QUALITY

As per RBI norms, loans on advances given by the Banks become non-performing when interest and/on installment of principal remains unpaid on overdue for more than 90 days. Loans on advances which do not generate any income and which are doubtful of recovery badly affect the health of the Bank and also hampers the very vital function of Banks viz. mobilization of savings, deposits, bonds etc. and providing loans/facilities of Borrowers. No country in the world can have a healthy economy if the quality of Banking assets is weak and Bad. The asset quality the Banks become weak and Bad due to its non-performance and unable to generate income.

With Indian banks transitioning to the new Basel-III norms, the need for growth capital has become even more critical. Globally, Basel-III norms requires total capital of 10.5 per cent including a buffer of 2.5 per cent. But RBI has mandated for Indian banks, the capital should be 100 basis points higher-they will have to maintain a capital adequacy of 11.5 per cent and a capital conservation buffer of 2.5 per cent. The domination of PSBs, with 73 per cent market share of assets and 83 per cent of the branches, means more capital requirements. If these aren't met, the PSBs will have to stop lending.

ASSET QUALITY OF INDIAN BANKS AS ON 30.9.2013

Based on secondary data, the study covered 39 banks, namely, 26 Public Sector Banks and 13 Private Sector Banks.

As per the Central Statistical Organization (CSO), the GDP growth stood at 5% in FY13 as compared to 6.2% in FY12 with growth in most sector being lower than earlier presented advance estimates of GDP. The manufacturing sector showed stagnated growth (0.1%) on account of slackened demand conditions both in domestic as well as global markets, high borrowing costs and overall dull investment scenario in the country.

The environment of overall subdued economic activity continued to impact the banking sector as weakening of corporate top-line resulted in deceleration in credit and deposit growth and in turn impacted their profitability indicators. The banking sector has also seen marked deterioration in its asset quality during FY13 with significant rise in Non Performing Assets (NPAs) and restructured advances.

Quality of assets of Indian Banks

High interest and show down overall economy has affected the debt repayment capacity of the borrowers which has put pressure on the asset quality of banks during 2013. A study of performance of 39 banks have been carried out for the year 2013. The Gross NPAs of the banks under study showed an increase of 38.11% (year on year) as on 30.9.2013 vis-à-vis credit growth of 17.96% (Y-o-Y) during the same period. The NPAs of the Public Sector Banks (PSBs) saw an increase of 41.41% while that of the private sector banks was comparatively lower at 12.91%.

Overall Gross NPA ratio has sequentially risen from 2.79% as on March 31, 2012 to 3.26% as on March 31,2013 to 3.98% as on September 30, 2013.

On comparing the asset quality of PSBs vis-à-vis private sector banks, it can be observed that PSBs have witnessed higher deterioration in asset quality than their private sector peers. The Gross NPA ratio for PSBs stood at 4.47% (March 2013: 3.59%) as compared to 1.955 (March 2013: 1.86%) for private sector banks as on September 30, 2013.

TABLE I

Status of overall NPA position of Banks in India as 30th Sept., 2013

	Overall			Public Sector Banks			Private Sector Banks		
	31.03.12	31.03.13	30.09.13	31.03.12	31.03.13	30.09.13	31.03.12	31.09.13	30.09.13
Gross NPA Ratio	2.79	3.26	3.98	2.98	3.59	4.47	1.96	1.86	1.95
Net NPA Ratio	1.04	1.71	2.27	1.18	2.00	2.67	0.36	0.36	0.61
Net NPA/Net Worth	13.04	16.39	20.91	17.54	22.39	29.26	2.70	2.97	3.39
Rest. Advances/Net Advances	5.38	6.03	6.47	6.24	7.05	7.61	2.02	1.71	1.76

Source: (RBI website) www.rbi.org

In addition to higher NPAs, the PSBs also had a large amount of restructured advances which stood at 7.61% of advances (March, 2013: 7.05%) as on September 30, 2013. There is every possibility that the restructured advances would turn into NPAs soon.

The restructured advance as a proportion of advances stood comparatively lower at 1.76% (March 2013: 1.71%) for private sector banks as on September 30, 2013. An industry-wise analysis of NPAs shows that the major industries which have been putting pressure on asset quality are infrastructure (especially power), iron 7 steel, textiles and aviation.

Rise in restructured assets

The banks continued to see rise in restructured advances during the year ended 31.3.2013 and half year ended the 30th September 2013. The restructured assets the banks under study increased to Rs. 3.6 trillion as on September 30, 2013 from Rs. 3.4 trillion as on March 31, 2013. The restructured advances as a proportion of advances stood at 6.47% as compared to 6.03% as on March 31, 2013 (March 31, 2012: 5.38%).

A study of the industry-wise distribution of the restructured accounts for 10 banks revealed that infrastructure, Power, Iron & Steel, Textiles and Aviation Industries accounted for approximately 60% of the restructured assets outstanding as on September 30, 2013 (March, 2013: 59%). Following table gives the industry wise restructured assets outstanding.

TABLE IA

Industrywise outstanding Restructured Assets as on 30th Sept., 2013

Industry	Amount (Rs trillion)	(% share)
Infrastructure (including Power)	0.77	36.63
Textiles	0.19	9.24
Iron and Steel	0.18	8.54
Aviation	0.11	5.29
Total	1.26	59.71

An analysis of the progress report of the Corporate Debt Restructuring (CDR) Cell during the period March, 2013 and September, 2013 shows that the major sectors where maximum cases of restructuring have been approved are iron & steel, infrastructure, textiles and power. The following table shows the amount approved under CDR for the top four industries as on various dates and their percentage share in the total amount approved for CDR.

TABLE II

Restructured amount approved by CDR for top four Industries as on 30th Sept., 2013

Industry	31 Mar 13 Rs. Crore	% Share	30 Jun 13 Rs. Crore	% Share	30 Sep 13 Rs. Crore	% Share
Iron & Steel	52,682	23.00	53,543	21.39	41,812	21.30
Infrastructur	21,912	9.60	34,676	13.85	35,543	18.11
Textiles	17,767	7.80	20,662	8.26	19,545	9.96
Power	18,460	8.10	18,460	7.38	17,225	8.78
Total	229,014	100.00	250,279	100.00	196.267	100.00

source:RBI

Total amount restructured under the CIR mechanism increased to Rs. 250279 Crores by June 2003 as compared to Rs. 229014 Crores as on March, 2013. However, the amount of restructured debt under CDR declined to Rs. 196261 Crores by September, 2013 due to certain accounts exiting due to successful performance in the CDR package and certain accounts getting withdrawn on account of failure. The total number cases declined from 401 as on March 31, 2013 to 261 as on September 30, 2013. The infrastructure sector saw stress mainly during H1FY14 with the amount under CDR increasing by 62% as on September 30, 2013 compared to March 31, 2013.

Some revival in credit growth

As per RBI publication, the credit growth for scheduled commercial banks (SCB) in India saw a decline in credit growth to 14.1% for FY13 as compared to 17% for FY12. A slowdown in the overall economy, risk aversion by banks due to rise in quantum of bad debts and regulatory bottlenecks affecting infrastructure sector led to the moderation in the credit growth.

During H1FY14, the banks saw some revival in credit growth at 17.70% (y-o-y) to reach outstanding credit at Rs. 56.7 trillion as on October 04, 2013. Credit growth was observed in all the major subsectors, barring engineering, construction, and mining & quarrying. The RBI’s liquidity tightening measures resulted in spike in interest rates in the money market resulting in the corporate shunning the CP market and approaching banks for their funding requirements. This led to higher credit growth in September, 2013.

TABLE III

Total Credit for Scheduled Commercial Banks and year on year growth for 2 years ending 30th Sept., 2013

Industry		Y-o-Y Variation %		
	31 March 12	31 Mar 13	30 Sep 12	30 Sep 13
Infrastructure	19.8	16.5	16.4	20.6
Of which power	23.1	26.4	22.0	26.3
Of which Telecommunications	(6.2)	(5.5)	0.0	0.4
Of which Roads	20.0	18.8	23.0	16.7
Textiles	10.4	16.2	14.3	14.4
Metal & Metal Products	25.0	20.7	18.6	21.1
Engineering	21.3	12.9	18.2	16.7
Gems & Jewellery	30.0	18.5	15.9	28.8
Chemicals & chemical products	34.8	26.2	18.5	29.9
Mining & Quarrying	42.2	8.0	17.8	0.6

Source: RBI (www.rbi.org)

TABLE IV

Credit growth of Public & Private Sector Banks in India as on 30th September, 2013

The following table shows the growth percentage of credit growth for public sector banks and private banks covered in the study.

	31 Mar 12		31 Mar 13		30 Sep 13	
Advances	Amt (Rs bn)	Y-o-Y growth (%)	Amt (Rs bn)	Y-o-Y growth (%)	Amt (Rs bn)	Y-o-Y growth (%)
Overall	47,791	17.84	55,702	16.55	58,336	17.96
Public Sector Banks	38,795	17.25	45,082	16.21	47,006	18.48
Private Sector Banks	8,996	20.44	10,619	18.05	11,330	15.88

Source: RBI (www.rbi.org)

Moderation in deposit growth continued

The published data by the RBI showed that SCBs recorded a deposit growth of 14.4% during FY13 as compared to 13.4% during FY12. During H1FY14, the deposit growth was at 14.8% to reach Rs. 73.06 trillion as on October 04, 2013.

For the banks covered in the study, the growth in total deposits stood at 15.54% y-o-y in FY13 (FY12:15.25%). Deposit growth marginally declined to 15.30% (y-o-y) in H1FY14. The proportion of low cost Current Account Savings Account (CASA) remained at around 30%-33% as on September 30, 2013**.**

TABLE V

Total Deposit of Public & Private Sector Banks and year by year growth as on 30th Sept., 2013

	31 Mar 12		31 Mar 13		30 Sep 13	
Deposits	Amt (Rs bn)	Y-o-Y growth (%)	Amt (Rs bn)	Y-o-Y growth (%)	Amt (Rs bn)	Y-o-Y growth (%)
Overall	60,881	15.25	70,343	15.54	73,932	15.30
Public Sector Banks	50,020	15.01	57,457	14.87	60,700	15.98
Private Sector Banks	10,861	16.36	12,886	18.64	13,231	12.28

Source: RBI (www.rbi.org)

Financial performance of the Public Sector Banks for the half year ended September, 2013

Pressure on margins and asset quality stress has impacted profitability especially for public sector banks.

Banks

The 39 banks covered in the study showed that the growth in total income continued to show saw sharp moderation to 12.29% (y-o-y) during H1FY13 . The Net interest Income (NII) grew by 10.87% during H1FY14 as compared to 13.73% during H1FY13 due to higher cost of funds and rise in NPAs resulting in reversal of interest income. The banks saw a growth of 26.44% in non-interest income led by treasury income generated in Q1FY14 on account of soft interest rates.

TABLE VI

Financial performance of Public Sector Banks for the half year ended 30th Sept., 2013

Growth H1FY14 (y-o-y)	Total Income	Net Interest Income	Net Profit (PAT)	Non-Interest Income
Category	%	%	%	%
Overall	12.29	10.87	(11.30)	26.44
Public Sector Banks	11.43	6.87	(27.43)	27.41
Private Sector Banks	15.21	23.44	22.85	24.62

Source: RBI (www.rbi.org)

The impact of moderation in credit growth and slowdown in the manufacturing and core sector was largely felt by public sector banks as they were unable to maintain spread in FY13. The Net interest Margin (NIM) for public sector banks declined to 2.58% for FY13 as compared to 2.78% for FY12 and remained at FY13 levels during the first half of FY14.

TABLE VII

Status of net margin & return on total Assets of Public and Private Sector Banks for past $2^1/_2$ year period ended 30th Sept., 2013

Growth (y-o-y)	Net Interest Margin (NIM) %			Return on Total Assets (ROTA) (%)		
Category	FY12	FY13	H1FY14*	FY12	FY13	H1FY14*
Overall	2.86	2.73	2.78	1.01	0.96	0.80
Public Sector Banks	2.78	2.58	2.58	0.88	0.78	0.56
Private Sector Banks	3.17	3.26	3.55	1.52	1.61	1.69

Source: RBI (www.rbi.org)

*annualized

Due to contraction in margins coupled with rise in provisioning (mainly for NPAs) on account of worsening asset quality and rise in operating costs the profitability of public sector banks was impacted. The public sector banks under study reported de-growth of 27.43% in Profit After Tax (PAT) during H1FY14 as compared to growth of 2.16% in FY 13 over FY 12. Public Sector Banks other than the State Bank of India (SBI) group reported de-growth of 28.73% in PAT for H1FY14. However, the private sector banks were able to maintain their margins and asset quality due to which they were able to report a growth of 22.85% in PAT for H1FY14.

The provisioning cost (excluding provision for income tax) for banks under study increased sharply by 56.33% (y-o-y) in H1FY14. Overall provisions for public sector banks increased by 56.98% and for private sector banks the provisions increased by 52.00% for during H1FY14. The provisioning cost as a proportion of Net Interest Income stood at 41.03% for PSBs as compared to 16.08% for private sector banks for H1FY14 indicating credit costs largely impacted the profitability of PSBs.

The operating expenses increased by 21.66% in H1FY14 for the banks under study. The rise in operating costs for PSBs was at 24.21% on account of increase in employee costs as compared to rise of 14.98% for private sector banks. Overall the Cost to Income ratio for public sector banks was 48.94% whereas that for private sector banks stood at 42.91% for H1FY14.

To summarize, the profitability of the public sector banks was largely impacted on account of slowing economy leading to weakening of income profile, pressure on margins and higher provisioning on account of weakening asset quality. On the other hand, the private sector banks continued to show stable growth in income and were able to maintain profitability and asset quality.

Government support to public sector banks required to maintain healthy capital adequacy ratio (CAR) under Basel III

The capital adequacy ratio levels for levels for the select banks continued to be comfortable with strong levels of core (Tier I) capital. The overall median CAR stood at 12.59% as on March 31, 2013 as compared to median CAR of 13.26% as on March 31, 2012.

As mandated by the RBI, Indian banks started computing and reporting CAR under Basel III from quarter ended June 30, 2013. As on September 30, 2013 all the banks under study continued to report CAR in excess of minimum regulatory required of 9%. The median Tier I CAR under Basel III was at 8.73% with the median Tier I CAR for private sector banks being higher at 11.38% as on September 30, 2013 which was higher than stipulated minimum of 6.5% as on March 31, 2014 during the transition phase of fully shifting to Basel III by March 31, 2018.

TABLE VIII

Status of capital adequacy ratio of Public and Private Sector Banks as on 30th Sept., 2013

Category		Median CAR (%)				Median Tier I CAR (%)		
	31.03.12	30.09.12	31.09.13	30.09.13	31.03.12	30.03.13	31.03.13	30.09.13
		Basel II		Basel III		Basel II		Basel III
Overall	13.26	12.41	12.59	11.43	9.45	8.99	9.12	8.73
Public Sector Banks	12.92	12.22	12.10	10.87	8.99	8.57	8.49	8.00
Private Sector Banks	14.00	13.73	14.73	14.64	11.37	11.40	12.05	11.38

Source: RBI

The Basel III guidelines lay emphasis on the quality of bank's capital to provide robustness in order to absorb any shocks arising from financial and economic stress. As a result, there is a higher emphasis on the component of equity and equity-like instruments counted as capital of a bank which form the Tier I component of equity.

Under Basel III, all Indian banks have to maintain a minimum Common Equity Tier I capital of 5.5% excluding Capital Conservation Buffer (CCB) and minimum Total CAR of 9% by March 31, 2018. Over and above the total CAR of 9%, the banks have to build up a CCB of 2.5% by March 31, 2018 and maintain on an on-going basis. The CCB would constitute of equity capital. The banks would be allowed to issue two types of capital instrument viz. Tier I bonds and Tier II bonds which would be classified as part of Tier I capital or Tier II capital respectively.

Tier I Bonds under Basel III have additional loss absorption features and coupon discretion features. The loss absorption feature requires the issuing bank to write-off/convert the bond into equity in case the bank faces financial difficulties and its minimum Common Equity tier I ratio of 6.125% breached or the bank has reached the Point of Non Viability (PONV) as determined by the RBI. Under Basel III, only one category of Tier II bonds are allowed which have loss absorption features by which the instruments can be written-off/converted into equity up on declaration of non-viability by the RBI.

Outlook

A host of factors like slowdown in the overall economy, risk aversion by banks due to rise in quantum of bad debts and regulatory bottlenecks affecting sectors like infrastructure led to the decline in the credit growth for scheduled commercial banks in FY13 to 14.1% from 17% a year ago. As on October 4, 2013, on a y-o-y basis, credit growth stood at around 18% whereas deposits grew around 15%. Credit to industry increased by 17.6% in September 2013 as compared with the increase of 17.0% in September, 2012. Acceleration in credit growth to industry was observed in all the major sub-sectors, except engineering, construction, and mining & quarrying. On the deposit front, growth in term deposits base was low at 13.7% as compared to 17.6% growth in demand deposits as on September 30, 2013. The RBI's liquidity tightening measures resulted in spike in interest rates in the money market, as a result corporate approached banks for their funding requirements shunning the CP market. This led to higher credit growth in H1FY14. However, gradual withdrawal of measures has softened rates in the CP market. This may result in corporate shifting to CP market for funds which would lead to softening of credit growth going forward. For FY14, it is expected that advance growth to be around 13-15% given the GDP growth estimate of 4.9%. With capex plans being on hold the project loan demand is expected to be tepid. It is also expected that the deposit growth to be around 14-15% given that the high level of inflation has impacted the savings ability of people as well as the attractiveness of fixed deposits as a mode of investment.

Slower credit growth leading to weakening of income, pressure on margins and higher provisioning on account of weakening asset quality impacted the profitability of Indian banks. The PSBs saw higher impact on their profitability as compared to private sector banks which were able to maintain profitability and asset quality.

CONCLUSION

Deterioration in asset quality continues to be the major factor impacting profitability of banks in the near future. It is estimated that the overall Gross NPA ratio for the banks under study would be around 4.5% by March 31, 2014 with higher proportion coming from PSBs whose Gross NPA ratio is estimated to rise to around 5%. Further, banks will have to provide more for restructured assets as per the RBI's guidelines. These factors would exert downward pressure on margins and are likely to impact profits for FY14 by around 25%-30% (y-o-y).

The capital adequacy levels for the select banks continued to be comfortable. Indian banks would require capital infusion at regular intervals to maintain their credit growth as well to maintain adequate cushion to withstand asset quality pressures and comply with Basel III norms. This coupled with the sharp rise in NPAs necessitates the Government of India (GOI) to infuse capital in PSU banks. The continuing pressures on asset quality and profitability are the major challenges faced by the Indian banking sector.

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