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A NEWSLETTER OF THE FINANCE LAB

June 2020, Volume 6, Issue 1

INDIAN INSTITUTE OF MANAGEMENT CALCUTTA

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Financial Research & Trading Laboratory

ALUMNI CORNER

Covid-19 impact, will some banks fail?

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As the economy reels under the impact of the coronavirus pandemic, banks are bracing themselves for the multiple challenges they face.

Capital adequacy and asset quality

Banks need capital as a buffer for bad loans. The Basel norms require banks to set aside 10.5% of their risk weighted assets as capital including capital conservation buffer of 2.5%, while the Reserve Bank of India mandates a slightly higher figure of 11.5% (end state). Thanks to massive capital infusion into public sector banks by the government through recapitalisation bonds and direct equity after the NPA crisis, most banks were scoring well on this front, pre Covid-19 outbreak.

With the economy just emerging from a prolonged lockdown on account of the pandemic, banks face mounting losses on their exposure to the MSME segment, unsecured consumer loans, weak NBFC's and Micro Finance Institutions, direct lending to the micro finance segment, real estate financing etc. In addition, while most of the hidden skeletons in the large corporate segment surfaced during the last NPA crisis, the large/mid-sized corporate segment could again pose some shocks to banks.

The Reserve Bank of India, in its last Financial Stability Report, had projected bank NPA's to rise to 10.5 % in a severe stress scenario by September 2020. Such a scenario would not have included the current extreme stress faced by the economy, on account of the lockdown. Even with the lockdown being lifted in stages, exporters face ruin on account of cancelled orders, no new order flows and payment defaults for previous shipments. In addition to demand destruction in both the export and domestic segments, supply chain will take a while to come back to normalcy.

To top it all, there has been a humanitarian crisis, with migrant workers stuck in work places far away from home without salaries and living on food handouts. . Despite attempted acts of medieval cruelty by certain states in stopping their transport back home at the urging of the business lobby, a mass reverse migration has taken place from cities to villages, cutting off a workforce which has sustained manufacturing, service and construction industries.

To provide relief to stressed borrowers reeling under the Covid-19 impact, RBI has permitted banks to provide a three-month moratorium on loan payments, which has been extended by a further period of three months. In line with this, asset classification has been put on standstill during the moratorium period, but with a caveat from RBI that additional provisioning of 10% has to be made for loans under moratorium. Though the moratorium of may be justified from the stressed borrowers' perspective, it merely postpones the day of reckoning for banks. While it is difficult to forecast if the pre Covid NPA level of 9.3% will increase by 50%, 100% or more post Covid, it is almost certain that the accompanying provisions will lead to a massive erosion of bank capital. RBI's projected gross NPA figure of 10.5% by September 2020 in a "severe stress" scenario now appears embarrassingly optimistic in the medium term, unless we see a comeback of the "extend and pretend" culture.

With GST collections hit and possible impact on direct taxes too, and rising expenditure requirement to manage the crisis, the government may struggle to find money for fresh public sector bank capital infusion.

The private sector too may find the going tough despite a comfortable capital adequacy position pre covid-19. A capital issue may arise at Yes Bank which is now a quasi PSU bank, and a common problem child for the banking sector with many private sector banks having participated in its recent SBI led rescue. Yes Bank's capital adequacy ratio of 8.5% on 31 March 2020 is way below the regulatory requirement.

While all is quiet on the small finance bank front, this may just be the calm before the storm. Many of them have reinvented themselves from micro finance companies into banks. The well-oiled collection mechanism that the industry had out in place has ground to a halt, significantly denting recoveries. With their borrowers like daily wage earners and self-help groups in a severe crisis, NPA levels and capital requirement may increase. Whether some of their deep pocketed investors will pump in more capital to protect their existing investments, is to be seen.

Liquidity

With RBI reducing Cash reserve Ratio by 1%, multiple long-term repo operations (LTRO, TLTRO 1 and TLTRO 2.0), and huge increase in government borrowing from RBI through ways and means advances, banking system liquidity has zoomed with Rs 8 lakh crore surplus being parked by banks with RBI. Some bankers claim that with the downturn in business of their industrial borrowers, demand for credit has come down.

Small finance banks would have offered moratorium to their borrowers for six months in line with RBI's approval to do so. This would have hurt their collections with consequent impact on liquidity. It is not clear if the liquidity overhang of the banking system in general, extends to small finance banks as well.

Profitability

With both lending and deposit rates drastically down, the jury is out on the pandemic's impact on net profit margins. However, expect many banks to go into the red, on account of increased provisions for bad loans.

Credit growth and risk aversion

The meltdown at Franklin Templeton's debt mutual fund schemes has seen a dramatic flight to safety in the entire segment with investors exiting credit risk funds in droves.

A similar risk aversion at banks will crimp lending and business growth. A classic example, is the near "boycott" by banks of RBI's TLTRO 2.0 auction meant to provide funds to banks at cheap rates to on lend to smaller MFI's/NBFC's. Banks have been in no mood to lend to weak/small entities, to avoid NPA's down the line, preferring the safety of large, well known corporates. The new package for MSME's announced on May 13, addresses this issue to an extent, with the government guaranteeing Rs 3 lakh crore of incremental lending by banks to MSME's. This is a collateral free and seemingly "no questions asked" facility, though details are awaited. Whether the borrowers will pay back loans on such easy terms or will this contingent liability to the government/tax payer fructify down the line, remains to be seen. The US government has been much more forthright in its fiscal package by stating upfront that the loan will be forgiven provided beneficiary businesses don't lay off employees. It is possible that India's fiscal package too may be such a giveaway, though it postpones the issue down the line, when the government's finances are in a better position to absorb the fiscal impact.

RBI has put in place an elaborate early warning system for banks to identify potential NPA's at an early stage. The front-line relationship management staff and risk management teams of banks must be working overtime to identify such accounts, though applying the criteria strictly would see the bulk of their asset book, flagged under the "early warning" category.

Recoveries

The Insolvency and Bankruptcy Code (IBC) has been effectively suspended for a year, with no new cases to be filed for defaults during this period, which will lead to delays in resolution/recoveries. Of more significance, most potential corporate buyers are stressed and in a cash conserving mode, and therefore unlikely to participate in large scale bidding wars for IBC cases, as witnessed during Essar Steel's insolvency process. Recoveries on corporate loans may therefore be muted for the immediate future.

Prognosis: will some banks fail?

Banks face challenges on most of their key performance parameters, capital adequacy, asset quality and earnings. With the recent SBI led rescue of Yes Bank pre covid-19, despite its dismal corporate governance standards and horrendous asset quality, the government seems to be reluctant to allow banks to fail and create panic among depositors through a contagion effect. That said, Yes Bank's peers (i.e. private sector players apart from the big four, HDFC bank, Kotak Mahindra Bank, ICICI Bank and Axis bank) will be closely watched by the financial markets for signs of stress. Some of their share prices have seen drastic fall and volatility increase in recent times, along with flight of deposits. Even more concerning and therefore meriting careful watch would be the recently launched small finance banks with exposure to some of the most stressed segments of the economy. Their balance sheet size is too small to pose contagion risk like Yes Bank, potentially tempting RBI to give them a pass and let their depositors take the DICGC route, in case they reach the threshold of failure.

A number of corporate bankruptcies in the US including well-known names like Neiman Marcus is already impacting lenders, despite a very large fiscal and monetary support to the economy. Indian banks too have to brace themselves, for a second wave of corporate bankruptcy cases under the Insolvency and Bankruptcy code once its opened up after a year, which unlike the bidding wars seen earlier, may see more liquidations than resolution, unless foreign distressed asset buyers step in.

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