Enough lies: India’s banks get an ultimatum on bad loans

The Indian central bank is shutting down its halfway houses for debt addicts. In the process, it’s also throwing out an infuriating alphabet soup: CDR, SDR, S4A and their ilk.

Lenders will now have a much cleaner—and stricter—system for dealing with distressed large borrowers. If they still try to hide bad loans, the Reserve Bank of India (RBI) will whack them.

The timing of the change is interesting. Late last week, State Bank of India (SBI) posted an unexpected quarterly loss, its first in 17 years. New chairman Rajnish Kumar disclosed $3.6 billion in additional bad loans as of 31 March last year, and made $2.8 billion in loan-loss provisions, a 145% jump from a year earlier.

Investors have resigned themselves to being told lies by Indian banks about asset quality until central bank audits force them to come clean about the past. By which time it’s too late to do anything.

The sell side’s unwavering message to the buy side is keep calm and carry on; the end of the country’s $207 billion bad-loan tunnel is in sight.

For the RBI, the banking regulator, the time to frown from the sidelines is over. US 10-year yields are inching up toward the 3% danger zone. India’s own 10-year government yields are about 7.5%—a full point higher than in July. State-run Indian lenders, which dominate the banking system, are badly exposed to interest-rate risk because of their outsized government bond holdings.

During the December quarter, State Bank had to make a $622 million provision on the depreciation of investments mainly because it marked to market its government securities portfolio. This makes for conflicting objectives for a central bank: It may be desirable to tighten policy, but that risks complicating lenders’ efforts to tackle bad debts.

Hence the decisive step. Under the new RBI guidelines, delinquent loans above $300 million will have to be resolved with the borrower within 180 days. If there’s no action, the debtor must be dragged to a bankruptcy tribunal within 15 days.

That’s goodbye to things like corporate debt restructuring (CDR), strategic debt restructuring (SDR) and scheme for sustainable structuring of stressed assets (S4A). These were all regulator-sanctioned plans that allowed taxpayer-funded banks to take haircuts without the fear that their CEOs could be hauled to jail on charges of collusion with debtors. Some of these measures were introduced by the previous RBI governor, Raghuram Rajan.

India didn’t have a modern insolvency law when it was hit by a surge in corporate distress during Rajan’s tenure. Now the fledgling bankruptcy tribunal is dealing with some of the biggest consequences: Bids for Essar Steel India Ltd, which owes creditors $8.1 billion, have just come in from the likes of ArcelorMittal.

As I’ve argued, retaining makeshift arrangements is pointless now, because it gives lenders an excuse to delay recognizing bad debts to save on their loan-loss provisions—and to keep crony capitalists in business.

Throwing out the acronym soup also helps investors. The price-to-book ratios they see on their screens for India’s banks are bogus. The real book values after properly accounting for asset impairment are much lower.

When it comes to punishing managements who lie about bad loans, Indian lenders' boards are wimps. Naturally, sell-side analysts don't want to compromise their access to bank CEOs.

Ending this culture of deceit needed a big stick. Urjit Patel, Rajan's successor at the RBI, was biding his time because there was no capital to rescue the banking system. Now that the government is implementing a $33 billion bailout, he's not letting a good crisis go to waste. The "evergreening" of dud loans will be crushed with penalties and higher provisions, the RBI said in announcing the guidelines.

Expect Indian banks to emerge a lot stronger in a couple of years than the condition in which Patel found them. **Bloomberg Gadfly**

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