The RBI got this one right

Last Monday, the Reserve Bank of India (RBI) issued a new circular cancelling all the previous circulars issued in respect of the classification and restructuring of stressed assets. Over the weekend in Chennai, I heard some expressing concern that the move was ill-timed and that this “abrupt” withdrawal of the old debt restructuring schemes was like adding “fuel” to the fire (of uncertainty). Perhaps they were speaking with the benefit of hindsight after the Punjab National Bank (PNB) scam surfaced. Of course, at the margin, the PNB scandal raises concerns that it could be a large rock in a giant iceberg. But, one hopes that the analysis here gives some comfort that the government’s recapitalization plan steers the economy clear of even such a “giant iceberg”.

The question is whether RBI did the right thing in upping the ante. I think it did. As the last paragraph of the circular stated clearly, it was acting in the context of the powers issued in exercise of powers conferred under Section 35A, 35AA and 35AB of the Banking Regulation Act, 1949; and, Section 45L of the Reserve Bank of India Act, 1934. Hence, I do not deem it an arbitrary decision but a systematic one.

Since those amendments to the Banking Regulation Act issued in May last year, the government, on its part, has passed the Insolvency and Bankruptcy Code and notified it. It is working well. Defaulters are responding. Non-performing assets (NPAs) are getting resolved.

The big unknown is whether the RBI’s new guidelines will lead to the declaration of more bad loans and hence, more provisioning and higher losses. For that, we need to look at individual banks’ balance sheets, and it could be a moving target. Recently, the State Bank of India (SBI) announced a sum of NPAs higher than previously reported. The bank assets that slipped into the non-performing category were nearly three times more than the slippage in the second quarter. But this restatement was in compliance with the RBI’s directives. Further, the “total stress ratio” (non-performing loan, watchlist, and restructured loan) for the SBI had actually declined from 14% in the second quarter of 2017-18 to 13.4% in the third quarter. Worries that India might be getting into a fresh cycle of non-performing assets, necessitating a larger-than-allotted capital infusion, creating a bigger fiscal hole with consequent impact on bond yields, are overblown.

Underlying economic conditions are improving. Industrial production growth is accelerating, based on the report for December 2017 released earlier this month. In December 2017, overall industrial production growth was 7.1%, year-on-year (y-o-y). It was 2.4% (y-o-y) in December 2016—the month after demonetization was announced. In manufacturing (a subset of overall industrial production), annual growth in December 2017 had improved sharply to 8.4% vs 0.6% in December 2016.

In fact, consumer price index inflation for January slowed a little to 5.07% from 5.21% in December.

Two, bank credit growth to businesses and households is picking up and growing now at a double-digit rate. Credit to businesses and households (called “non-food credit”) in India stood at Rs73.1 trillion as of 20 January 2017. As of 19 January 2018, it had risen to Rs81.1 trillion. That is an 11.1% rise in “non-food credit”. In fact, one of the interesting observations in the quarterly analyst presentation of the State Bank of India pertains to the changing composition of its assets. Corporate loan growth might have been tepid but its commercial paper and corporate bond assets rose 25% y-o-y in the third quarter.

Third, according to the RBI quarterly industrial outlook survey, published in mid-January, order books of manufacturing companies have improved substantially.

For some, whether the recognition of “fresh” bad loans and the consequent increase in provisioning and decline in profits would lead to higher-than-reckoned capital requirements not just in the SBI but in other government-owned banks are open-ended questions. But I feel that they are questions that have answers that will keep changing for the better (more likely than changing for the worse) for the above reasons.

Fourth and finally, I would like to quote this important paragraph from the Financial System Stability Assessment Programme for India done by the International Monetary Fund (IMF) and published in December 2017: “India’s key banks appear resilient, but the system is subject to considerable vulnerabilities. Stress tests show that while the largest banks are sufficiently capitalized and profitable to withstand a deterioration in economic conditions, a group of public sector banks (PSBs) are highly vulnerable to further declines in asset quality and higher provisioning needs. Capital needs range from 0.75% of GDP in the baseline to 1.5% of GDP in the severe adverse scenario.”

The IMF added: “The authorities recently announced a recapitalization plan for the PSBs amounting to approximately 1.3% of GDP, as well as the establishment of a mechanism to seek consolidation across these banks.... This recapitalization package will effectively address the capital gap assessed in the FSAP (Financial Sector Assessment Programme) exercise even under the severe stress scenario.”

So, Bloomberg Gadfly columnist Andy Mukherjee is right: “Expect Indian banks to emerge a lot stronger in a couple of years than the condition in which (Urjit) Patel found them.”

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