Is the endgame for NPAs in sight?

Of late, the Reserve Bank of India’s (RBI’s) attempt to purge the banking system of bad loans has begun to resemble the spring-cleaning of a long-neglected kitchen cupboard. After demolishing the first few cockroaches with glee, one is dismayed to find dozens more sauntering out of the woodwork.

So, given that non-performing assets (NPAs) have been making headlines for nearly three years now, how far have we come in identifying the extent of these bad loans? And given the big hits that banks have been taking lately, how close are we to the endgame on NPAs?

We take stock, using RBI’s statistical tables and its half-yearly Financial Stability Reports.

Galloping NPAs

Gross NPAs of Indian banks, after staying below the Rs. 1 lakh-crore mark between FY06 and FY11, began to gallop from FY12. Jumping to Rs. 1.4 lakh crore in March 2012, gross NPAs proceeded to rise almost sixfold over the next five years to Rs. 7.9 lakh crore by March 2017.

The picture is equally dire if one considers gross NPAs as a proportion of total loans. After hovering below 3% till March 2012, it soared to 10.2% by September 2017, data from RBI’s financial stability reports show. In effect, for every Rs. 100 in loans advanced by Indian banks over the years, Rs. 10 is already in default. Indian banks recognise a loan as an NPA if its interest or principal repayments are overdue for more than 90 days.

The bulk of these NPAs have been stockpiled by public sector banks. In March 2017, they held Rs. 6.8 lakh crore of the Rs. 7.9 lakh crore bad loans; private sector banks held Rs. 91,900 crore and foreign banks the rest.

Provisions kill profits

As soon as a bank recognises a loan as an NPA, RBI rules require it to set aside a percentage of its current profits towards the likely loss, ranging from 15% to 100% of the loan amount.

Therefore, as banks’ NPAs soared in the last five years, bad loan provisions rose in tandem. This has directly dented their reported profits. Aggregate net profits of Indian banks have slumped from about Rs. 91,000 crore in FY13 to Rs. 43,900 crore by FY17. That there is still a profit, is thanks to private sector banks. Public sector banks in aggregate,have reported losses since FY16.

Persisting losses pose a threat to continued operations for a bank because they eat into its capital buffers. Basel III norms require banks to maintain a minimum 9% of owned capital to its total assets (CRAR).

RBI’s FSR reports, which keep a close watch on the capital adequacy ratios of Indian banks, have shown that Indian banks have consistently maintained a CRAR above regulatory norms in the last four years. Though private sector banks (16%) were far more comfortably placed than public sector ones (12.2%), none of the banks fell short of 9% in March 2017.

But given the galloping NPAs, RBI’s worry is whether individual public-sector banks are teetering on the brink and runs half-yearly stress tests to assess capital adequacy. The most recent one showed that if the system GNPA ratio were to spike to an extreme 16.6%, 19 banks would fall short of 9%.

RBI can stop worrying about capital adequacy, if only the gross NPA ratios of Indian banks showed signs of peaking out. But the higher 'stressed advances' ratios of Indian banks hint at more bad news to come. While the gross NPA ratios of banks were at 10.2% as of September 2017, their 'stressed assets' were higher at 12.2%.

While the gross NPAs of Indian banks reflect overdue loans recognised in their books, there's a whole bunch of dubious loans outside these, which go by the moniker of 'stressed assets'.

Basically, after indiscriminate lending during the boom times of 2003 to 2010, banks found that many large corporates couldn't service their loans. They entered into restructuring deals to extend their repayment timelines, and managed to keep these loans out of their official NPA accounting, with RBI looking the other way.

In 2014, as it became increasingly clear that 'restructured' was euphemism for 'doubtful', RBI cracked the whip on banks to estimate and account for these NPAs. This is the key reason for the sharp spike in both the stressed advances and gross NPA ratios between March 2015 and September 2017.

While banks have reluctantly identified stressed assets, their bad loan provisions haven't kept pace with the sprinting NPAs. As a result, as of September 2017, the average provision coverage ratio for all banks stood at about 44%. In effect, for every Rs. 100 worth of disclosed NPAs, banks had provided for losses of just Rs. 44.

RBI is not yet done with tightening the screws either. Recently, it decreed that banks would have to take more proactive steps to report large corporate loans overdue for less than 90 days and abruptly discontinued older schemes to restructure corporate loans.

Over the next few quarters, therefore, apart from dealing with slippages on their legacy loans, banks may have to come clean on NPAs on newer loans as well.

Is it over?

So, given that this spring-cleaning has been on for three years now, when can we expect Indian banks to emerge squeaky clean from this exercise? There's a long way to go. As the Economic Survey noted, resurrecting Indian banks requires four Rs — recognition, resolution, recapitalisation and reforms.

We're still not done with the first one — 'Recognition'. One can presume that the first R is over and done with when the key indicators of bad loan stock — the stressed advances ratio, gross NPA ratio and the net NPA ratio — stop escalating.

On this, FSR data for the period between September 2016 and September 2017 does offer hope. The stressed advances ratio for the banking system, after peaking at 12.3% in September 2016, has dipped a bit this year to 12.2%. The gross NPA ratio has risen by 1 percentage point to 10.2%, but the pace of increase is far slower than the 4-percentage point spike last year. Net NPAs have also just inched up from 5.4% to 5.7% over 2016-17.

But still, stability in these ratios is contingent on no new cockroaches, such as the PNB fraud, emerging from the woodwork. It is also important that newer bank loans given out in the last three years display good behaviour.

The rating agencies are optimistic that the stock of NPAs may not grow rapidly from here. Crisil expects the stock of gross NPAs for Indian banks to stand at 10.5% by March 2018 and stressed assets to top out at 14%. But provisioning and losses from these NPAs are expected to stretch on for the next year or two.

Yes, depositors can take comfort from the fact that the capital adequacy problem has been addressed by the Centre’s mega recapitalisation package for public sector banks. Investors in bank stocks though, must brace for more pain.

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