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WHAT TODAY’S SUPREME COURT ORDER ON LOAN MORATORIUM MEANS FOR BANKS

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As of now, the good part is that banks can start recognizing their bad loans as bad loans. The only way to solve a problem is to first recognize that it exists. Now that the Supreme Court interim order is out of the way, the banks are in a position to do that

Banks can finally start declaring their non-performing assets (NPAs) or bad loans. Bad loans are largely loans which have not been repaid for 90 days or more.

In an interim order on 3 September, 2020, the Supreme Court had directed banks not to classify those loans which hadn’t been classified as bad loans as of 31 August, as bad loans. This meant that since 1 September, banks have been unable to categorize their bad loans as bad loans.

In an order earlier today, the Supreme Court vacated this stay. As it said in its order: “Interim relief granted earlier not to declare the accounts of respective borrowers as NPA stands vacated."

Further, the court ruled that the banks cannot charge interest on interest (compound interest) on the outstanding loans during the moratorium period of 1 March to 31 August, 2020.

The central government had made a policy decision not to charge interest on interest for retail loans and loans made to micro, small and medium industries (MSME), up to a loan size of 2 crore.

The Supreme Court said that there was no justification in limiting relief only to retail and MSME borrowers and up to a loan of 2 crore. As it said in its order: “There is no rationale to restrict such relief with respect to loans up to 2 crores only… We are of the opinion that there shall not be any charge of interest on interest/penal interest for the period during the moratorium from any of the borrowers."

Let’s try and understand the impact of this Supreme Court order point-wise.

1) The government will now have to compensate banks for not charging an interest on interest on all loans during the moratorium period. As per rating agency ICRA, the interest on interest for a period of six months is expected to be 13,500-14,000 crore. Of this, waiver of interest on interest on loans of up to 2 crore is expected to have cost the government 6,500 crore. An extra 7,000-7,500 crore will have to be spent with the Supreme Court removing the 2 crore limit.

2) While the government will end up spending a lot of money in order to fund this Supreme Court decision, on the whole, it is an exercise in futility, given that it barely helps at an individual loan level. Take the case of a loan of 2 crore being repaid at an interest of 8%. The interest on interest on this for a period of six months amounts to 13,452. This amounts to 2,242 per month. If an individual or an institution taking a loan of 2 crore does not have the ability to repay a little over 2,200 per month, he shouldn’t have been given the loan in the first place.

3) Further, in a country starved of state capacity, this case has gone on for a while, needing the attention of not just the Supreme Court, but also the government and the Reserve Bank of India.

Thankfully, the demand for waiver of interest during the moratorium period, which was something that some of the petitioners had demanded, wasn't considered. This waiver would have cost the government 6 trillion and would have led to the destabilization of the financial system in general and banks in particular.

4) Also, the decision has created a moral hazard where business associations now know that in the future, they can petition the courts to intervene, to force the banks and the government to give them a better deal, which isn't possibly a good thing.

5) Of course, banks can now start recognizing their bad loans as bad loans. This means that bad loans for the period September 2020 to March 2021 will start being declared when the March quarter financial results are declared.

ICRA estimates that if the Supreme Court hadn't intervened in August, the bad loans of banks would have been higher by 1.3 trillion and would have amounted to 8.7 trillion or 8.3% of bank advances as of 31 December, 2020. Of course, the March end number will be higher.

The RBI expects bad loans of banks to touch 13.5% by September 2021 under a baseline scenario. Under a severe stress scenario, they are expected to touch 14.8%.

Even while banks were not supposed to mark their bad loans as bad loans, they were declaring an estimate under the heading proforma bad loans. But these proforma bad loans are nowhere near as high as the RBI expects bad loans to be by September 2021. Is the situation not as bad as the RBI expected it to be? Or are the banks kicking the can down the road by evergreening their loans, as they did during the period 2011 and 2015? That only time will tell.

As of now, the good part is that banks can start recognizing their bad loans as bad loans. The only way to solve a problem is to first recognize that it exists. Now that the Supreme Court interim order is out of the way, the banks are in a position to do that.

(Vivek Kaul is the author of Bad Money.)

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