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BANKING HEALTH AND THE 'K CURVE' DYNAMICS

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

As the financial ecosystem navigated one more pothole last week, with depositors in Lakshmi Vilas Bank Limited (LVB) getting bailed out, the implications of the Reserve Bank of India's sleight of hand have got all stakeholders thinking about the way forward. Throw in the non-banking financial companies, or NBFCs, into this cocktail and you sense a lot of pieces are likely to move in this jigsaw puzzle. While different stakeholders may have their own opinions on the way forward for the financial sector, markets, to a large extent, incorporate those differing views and reflect it in the price performance of individual banks. Such price action of banks can give us very useful insights on how the financial system dynamics are likely to change in the coming years. Focusing on the trends in valuation metrics since the ILF&S crisis can give us some important pointers on how the system is likely to take shape. What is the market prognosis right now?

Any sector expert would tell you that the key metric for financial companies would be the 'Price to Book Value' ratio (P/BV). The P/BV holds the mirror on the two critical attributes the market values most: adequacy of current capital and runway available to the entity for profitable growth.

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A P/BVB ratio above 1 indicates that the market believes that the company can grow and generate Return on Equity (RoE) above the hurdle rate that investors expect. The faster it can grow or the greater the spread of the ROE above the hurdle rate, the greater the P/B multiple (above 1). A P/BV below 1, on the other hand, indicates that the market either does not believe the bank has recognised all its bad loans or has the business model to deliver returns above the hurdle rate. This may be because the bank does not have a good deposit franchise, has bad cost discipline or a broken lending model.

Now let us see what the market is telling us through prevailing P/BVs (need to look at a bank's P/BV over a period). You have banks that have a P/BV above 4 while some others languish at much below 1, even at 0.25. With NBFCs, the P/BV range is even wider, with some NBFCs being valued in excess of 7. The growth trajectories of these entities with dispersed P/BV will be varied, resulting in a classic K Curve playing out. The K Curve depicts the inequality existing between different financial entities in terms of their attributes that determine their future growth and profitability. Widening of the arms of the 'K' would imply that the inequality is increasing, while narrowing of the span of the 'K' would mean the opposite.

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Looking at private sector banks, one can clearly see a couple of banks which have always had their P/BV above 3 on a consistent basis. Capital is available in plenty for these banks and the market is betting that these banks will grow much above system average and generate attractive RoE. This would imply that these banks will have disproportionate incremental market share on both assets and liabilities.

Next comes the set of banks which have had P/BV of above 1.5 for most periods of time. The market insight on these banks is that they are long-term bets, have access to sufficient capital but have to demonstrate a business model that works across cycles. As comfort levels increase on the business model, the P/BV should climb as runway for growth is available for these banks. Both the above set of banks ('Alpha banks') would form one arm of the K, having adequate access to capital and the intrinsic ability to grow market share. The only constraint for these banks would be their ability to grow their liability franchise as changes in market share on deposits are much slower than changes on the asset side.

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The other private sector banks have a P/BV of around 1 or much below 1. For some of them which have demonstrated an ability to raise capital even through COVID-19 times, it is a business model issue and whether they have strengths to grow profitably in a sustained manner. The new generation banks amongst these have to demonstrate consistent growth and stability on the liability side to earn their stripes for a higher P/BV again. Quite a few of the old generation private sector banks have an issue with the credibility of their business model and their ability to generate above hurdle RoE through the cycle. While they may have a reasonably stable liability franchise, the market perceives issues with their lending practices and thereby, asset quality. That is the reason their P/BV is at very low levels. They need to transform themselves by upgrading technology, add skilled manpower and improve management quality and governance.

Coming to public sector unit (PSU) banks, their current governance model depresses valuations. Their P/BV would better reflect their intrinsic strengths when the banks are run in a professional manner with an ability to decide their own destiny. The largest bank in the country is surely part of the Alpha banks as its ability to attract capital and grow profitably is well accepted. The other PSU banks are viewed by the market broadly as a homogenous set with similar business models and skill sets. Along with the government move to consolidate PSU banks into few large banks, a new vision needs to be drawn out for these banks to ensure that they have differing value propositions to offer to the economy and market. There needs to be a clear level playing field amongst all banks and the government should move to paying transparent and fair compensation for services rendered to various State-sponsored programmes to all players. PSU banks should be free to adopt human resource practices to on-board lateral talent to fill in skill set gaps and adapt to the new digital world. This, coupled with better governance, is the recipe for higher P/BV for PSU banks.

So what happens from here on? The consensus opinion would be that the Alpha banks widen the gap with respect to the rest, thereby widening the K Curve even more and squeezing out the weak banks. If one looks at the financial performance of banks over the last few years, this trend is palpably seen, lending more credence to the widening K curve hypothesis. However, there is clearly more room for banks to migrate into the Alpha banks set. Vision, perseverance and consistent execution will make that happen. For the wheels of the economy to grind faster and higher, we need more than the current handful of Alpha banks to propel it and it is in all stakeholders' interest to do their bit to make that happen. The multi baggers lie in spotting the bank that can straddle the K. The system can ill-afford another LVB.

For NBFCs, it is a more scary thought. Would both arms of the 'K' remain is the moot question for them. Or, would the more valued NBFCs be the ones that become part of the Alpha banks in the long term?

Srinivasan Varadarajan is a veteran banker and market expert

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To reassure Indian Muslims, the PM needs to state that the govt. will not conduct an exercise like NRC

END