Bad loans and investment climate: not as bad as it seems

When we are bombarded with something every quarter, we end up believing it. In fact, sometimes it seems foolish to not believe it. There was an advertisement sometime earlier on TV, with the punchline, “PSPO *nahin jaante* (you don’t know what is PSPO)?” which typifies peer pressure.

Of late, everyday, we are hit with media headlines of either a company being taken to the National Company Law Tribunal (NCLT), or an award being passed by NCLT or a higher court on a default-grade company or some kind of trouble in a company. While all these reports are true and correct, it has to be seen in perspective.

When you clean your dirty cupboard after many years, dirt does come out, which has a visual impact and makes one react, “Oh we are in a dirt.” However, all these years we were living in this dirt, only that we were not aware of it. Rather, we should look at it positively that the dirt is being cleaned up.

Please don’t get me wrong. Banks having non-performing asset (NPA) ratios of more than 20% is indeed alarming. A haircut of 94% in an NCLT award is indeed alarming. The point is, the clean-up is happening. The clean-up started in 2015 with the launch of Asset Quality Review (AQR) by the then Reserve Bank of India governor Raghuram Rajan. The muck is peaking now. Not that the banking system will become free of bad debts; the biggest ‘clean-up’ is that the ‘equation’ is changing.

Earlier, the equation was that if I am a small borrower and cannot repay, I am in trouble and if I am a large borrower and cannot repay, the bank is in trouble. That needed to change.

With the Insolvency Code, the heat is rightly being shifted to large defaulting borrowers. Even after the clean-up, there will be cases of default due to reasons like business cycles and industry-oriented issues. However, one fundamental is being established: business risk is to be borne by the entrepreneur and it cannot be passed on to the banks.

So why isn’t the situation as bad as it seems? Let us look at some numbers other than bank NPA. Crisil publishes a report called *Ratings Round-Up*, which analyses the rating changes in terms of upgrades and downgrades during the period under review. There are two ratios; one is the upgrade-downgrade ratio, which divides the number of upgrades in credit rating during that period by the number of downgrades. The other one is debt-weighted upgrade-downgrade ratio which takes the outstanding debt of the rated entities as the weight. A number more than one is positive as it signifies more upgrades than downgrades. The ratio was 1.22 in financial year (FY) 2016-17 against 1.29 in FY16. In the first half of FY18 (April to September 2017), it has improved to 1.88. The debt weighted ratio in FY17 was 0.88 against 0.31. In first half of FY18, the debt weighted ratio has surged to 3.19, and Crisil observes that for the first time in past 5 years, both these ratios are above 1 on a rolling 12-month basis.

Given that Crisil has ratings outstanding on approximately 14,000 issuers, this is a large universe. Taking the publication as the barometer for trends in corporate health, we observe that: (a) the upgrade-downgrade ratio is positive; (b) the debt weighted ratio shows significant improvement and is at a 5-year high. In the first half of FY18, ICRA rating action shows a credit ratio of 1.16, i.e., 304 upgrades versus 261 downgrades. The debt-weighted ratio was 1 in the first half of FY18 against 1.7 in FY17, little contradictory to the Crisil trend.

The relevance of discussing the upgrade-downgrade trend is that in the current context, when references to NCLT are peaking, issuers of corporate debt have already turned the corner in

FY17. What is happening now is cleaning of old muck hidden in the cupboard, on loans given by banks earlier in a boom phase.

What does it mean for your investments?

It means that there is no systemic issue, only that failed promoters are being asked to ‘go home’, which means, if there is no feasible revival package put forth by the insolvency resolution professional, assets have to be sold off to pay dues and the promoters have to give up on that business. You can take calculated risks on certain credit exposures as long as you have comfort. For example, IDBI Bank Ltd was downgraded to BBB in May 2017 but there was the implicit comfort of majority shareholding of Government of India, about 74%, and the systemic importance of banks. Thereafter, further capital infusion happened in IDBI Bank in August 2017 and things are expected to improve gradually. From your equity-investment perspective as well, the consensus view is that banks are gradually turning the corner.

Net-net, it will be a few more quarters before things start settling down on the bad debts issue.

Till then, go with your professional fund manager and professional investment adviser, let the headlines not unsettle you.

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