A lease of life called bank recapitalization

The Rs2.11 trillion recapitalization package announced by the government is a major initiative towards revitalizing public sector banks (PSBs) grappling with non-performing assets (NPAs) and inadequate capital, and will help them focus on credit growth.

Also, with incremental accretion to stressed assets unlikely to materialize going forward, we expect the credit profiles of PSBs to improve.

The proposed infusion would be adequate, because CRISIL estimates that PSBs would need Rs1.4-1.7 trillion of capital by March 2019 to offset profit and loss (P&L) losses stemming from higher NPA provisioning, and to comply with Basel III capital adequacy norms. And that’s after some capital savings (because of slower growth in risk-weighted assets) and approximately Rs30,000 crore raised through additional tier 1 (AT1) bond issuances in the last fiscal.

The recap will help PSBs accelerate provisioning for, and resolve, NPAs, and clean up their balance sheets. Consequently, and over the next couple of years, their credit growth should nudge double digits, compared with the approximately 3% compound annual growth rate (CAGR) seen between fiscals 2014 and 2017.

The capital infusion would come in two tranches—Rs1.35 trillion in the form of recapitalization bonds that will be front-loaded, and Rs76,000 crore through budgetary allocations, equity placements and follow-on public offerings.

Front-loading of capital will help PSBs bring forward provisioning for NPAs, and leave them in a better shape to ride the recovery in the credit cycle.

Stressed assets may not increase significantly

CRISIL estimates overall stressed assets in the banking system to be around Rs11.5 trillion, or approximately 14% of total advances, and does not expect them to increase significantly over the medium term. PSBs account for a bulk of this given their higher exposure to chunky corporate loans in vulnerable sectors such as power, construction and steel. About two-thirds of this has already been recognized as NPAs. We expect gross NPAs in the banking system to inch up to approximately 10.5% by March 2018, compared to 9.4% as of March 2017.

In addition to the reported NPAs, stressed assets also comprise not-yet-recognized bad loans (recognized as NPAs in one bank, but not in others). Additionally, there has been some stress in the small and medium enterprise (SME) and agriculture loan portfolios because of the implementation of the goods and services tax regime and farm loan waivers.

A gradual recovery in the credit quality of corporate entities led by firmer commodity prices, lower interest rates, and improved capital structures means that the (incremental) flow of stressed assets is unlikely to be significant from here, even though the stock may remain high for a while.

Public sector banks better placed

Owing to asset quality pressures and lower profitability following a sharp rise in provisioning for NPAs in the recent past, the capital cushion available to PSBs had reduced compared to what they need as per regulations. On an aggregate basis, PSBs have reported losses of approximately Rs27,000 crore in the past two fiscals. Given the milieu of abating asset quality pressures and adequate capital infusion, PSBs would be well advised to bite the bullet and crank up provisioning, especially on large corporate NPAs, this fiscal itself.

This might mean aggregate losses for the banking system of approximately Rs60,000 crore this fiscal, compared with an aggregate profit of approximately Rs31,000 crore in fiscal 2017 (after PSB losses), because they have to provide for ageing NPAs and loan write-downs (to resolve cases under the Insolvency and Bankruptcy Code). The good part is, this will mean the pressure on earnings profiles will reduce from the next fiscal. So, a window to clean up balance sheets is opening and PSBs would do well to grab it with both hands.

Credit momentum to revive

In the past couple of years, deterioration in asset quality, constraints on capital, sluggish investment activity in the economy, and the looming Basel III capital adequacy norms had had an impact on the credit growth of PSBs, which have traditionally been lenders to corporate entities. But Tuesday’s announcement of nearly Rs7 trillion investments in highways, and a gradual uptick in the private investments cycle, would improve demand for corporate credit in the medium term. Retail loans, on the other hand, are already buoyant. The recapitalization package will also allow PSBs to ride the forthcoming recovery in the credit cycle, and improve their toplines over the medium term.

Credit positive

The recapitalization plan is a credit positive for PSBs because of its salutary impact on their balance sheets. It also reinforces CRISIL’s belief that the government will continue to provide strong support to PSBs—something that gets centrally factored in our ratings.

Rating action will depend on how much capital is infused in individual PSBs. The enthusiastic market response to the shares of PSBs following the government’s recapitalization announcement also potentially opens up another source of capital—the equity market.

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