A ‘Sudarshan Chakra’ solution for PSU banks

Everyone agrees that fixing the banks is critical for reversing the current slowdown, and returning to healthy growth in the medium term. But a credible solution has yet to be outlined. Reserve Bank of India (RBI) deputy governor Viral Acharya hit the nail on the head when he said Indradhanush, the banking reforms programme announced two years ago, is not enough and we should look for a Sudarshan Chakra instead. The imagery is apt. Indradhanush is not the weapon of Lord Indra. It is only the Hindi word for “rainbow”, which is an ephemeral phenomenon, disappearing as suddenly as it appears. Sudarshan Chakra, on the other hand, is Lord Vishnu’s weapon, which, once released, unerringly chops off whatever heads it was meant to chop off, and then returns to the sender.

So what would a Sudarshan Chakra for fixing the banks look like? Let us consider the four “R”s which are said to be the key to solving the problems of the banks: recognition, resolution, recapitalization, and reform.

Recognition

There is progress here. The RBI’s asset quality review has revealed that the gross non-performing asset (NPA) ratio of both public and private sector banks is higher than was earlier thought, but in the PSU (public sector undertaking) banks, it is alarming at about 12%. And this is an underestimate, because it does not include assets that are “stressed” but not yet NPAs. The market assessment is that when these chickens come home to roost, the NPA percentage may increase by up to 6%.

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Resolution of problem loans

The Insolvency and Bankruptcy Code (IBC) is a major reform with some Sudarshan Chakra like qualities. Once an account is referred by a creditor under the IBC to the National Company Law Tribunal, and is admitted, the powers of the management and the board are transferred to an independent insolvency professional (IP). The IP then looks for someone willing to take over the project on suitable terms, including a write-down of the debt. The extent of the debt write-down needed will vary from project to project.

If the IP succeeds in finding an investor willing to take over the project with a sufficient reduction of debt, and the creditors accept the debt reduction, then the new management takes over. If no one is willing to take over, or the banks don’t accept the debt reduction implied by the package, the company is simply liquidated. The law prescribes that the process must be completed within 180 days, extendable by another 90 days at most. If there is no resolution within this period, liquidation must take place.

The process changes the incentive structure facing bank managements by giving them a legally sanctified method of determining what is a reasonable haircut. Since the alternative is liquidation, they should be willing to accept any haircut that gives them more than they would get from liquidation. Hopefully, the process will free managements from having to worry about the Central Bureau of Investigation/the Central Vigilance Commission/the Comptroller and Auditor General, which otherwise discourage decision making.

In June, the RBI directed the banks to file insolvency applications for 12 large accounts that had defaulted on payments. The time table set by the law implies that these accounts must be resolved or the companies liquidated by April 2018 at the latest. It is not certain that new investors can be found willing to take over all these projects; so some liquidations may well take place. This

is actually good from the system’s point of view, since it will set precedents about realizable values in the event of a liquidation and the variation in these values across projects.

The RBI has also identified another 29 which the banks must first try to “resolve” by mid-December, and file insolvency petitions thereafter if no resolution is possible. Whether the banks will be able to resolve some of these cases will depend on whether they are willing to reduce the outstanding debt in favour of the existing management based on a negotiation process. They may be reluctant to do so for fear they may be criticized for favouring undeserving managements . In that case, we will have another 29 cases going down the IBC route by mid-December, with a final conclusion in October 2018.

The process will certainly clean up the books of the banks over the next 12 months or so, but it will also mean acceptance of large losses and a corresponding depletion of capital. It is impossible to judge what the scale of losses will be. The Synergies Dooray Automotive Ltd case, the first to emerge from the IBC process, ended up with a haircut of 94%! But that was an old case, which had been referred to the Board for Industrial and Financial Reconstruction in 2005. The cases now being referred may be better, but even so, market expectations are that haircuts of 60% or more may be necessary to attract new investors. This will clearly lead to a considerable erosion of capital.

Recapitalization

This brings us to the third “R” i.e., recapitalization. In 2015, the finance ministry had estimated that the PSU banks needed Rs2.4 trillion of capital, of which Rs1.1 trillion was to come from the market, Rs60,000 crore from retained profits, and the remaining Rs 70,000 crore from the budget. The budget provision was duly made, and under the existing Indradhanush programme, only Rs10,000 crore is due this year and the same amount next year. This is clearly insufficient because the NPA situation has turned out to be much worse than expected.

Fitch Ratings has estimated that Indian PSU banks will need as much as Rs4 trillion of capital by end of March 2019 to meet the capital requirements under Basel III. Other estimates put the need even higher. If Fitch’s estimates are correct, the finance ministry faces a major problem. The problem is worsened by the fact that there are pressures on the budget for fiscal stimulus to counter the current slowdown.

The scope for using public funds to recapitalize the PSU banks can only be judged on the basis of a holistic view of the many other demands for government expenditure. We cannot keep talking of stimulating the economy through increased government expenditure, without a clear view of how much of the capital requirement of the PSU banks has to be met from the budget.

Reforms

This brings us to the last of the four “R”s. Reforms in PSU banks are expected to make the banks more efficient and the need for reform is therefore independent of whether public resources are being used to recapitalize them. However, the compulsion to undertake reforms is greater if the budget is being saddled with a huge burden.

What sort of reforms do we need? Some of what is being called reform, e.g., the idea of merging public sector banks, is not reform at all. Merging strong banks with other banks will do nothing to improve the average balance sheet, and will saddle the merged entity with innumerable personnel problems related to establishing equivalence across different bank cadres. What we need are reforms that improve governance, upgrade the skill set, and improve the quality of risk assessment within the PSU banks.

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The most important reform will be to reduce the government's equity to 33% in selected PSU banks. This would allow the stronger PSU banks to raise additional capital from the market, including from possible strategic investors, who could be offered seats on the board. The inclusion of strategic investors, with representation on the board, may make it easier to raise capital without burdening the budget.

The proposal to reduce government equity to 33% is not new. It was first made 20 years ago in 1998 by the Narasimham II Committee set up by United Front government. Yashwant Sinha as the finance minister of the Vajpayee government had even intended to do it in 1999, but the government baulked at that time. There may be political opposition from many parties even today, but as in the case of the goods and services tax, you never know when the system is ready for a consensus.

With a 33% equity share, the government would still have a controlling position in the board, but the banks would become board-managed companies and the board, including representatives of the strategic investors, would take all the critical decisions, especially regarding the appointment of top management. These banks will no longer be subject to micro management by the department of financial services. Anyone who thinks that active involvement by the finance ministry helps the quality of credit decisions has to be reminded that the NPAs have been built up despite the finance ministry, and even the RBI, being represented on the boards of the banks.

Finally, if the budget is under stress, all public sector banks need not be recapitalized to ensure targeted growth in lending. Weak banks that have eroded their capital very substantially should be subjected to the RBI's "prompt corrective action" discipline, which limits new commercial lending until their capital position improves. This will allow healthier banks, both private and public, and also more nimble non-bank financial companies, to expand and occupy the lending space created.

Even with these reforms, the scale of the capital injection needed may lead to the fiscal deficit limit being exceeded. However, if this is at least accompanied by serious reforms, such as reducing government equity below 33%, we have a better chance of being viewed positively by international analysts and opinion makers.

To summarize, the scale of the problem is much larger than was thought and the downturn in the economy has also made the need for corrective measures more urgent. We do need a Sudarshan Chakra on reforms. Merely dressing up Indradhanush will not do.

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