The Looming Banking Crisis

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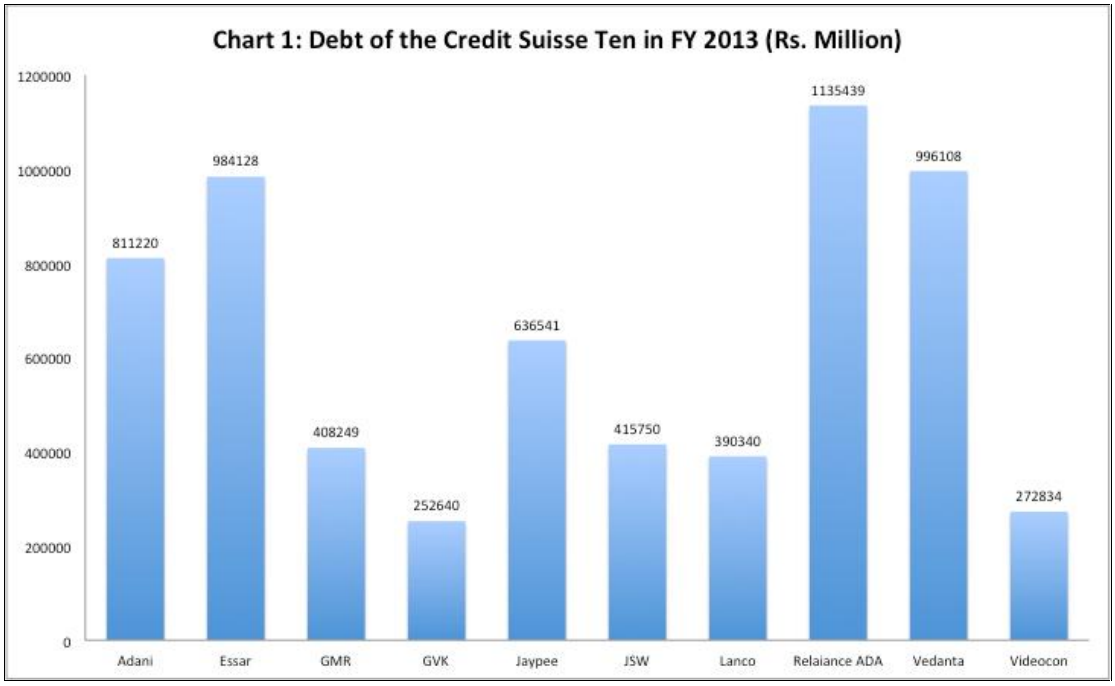
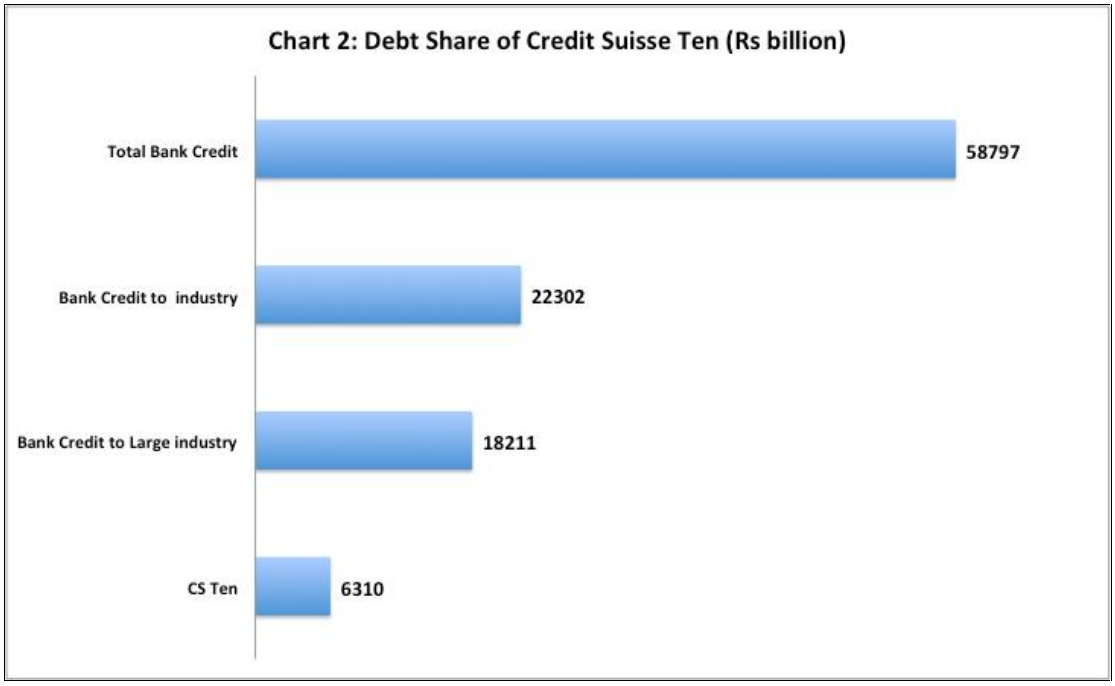
With the collapse of the rupee and the stock market capturing attention, and corporate and media anger directed at the Food Security and Land Acquisition bills, attention is diverted from much else that is wrong with the Indian economy. Except for occasional and startling reminders. One such came from Credit Suisse that pointed to the debt overload among leading Indian corporates. Another came from Reserve Bank of India Deputy Governor, K.C. Chakrabarty, on the losses building up in India's infrastructural sector, including in its privately operated component.



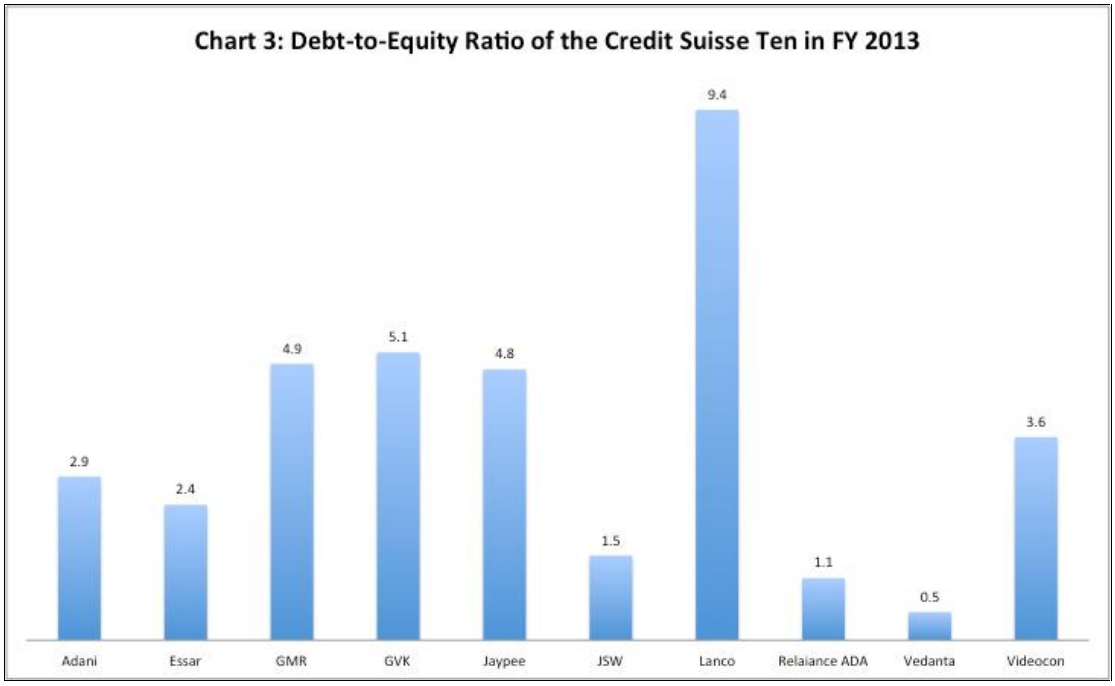
These are problems in themselves. But they are also problems that spill-over into other sectors, especially banking. Consider for example the Credit Suisse India report tracking borrowing by 10 leading Indian business groups that are among the biggest corporate borrowers. The groups covered are Adani, Essar, GMR, GVK, Jaypee, JSW, Lanco, Reliance ADA, Vedanta and Videocon. These groups have been on a borrowing spree with their liabilities rising six-fold over the six years ending March 2013 to touch Rs. 6.31 trillion (Chart 1). This amounts to close to 35 per cent of the gross bank credit outstanding from scheduled commercial banks to large industry (Chart 2), and 28 and 11 per cent respectively of bank lending to industry and all sectors. Bank exposure here is large enough to trouble the banks if the firms concerned are in trouble.



There are wide variations across these groups with Reliance ADA, Vedanta, Essar and Adani leading the pack. But it is not the level of gross debt that matters most but its relation to the net worth of the company or group concerned. The difficulty is that leverage in many cases has been high and rising. There is only one among these groups that has a debt equity ratio of less than one, two have ratios between 1 and 1.5, three have ratios between 2 and 4, another three between 4 and 5 and one with a ratio of 9.4 (Chart 3). As compared to this the average debt equity ratio of the RBI's sample of 3,041 non-government non-financial public limited companies for the financial year 2011-12 stood at just 0.71 per cent. Leverage is clearly high. The result is some of these groups (such as Essar, GMR, GVK and Lanco) are carrying an interest burden that exceeds their earnings before interest and taxes.

This vulnerability is now being significantly aggravated by the sharp depreciation of the rupee, since in the case of at least half these groups between 30 and 70 per cent of their debt is foreign currency debt. With the rupee having depreciated by more than 15 per cent in recent months, the impact this would have on interest and repayment commitments on forex loans would be substantial. The possibility of default or major restructuring is indeed substantial. Either way, banks exposed to these and other such groups are likely to take a hit that would affect their bottom line and their capital adequacy.

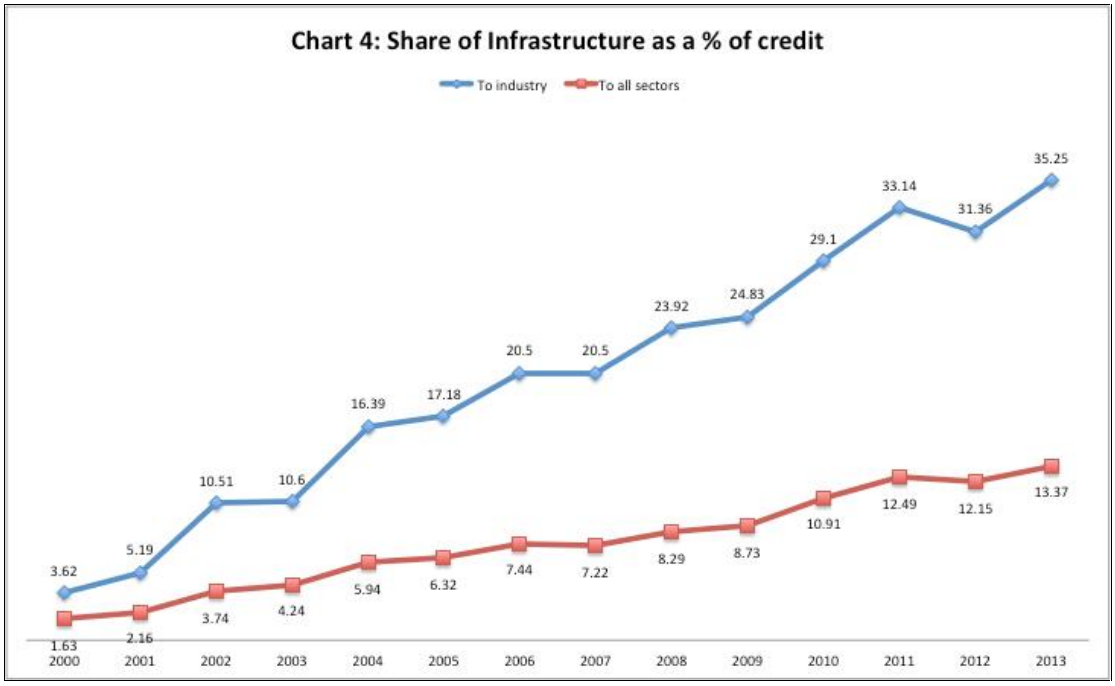
What needs to be noted is that a number of the groups tracked by Credit Suisse are infrastructure companies. This is an area of much concern to the government, partly because wrong decisions, bad governance, cost overruns, stalled projects and pricing constraints, besides rising input and raw material costs, are affecting the viability of many of the companies involved. Meeting end-August, as the rupee collapsed, the Cabinet Committee on Investment decided to get departments concerned directly or indirectly with infrastructure to clear bottlenecks within a month. The basic idea is to provide access to fuel through fuel supply agreements with Coal India for power plants, expedite environmental clearances, facilitate land acquisition and allocate iron ore and coal mines. Among the projects being targeted by such measures of promised support are those in the power, steel, coal, shipping and ports sectors.



This threat of activism on the part of the government is not explained just by bottlenecks to operation, expansion or implementation of new projects. Rather, the government is clearly concerned about the poor profitability of infrastructural projects and the need to restore the credibility of an important aspect of the liberalisation agenda: public-private partnership (PPP) projects in infrastructure managed largely by the private sector. If top corporates are overleveraged, it is partly because many of them have entered into an area where the government had promised major concessions and backed the projects with credit from the public banking sector.

According to Chakrabarty, there were by end December 2012 over 900 PPP projects at different stages of implementation in the infrastructure sector involving a total project cost of Rs.5430.45 billion. Growth has been scorching. The figure on March 31, 2010, for example, stood at 600 projects with project costs of Rs.3330.83 billion. Clearly, the private sector was not capable of financing that kind of expansion in such a short time. Not surprisingly, actual implementation had depended on state-organised financing. The problem with financing, however, is that India has a poorly developed bond market and development financial institutions that could contribute (such as IDBI and ICICI) had been eliminated during reform by conversion into commercial banks.

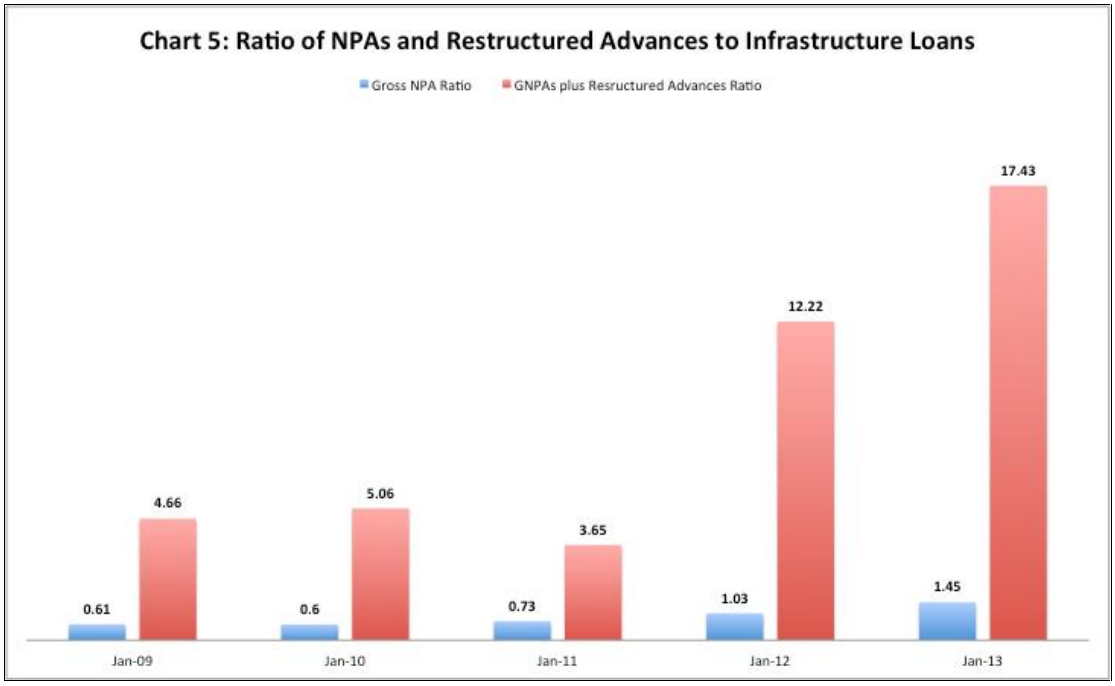
Hence, the government had to prod the banks to lend to this sector. Conventionally banks, which mobilise resources from the public through relatively small deposits that promise safety and liquidity, do not lend to projects involving lumpy, illiquid investments, with long gestation lags and relatively high risks. Not surprisingly, as recently as March 2000, bank lending to infrastructure amounted to just 3.6 per cent of bank credit to industry and 1.6 per cent of total bank credit. Since then, however, there has been a dramatic change (Chart 4). The share of bank lending to infrastructure had by March 2013 risen to as much as 35 per cent of bank credit to industry and 13.4 per cent of total bank credit. The difficulty is that this exposure has been concentrated in a few sectors. Bank lending to power which rose from 45 per cent of infrastructure lending in 2000 to 70 per cent in 2003, has since come down but still stands at around 50 per cent.



There were two, among many, important strategies the government adopted to ensure this. The first was, of course, to pressurise public sector banks to provide the bulk of this funding. Private banks, especially foreign private banks, looking to their non-performing asset and profitability record have been almost absent from this area. The second, is to spread the myth that bank exposure is only a stage in "take-out financing". This is meant to be an innovative financing method for long-term projects in which one set of institutions provide loans for the initial phase of the project (say 5 years), with the promise or commitment that the loans would be taken over by another set of institutions. These may be long-term financing institutions or other banks, and there could be more than one such transfer during the lifetime of the loan. As is to be expected institutions engaged in such take out financing are often government owned (such as the India Infrastructure Finance Company Ltd) and mobilise resources based on implicit or explicit government guarantees.

The problem with take out financing is that, while the banks take on the credit risk in the first instance, there is no guarantee that the loans would be moved out of the books of the bank that is the original funder. Further, it is often unclear at what price other institutions would be willing to take out the loans given to infrastructure companies that are not performing well in terms of profitability. In the event, as India's PPP projects, especially in areas like power are ridden with problems, banks find their loans turning sour.

Desperate to protect their books and succumbing to pressure, banks have restructured their loans. As a result, while the ratio of Gross Non-performing Assets to total infrastructural has risen from 0.61 per cent to 1.45 per cent between March 2009 and March 2013, the ratio of gross NPAs and restructured advances to infrastructural loans has risen from 4.66 per cent to 17.43 per cent (Chart 5). That is quite dramatic, and ominous, when we recognise that many restructured advances turn non-performing in time.



Thus, while the government had been successful in diverting credit to infrastructure in a period when total bank credit relative to GDP had risen dramatically, it was less successful in ensuring the profitability of the PPP projects it had promoted as part of its neoliberal strategy. In the event, the probability of default by large firms with excess leverage in these and other areas has increased considerably. In sum Indian banking is on the verge of what could be a crisis. But that goes unnoticed because of the other more visible problems that afflict the economy.

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