The Other Side January 7, 2016

A Tale of Two Banks

In one basic way, the business of lending money is significantly different from businesses in manufacturing: in the latter, quite often losses come in the initial years and the hope is that profits will follow; in the former, the cycle is reversed. Very often loans make money for the lender in the initial years and losses come later should they become bad or "non-performing assets". This was well illustrated recently in the cases of HBOS (the merged entity created from the Halifax Building Society and Bank of Scotland) in the UK, and the Indian Overseas Bank (IOB) in India.

As for HBOS, it needed to be rescued by infusion of public funds during the financial crisis of 2007-08. The Bank of England's report on the failure of HBOS, one of the largest UK banks, came out last year, seven years after the incident occurred. The basic problem with HBOS was that it evolved from being a "boring" bank to one which expanded rapidly into commercial and property loans, often relying on short term funding from the market. When the interbank market stopped functioning during the crisis, HBOS faced a major liquidity problem, even as the quality of its assets was coming under question. As John Kay commented (Financial Times, November 11, 2015) *"In credit markets, you can earn profits by doing better credit assessment than your rivals, or gain sales by doing worse credit assessment than your rivals. HBOS chose the latter."*

The case of IOB seems to be very similar, as reported in Mint, November 27, 2015 (I am taking most of my data from the report). Under a new Chief Executive, IOB doubled its loan book in a matter of four years, funding it from "high costs deposits" which increased to 20% of the total by March 2014, from less than 4% four years earlier. During a three year period, 2010-11 to 2012-13, the loan growth was 27% p.a., as against the industry average of 17.5%. No wonder IOB currently has the highest percentage of non-performing assets amongst all the listed public sector banks. The first sign of trouble was evident in the 2012-13 accounts reporting a very low return on assets, but it seems regulatory action got initiated only 2 ½ years later.

In a way, both cases illustrate regulatory weaknesses, if not major failures. This is perhaps more understandable in the case of the UK, which ideologically preferred – and probably still prefers – “light touch” regulation. This surely is not the ideology in India; just recall the number of circulars issued by the central bank on regulatory issues. Also, the central bank has representatives on the boards of all the public sector banks, and surely they would have known about the rapid expansion of the credit portfolio and how it was being funded. Did they not raise any alarm? Do they have any accountability for what happened, or are regulators to be considered as being above such mundane questions?

The Financial Stability Report (FSR) published by the Reserve Bank last month, highlights the issue of banks’ non-performing assets, now at their highest level for a decade, and that too when growth is 7%+. The Governor and senior RBI executives have been expressing concern over the issue from various fora. The FSR reports that five sectors – mining, iron and steel, textiles, infrastructure and aviation – which together constituted less than a quarter of the banking system’s loan book, contributed more than half of the “stressed advances”. As for mining and iron and steel, did the sharp fall of global commodity prices, and the overvalued exchange rate, lead to losses and therefore impairment of the quality of loans? As for infrastructure, what was the contribution of delays in various government clearances to the overruns in project completion schedules and costs (see a front page report on the issue in this paper on 2^{nd} January)? Within infrastructure, what was the contribution of the delays on the part of power distribution companies to pay for the power? Should the FSR be a compendium of data without much analytical and remedial comment?

This apart, the problem of banking profitability and capital adequacy could well become more complex when the new accounting standard (Ind AS109) is implemented in a couple of years. The Standard requires the lender to make an assessment of expected future credit losses and their recognition in the accounts. A “true and fair” quantification of these would be a challenging proposition – for bankers and accountants!

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