The Other Side April 24, 2014

Public sector banks' NPAs

The level of non-performing assets (NPAs) in public sector banks (PSBs) is obviously causing concern to the banking supervisor. There are several different perspectives to the issue: the first, to my mind, is the skill levels.

A couple of years back, in a one-to-one meeting with the finance director of a business group with large investments in capital intensive industries, I mentioned that the cost of capital of the group companies is extremely high, and that, for capital intensive businesses, the cost of capital (both debt and equity) is crucial to the bottom line. The finance director agreed with my comment but expressed his surprise that none of his bankers had made the point to the management! The group's principal lenders were from the public sector.

Another incident I recall is the "coupon swaps" some PSBs did a few years back, exchanging fixed rupee interest receipts for floating rate Japanese LIBOR linked yen payments – and incurred hundreds of crores of losses. My memory is that the pricing had huge margins in favour of the counterparty banks, and, even at the highest level, the PSBs were considering the coupon swaps as hedges! One has often wondered whether this lack of skill levels has two different origins:

- Lack of specialization within the organizations; and
- Every bank trying to do everything from micro lending to agriculture to international business: surely each of these segments requires different experience, knowledge, judgement! The era of the gifted amateur doing every job equally well is long over (except perhaps in our civil service).

The banking supervisor has recently recognized that every new bank cannot be a universal bank. As for the existing ones, this emphasizes the need for staff specializing in different kinds of businesses. This is all the more necessary when risk management and capital ratios are increasingly being based on models in quantitative finance. Is there a blind reliance on accepting the output of the "black box" as the gospel truth?

The recent case of NPAs in United Bank of India, extensively reported by the media, is illustrative of this phenomenon. On 19th February it was reported that the problem arose as a *"result of deficiencies in the software"* the bank was using. The very next day, the software vendor and the bank reportedly agreed that there was no flaw in the system! A month later, the then Financial Services Secretary in the Ministry of Finance reaffirmed that *"there was a genuine problem with the software"* (Mint, March 25th). Whatever the reality, the worrying fact remains that nobody in the management had even a rough mental idea of the size of the NPA portfolio!

There are two other interesting features of the case:

- In an interview (Mint, February 20), the bank's executive director stated that the bank was under pressure to give more loans to farmers and small businessmen, but that recovering money from them is a challenge because of "political interference": is "social banking" really "political banking"? ;
- The Ministry has directed UBI to recover a minimum of Rs. 1 crore of NPAs in each circle every day, and send a daily report to MoF: if directives and reports produced the results, we would have no problem!

While surely there are skill deficiencies in PSBs which they need to rectify, they also have to work under several constraints, quite apart from political interference. For one thing, they are exposed to infrastructure projects, many of them stuck in a regulatory maze, to a much larger extent than their private sector competitors.

Another is the plethora of institutional structures concerned with the problems of sick companies and non-performing assets: the Board for Industrial and Financial

Reconstruction (BIFR); the debt recovery tribunals; the corporate debt restructuring cell; the vigilance mechanism which means PSB executives need to focus far more on the paper work which often takes away focus from more substantive issues; forensic audits; etc. As if all these were not enough, the banking supervisor has now come out with a "Framework for Revitalising Distressed Assets in the Economy"; this requires the Indian Banks Association (IBA) to prepare a Master Joint Lenders Forum (JLF) agreement and operational guidelines. All these can only mean more paper work: culture of "*tippani uparant tippani*", as one banker remarked to me. Surely, micro-level, often overlapping institutional framework is not necessarily conducive to results! But as Mark Tully diagnosed a long time back, there are no full stops in India!

A rating company has projected further increases in bad debts: what else can one expect with growth slowing, and an overvalued exchange rate? Surely the PSBs are not responsible for either! One is also not sure about the wisdom of the banking supervisor pressing ahead with implementation of Basle III banking regulations, in the absence of adequate skill levels in banks in quantitative finance, or the models giving reasonably uniform output. Two recent examples: the Greek central bank quantified the need for additional bank capital at € 6 bn, the IMF at € 20 bn; in a BIS survey of models used by banks, their estimates of a hypothetical portfolio differed widely. We should also not forget the fragility of capital ratios in reassuring banks' creditors: after all, the first UK bank (Northern Rock) to experience a run on its deposits in the financial crisis, had the highest capital ratio amongst UK banks!

A.V.Rajwade

Email: avrajwade@gmail.com