THE PUBLIC-SECTOR BANKING CRISIS IN INDIA

THE GOVERNMENT NEEDS A CLEAR VISION FOR THE FUTURE OF INDIA'S BANKING SECTOR

David Bergeron • Amit Deshpande • Wolfram Hedrich
The Chinese and Indian economies have grown rapidly over the past decade. In China, this growth has been fueled by a dramatic expansion of credit, up from 140 percent of GDP in 2008 to 260 percent today. Credit has also expanded in India during the past decade, but it started from such a low base that private-sector debt is now only 86 percent of GDP – less than half the average of advanced economies.

Given this difference, you might expect Chinese banks to be struggling with bad debt while Indian banks enjoy the stability that comes with slow credit expansion. In fact, things are the other way around. Many commentators suspect that the official non-performing loan ratio of 1.7 percent understates the true extent of bad debt in China. A serious credit crisis may be looming in China.

But a credit crisis has already emerged in India, where the official non-performing loan ratio is 9.6 percent and the ratio of “stressed assets,” which also includes restructured loans, is 14 percent. Even at the height of the global financial crisis, non-performing loan ratios in Greece, Portugal, and Italy did not reach this level.

The relatively small size of the Indian banking sector may spare the country from the kind of pain experienced in Ireland and Iceland during the global financial crisis. Nevertheless, the Indian banking sector is in urgent need of stabilization and structural reform.

**A CONCENTRATION OF BAD DEBTS**

India’s bad debt problem is concentrated in the public-sector banks – though “concentrated” may be the wrong word, given that public-sector banks account for more than 70 percent of total lending in India.

The impaired loans are primarily to the corporate sector rather than households, with defaults arising from factors such as overcapacity, falling commodity prices, and troubled infrastructure projects. The Reserve Bank of India is trying to bring problems into the open, having conducted an Asset Quality Review and enhancing the reporting of restructured assets. It has also asked banks to initiate forced-bankruptcy proceedings against 12 large defaulters that, between them, account for 25 percent of the banking system’s non-performing loans; another 26 defaulters are scheduled to be forced into bankruptcy in December if their restructurings have not been resolved by then.

This high level of non-performing loans is eroding the ability of public-sector banks to retain earnings and is thereby damaging their capital positions. Under Basel III, banks must have capital ratios of at least 11.5 percent by March 2019. Various analyst reports have recently estimated that to meet this standard, the public-sector banks will need to raise between $19 billion and $21 billion (a finding in line with our own estimates from 2016).

**IMMEDIATE STABILIZATION**

Given that the troubled banks are state-owned, a disorderly failure is extremely unlikely. Nevertheless, they must be recapitalized to the legally required level, and this means somehow coming up with the $19 billion of capital. In October 2017, the government announced a recapitalization plan of $31 billion for the public-sector banks – primarily to shore up their capital and support future growth.
This capital will come from three sources: a direct infusion from the government; equity sales (including non-core assets) by the banks; and recapitalization bonds, which will account for 64 percent of the new capital. While this is a smart move on the part of the government – and will definitely help stabilize the banking sector in the near term – there should be stringent criteria attached to the capital-infusion plan (such as a business turnaround strategy, the upgrade of risk-management capabilities, and gradual privatization). This would help in building a healthy banking sector in the long term.

PROVIDING REASSURANCE

If the government wishes to provide some reassurance to the sector and its customers, it should consider guaranteeing bank assets, along the lines of the Asset Protection Scheme that the UK government used to stabilize the Royal Bank of Scotland (RBS) during the global financial crisis. The scheme was ultimately cash-flow positive for the government because RBS paid a premium for the guarantee and never claimed on it.

Once stabilized, India’s bank sector needs to be reformed to make sure that it contributes more effectively to economic development and at less cost to taxpayers. The best way to achieve this would be to drastically reduce the market share of state-owned banks. In many countries and over many decades, state-owned banks have shown a tendency towards poor risk management and misdirected lending.

Sometimes the problem is that lending decisions are guided by a political agenda rather than commercial logic. But even in the absence of this distortion, state-owned banks have less reason than private sector banks to be prudent lenders. The creditors of a public-sector bank expect to be bailed out by the government if the bank fails. So they charge no risk premium when the bank’s lending becomes riskier, and the bank has no short-term financial incentive to limit risk taking. It is no surprise that the non-performing loan ratio of India’s private-sector banks is less than half the non-performing loan ratio of its public-sector banks.

There may be a role for state-owned banks to supply services that pure profit-seeking banks will not, such as, perhaps, micro-business lending or major infrastructure-project financing. And public-sector banks may also help to discipline the pricing of private-sector banks. But these roles cannot justify public-sector banks accounting for 70 percent of the market.

Privatizations would be the most direct way of reducing the dominance of state-owned banks, and they would have the secondary benefit of raising capital for the government to put to better uses. However, they are likely to meet with considerable political resistance,

9.6%
India’s official non-performing loan ratio
if only because public sector banks employ hundreds of thousands of unionized workers. A more gradualist approach, which the government may already be following by design or default, is to stifle the growth of public-sector banks while encouraging private-sector development, as is happening with the liberal approach to granting new banking licenses in India. Given the likely growth of India’s banking sector, this approach would not take long to reduce public-sector banks to less than half of the market. But the approach taken is secondary to the goal. The government needs a clear vision for the future of India’s banking sector, and one in which state-owned banks play a smaller role.

David Bergeron is a Mumbai-based partner and Amit Deshpande is a Mumbai-based principal in Oliver Wyman’s Financial Services practice. Wolfram Hedrich is the Singapore-based executive director of Marsh & McLennan Companies’ Asia Pacific Risk Center.

This article is based on an article that first appeared in India’s Business Standard.