Financial Stress in Indian Corporates: Banking Implications

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Abstract

Asset quality is a key concern for the Indian banking system, in large part due to stress in large corporates. The note presents a quick summary of the key facts, a diagnosis of the causes of the stressed asset problem, and the challenges and likely prognosis going forward.

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1. Origins of Bank Stress

Stress in the corporate sector has posed a significant challenge to the Indian banking system. Figure 1, which displays data for listed Indian corporates, captures the essence of this problem. In FY 2015, over one third of the debt of listed firms is owed by firms that cannot even cover their interest payments. Safe debt of firms with interest coverage of more than 2.0 is only 40% of debt in 2015. Aggregate debt of listed firms with interest coverage less than 2.0 is ₹ 8.5 trillion in 2015, up at 27% per year from ₹ 1.6 trillion in 2008.

The picture is similar when viewed from the banking side. System-wide stressed assets of banks are estimated to be ₹7.5 trillion (about US$110 billion). Of these, more than half are non-performing assets. By way of comparison, the aggregate equity market capitalization of listed banks is US$160 billion. The bank NPA problem is aggravated by India's slow bankruptcy system. India's 2016 Economic Survey shows that outstanding bankruptcy cases exceed ₹4 trillion. Court data from Debt Recovery Tribunals, fast track bankruptcy courts, show that pending bankruptcy cases resolve at below 2% per month.

2. Diagnosis

India's NPA problem appears to have three root causes: a growth slowdown in the corporate sector, inadequate bank risk management, and inadequacies in bankruptcy resolution. We discuss each of these issues next.

2.1. Slowdown in Corporate Sector Growth

The first cause is a sharp slowdown in corporate growth. Over 5 years, the aggregate sales growth of all listed firms contracts from over 15% per year to nearly zero in 2015. An additional indicator is that according to the CAPX database of CMIE Prowess, 893 projects in India are stalled. Growth woes are compounded by declining profitability and limited external equity raising. The net effect is a thick tail of corporate with stressed debt.

2.2. Risk Management Issues

Inadequate risk management is a second cause of the stressed asset problem. India has a miniscule corporate bond market. Thus, banks are major suppliers of short and long-term debt to corporate India and bear the brunt of corporate stress. Among banks, a disproportionate share of stress is borne by government-owned banks. The asymmetric effect on government owned banks is readily seen in Figure 2, which displays default probability (PD) estimates from the NUS RMI database for government-owned and the new private banks formed after India's 1991 liberalization. The PDs for both sets of banks are similar in 2008 but increase and remain elevated for government owned banks after about 2011. As another indicator, shares of government-owned banks trade below book value while private banks trade at multiples of book value.

Sectoral exposures partly explain the elevated risks of government-owned banks. These banks are primary financiers in core sectors such as energy, steel, and cement, which are highly stressed. What is less clear, however, is why banks funded by short-term deposits are logical repositories for these risks. Relatedly, it is unclear whether state-owned banks are equipped to manage the long-term, cyclical, and systematic nature of exposures and political risks of the core infrastructure sectors.

Difficulties in risk management have led Indian banks to use regulatory forbearance as a first line tool for managing problem loans. Forbearance gives some insurance against short-run pressures by preserving accounting capital and perhaps avoiding panic runs on banks. However, forbearance is not, by itself, a complete answer to fundamental issues with asset quality. Nor is it a substitute for proper risk management.

2.3. Slow Bankruptcy Process

The third and perhaps the most important driver of corporate stress is India's slow bankruptcy process. India has a patchwork quilt of bankruptcy laws that date back to the early 1900s. Overlapping jurisdictions, mandates, and resolution processes contribute to clogging an already-clogged court process. The result is stasis. World Bank data for 2015 puts India at a low 190 out of 205 countries in insolvency resolution. The wheels of justice grind quite slowly in India's debt recovery courts.

3. Prognosis

What is the likely prognosis going forward? To remedy banking stress, action is probably necessary on all three fronts: corporates, banks, and the bankruptcy law. We discuss each in turn.

3.1. Corporate Sector

On the corporate front, reducing NPAs requires a nudge on the growth front. Handling past investment overhang is undoubtedly important, but perhaps more critical is the ability to find new sources of growth. In the short run, exports are unlikely to help, given the difficult global environment. In fact, India has experienced a year of monthly declines in exports. Growth is likely necessary from the domestic side, for which precursors are largely in place. The monetary environment is favorable, with decreasing inflation and interest rates. The government shows concerns about its spending quality and is finding technological answers to leakages. It is also attempting to create a predictable policy environment on matters such as land acquisition, natural resource allocation, labor, and taxation. These measures improve the odds of a favorable investment and growth cycle in the corporate sector through domestic growth.

3.2. Banking Sector

The banking system poses different issues. The short-term issue of bank stability has not been a major challenge at least until now. This is probably due to the government ownership of banks and its firm expressions of support, made credible by a commitment to fiscal discipline. A useful consequence of government support is that India's central bank has been able to stop forbearance and initiate an asset quality review. This effort has pushed banks to recognize risk and manage it but without U.S. style capital infusions or debilitating restructurings.

Longer-term issues are more vexing as they concern governance and organization of the state owned banking sector. Perhaps the key governance issue is the relative lack of pressure from outside shareholders in governing and protecting the value of the state-owned banks. Forming blocks of qualified institutions or employee-owners and representing them on boards can perhaps remedy this external governance deficit. Internal governance reforms are already under way. Senior and board appointments are now run by a credible Bank Boards Bureau.

The organization of India's state-owned banking sector is an unsolved conundrum. The central issue is that India's government-owned banks are inherited from nationalization of private banks in 1969 and 1980. A clearer architecture for state-owned banks, one that clarifies the number of state-owned banks and the scope of each, could perhaps inform the competitive environment they should reside in. The government has recently initiated discussions on these issues and aims to consolidate the banks it owns into a smaller set of larger banks. Scale may address efficiency issues, but the core NPA generation issue still requires attention to governance issues.

3.3. Bankruptcy Reforms

The final leg in addressing NPAs is bankruptcy reforms. From a creditor's viewpoint, India's current bankruptcy process is essentially an ineffective non-system. Recognizing this, the state has mounted periodic efforts, about once a decade, to change bankruptcy law. India has had the 1985 Sick Industrial Companies Act, then the 1990s debt recovery tribunals, and the 2002 SARFAESI Act. There is now yet another decadal effort, a new bankruptcy code passed in 2016.

India's 2016 bankruptcy reform offers reasons for cautious optimism. It envisages a time bound process for resolution without burdening the traditional court system. Assuming the law is passed, there are two hurdles to change on the ground. One is building appropriate capacity, e.g., the "insolvency professionals" envisaged in the law. The government's move to encourage institutional capital in distressed asset sales could accelerate this capacity formation. A second issue is how quickly the courts handle challenges to the new law. It took a decade to resolve legitimacy issues in the case of debt recovery tribunals.

An interesting development is a request by India's Supreme Court for bank NPA data. An optimistic reading of the interest is that it can trigger speeding up of the system even as it exists today, and also trigger faster resolution to any challenges to the new bankruptcy law.

4. Summary

India's stressed assets issue is serious. It has caught the attention of the media, regulators, and policy makers, and has sparked serious efforts at reform. The U.S. politician Rahm Emanuel remarks that "you never let a serious crisis go to waste." Whether India's stressed asset crisis goes to waste or creates beneficial changes in India's banking and corporate sectors remains to be seen.

Figure 1. % Debt by Interest Coverage

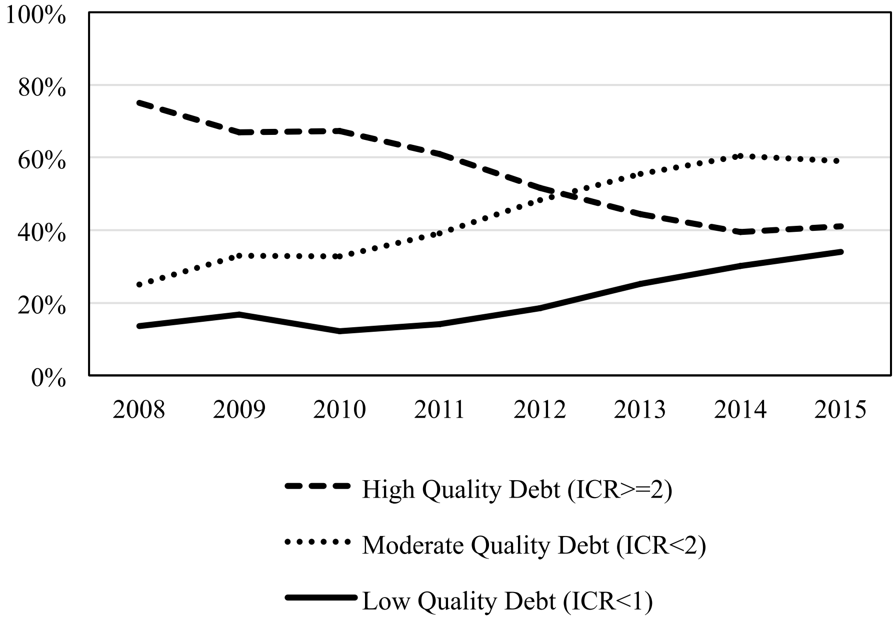

Figure 2. Median Default Probability