The gross bad debt ratio of the banking system may touch a two-decade high, with banks under prompt corrective action (PCA) expected to be the worst hit, warned the Financial Stability Report (FSR) released by the Reserve Bank of India (RBI) on Tuesday.

As bad debts balloon, the money set aside as provisions would drag down the capital position of Indian banks, with at least six banks witnessing a shortfall of capital, the inter-regulatory report warned.

Under the current macroeconomic environment, the gross non-performing asset (GNPA) ratio of scheduled commercial banks may rise to 12.2 per cent of the advances by March 2019, from 11.6 per cent in March 2018. The March 2019 level would be the highest since the financial year ended 2000, according to *Bloomberg*.

The system level capital to risk-weighted assets ratio may come down from 13.5 per cent to 12.8 per cent during the period.

The scenario is part of the macro-stress tests and represents the baseline scenario. If the macroeconomic situation worsens, the GNPA ratio would worsen too.

Despite that, India's financial system remained stable, the report said.

The banks undergoing the RBI's restrictive PCA framework would be worse off. The GNPA ratio of these banks is expected to rise to 22.3 per cent of the advances, from 21.0 per cent in the period under consideration.

"However, the capital augmentation plan announced by the government will go a long way in addressing potential capital shortfall, as also play a catalytic role in credit growth at healthier banks. In parallel, the PCA framework, by addressing the vulnerabilities of weaker banks, will help in improving the health of the banking sector," the report said.

The thrust of the PCA framework is to prevent further capital erosion and nurse the banks back to health.

"Furthermore, if undertaken promptly and well, governance reforms would not only improve the financial performance of the banking sector but also help reduce operational risks."

Sectors causing stress
Between September 2017 and March 2018, the GNPA ratio in the industry sector rose from 19.4 per cent to 22.8 per cent, whereas the stressed advances ratio increased from 23.9 per cent to 24.8 per cent.

"Within industry, the stressed advances ratio of sub-sectors such as 'gems and jewellery', 'infrastructure', 'paper and paper products', 'cement and cement products', and 'engineering' registered increase in March 2018 from their levels in September 2017." The asset quality of 'food processing' and 'textiles' improved in the period. The provision coverage ratio rose across all bank groups, with the foreign banks having the highest provision coverage ratio (88.7 per cent) followed by private banks (51.0 per cent) and then public sector banks (PSBs), according to the report.

A recovering economy
While interconnectedness in the interbank market has increased marginally, analysis reveals that the size of the interbank market itself has shrunk.

“Contagion analysis of the banking network indicates that if the bank with the maximum capacity to cause contagion losses fails, it will cause a solvency loss of 9.0 per cent of the tier-I capital of the banking system,” according to the FSR.

In his foreword to the report, RBI Deputy Governor Viral Acharya said domestically, “the economy appears to be gathering strength although global commodity price swings and turbulent capital flows are a reminder to our fast-growing economy that there can be little scope for complacence.”
Some of the structural vulnerabilities of the banking sector such as legacy bad debts are finally being tackled headlong. The revised framework on stressed assets, which states even one day delay in servicing loans should be treated as a default, would “incentivise early identification and resolution of credit risk.”

The Insolvency and Bankruptcy Code is emerging as the “lynchpin for resolving stressed assets in a time-bound manner,” and that these measures would bode well for allocative efficiency and financial stability in the medium term “even if there is some short-term pain in the process”. While praising the government’s recapitalisation programme for PSBs, Acharya said governance reforms and market capital-raising appear to have again taken the backseat at the PSBs.
The report noted that growth was getting broad-based, and the economy was “well on the recovery track” as there was an uptick in capacity utilisation. However, capacity utilisation still remains below the average of 74.5 between 2008 and 2017.

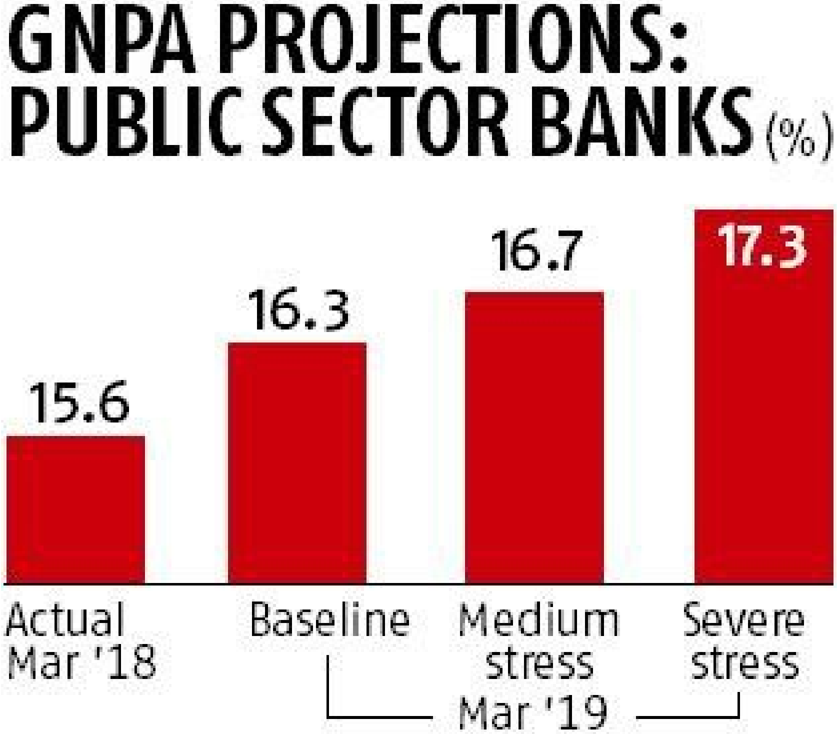
“The aggregate demand composition indicates broad-based growth with revival of investment,” the report noted.

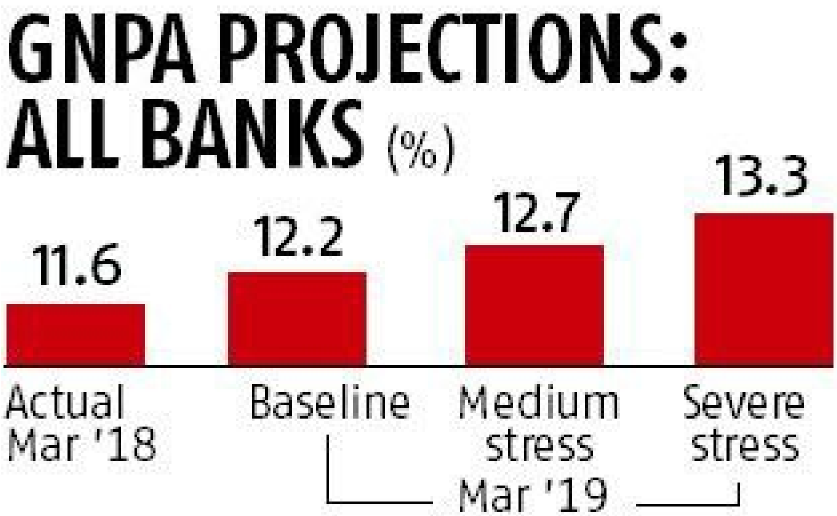
While the report was pleased with the Centre’s efforts to keep the fiscal deficit under check, at 3.3 per cent of gross domestic product in 2018-19, there could be challenges on the fiscal front “unless there is buoyancy in tax receipts and/or a restraint on expenditure,” it said.

“Going forward, increased domestic demand along with a worsening of the terms of trade, particularly due to rising crude oil prices, may impact the current account, although robust global growth is likely to boost India’s exports”, it said.

Ensuring that Indian PSBs have continuing access to global money markets is critical, as they contribute about 45 per cent of export credit. Aggregate export credit increased moderately from Rs 2,353 billion in March 2017 to Rs 2,445 billion in December 2017.

Disintermediation in credit rising
Private, foreign banks, and non-banking finance companies (NBFCs) could offset the shortfall in trade credit, the FSR said.





Note: Gross non-performing assets under various scenarios

Source: RBI

The report noted that the share of PSBs in credit was gradually coming down in favor of private banks. But credit intermediation was also shifting to non-banks. Mutual funds (MFs) have also become important sources of financial credit flows, which continue to benefit from the increasing trend of financial savings.

It further said from the perspective of the financial system, banks continue to be the dominant players, accounting for nearly 46 per cent of the bilateral exposure as of March 2018, however, down from 51 per cent a year ago. Meanwhile, asset management companies managing MFs saw their bilateral exposure increase to 15 per cent, up from 13 per cent in March 2017. The exposure of NBFCs and housing finance companies stood at 12 per cent and 9 per cent, respectively.

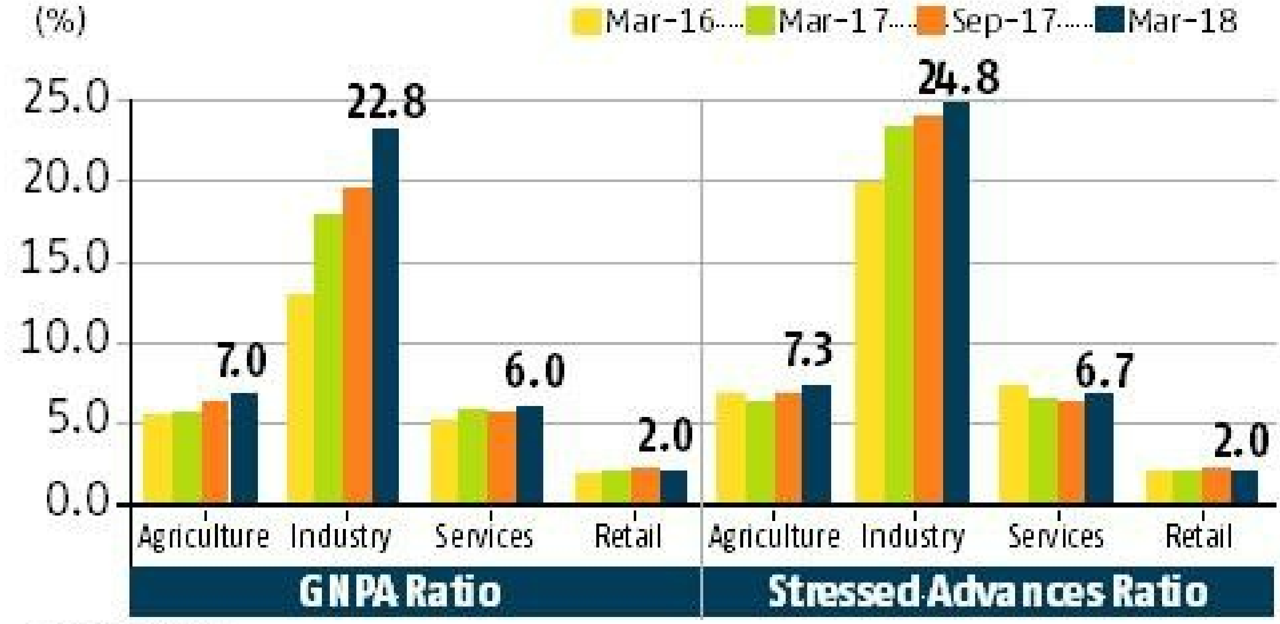
Also, the exposure of banking sector (gross receivable) stood at Rs 323 billion in March 2018 towards the insurance and MF sectors taken together. This has more than doubled from Rs 154 billion during March 2017.

FSR: Need more transparency in balance sheets

The FSR said there were efforts under way to bring transparency to banks' balance sheets and the functioning of their boards "so that the Centre's recapitalisation plans for PSBs do not engender a perverse incentive for banks' managements
to skirt accountability." The current challenge is to bring a sustainable credit culture buffeted by a superior governance structure in the banking ecosystem to cater to the needs of the growing and increasingly modern Indian economy. PSBs are exhibiting lower credit risk appetite than their private sector peers, given the difference in stress in their respective balance sheets. But PSBs continue to have the support of depositors. This enables PSBs to skip participating in interbank borrowing markets, preventing the development of adequate depth in the market.

ASSET QUALITY OF BROAD SECTORS¶I

Per cent of total advances of the respective sector



Sources: RBI