Banks and the contagion

We have not seen the full effect of the pandemic on the banking system yet, and the situation will keep panning out as we go further. Over the past few years, we saw an increase in provisions and booking of losses in the public sector banking space — several banks booked record losses, including the State Bank of India. Punjab National Bank and Bank of Baroda faced frauds and had to book losses. IL&FS and Dewan Housing crisis also had a contagion effect on the banking sector and took its toll on the private sector with the Yes Bank and Punjab and Maharashtra Co-operative Bank crisis.

The interconnectedness of the banking sector and the contagion is there for us to see. When Covid hit us, public sector banking was in the middle of a governance as well as performance crisis. Notwithstanding the early attempts at Gyan Sangam, Indradhanush and the experiment with lateral hiring from the private sector, the State slipped back to its own tried and tested ways of managing the banks through its offices and continues to do so.

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With the finance ministry hitting back at the central bank, it became business-as-usual for the state-owned banks. But then came the shock of demonetisation. Irrespective of how it wrecked the economy, it completely took the focus away from the challenges of governance and reform to exchange and logistics of cash. Significant months were lost counting currency, putting the staff to stress, with no additional business. This was followed by the double whammy "reform"— first by Bank of Baroda lapping up Vijaya and Dena Banks, culminating with a leadership vaccum at the peak of the merger process; and the second more widespread "reform" involving 10 banks. In the past year, with a faltering economy, half of the Indian public sector banks were involved in housekeeping, system integration, staff seniority alignment, permissions and regulatory clearances and rebranding. Luckily, the private sector banks had none of these, except the distractions of the Videocon-Chanda Kochhar issue and the fraud at Yes Bank. While the magnitude of the Yes Bank shock was worrying, the ICICI Bank issue was more an image and reputation one with a non-material long-term impact on the business and the balance sheet.

Now, we enter the Covid era from a position of significant weakness. We will not see the signs of stress and non-performing assets (NPAs) on the banking system this quarter or the next. The oxygen cylinders of liquidity support and moratorium given by the RBI are saving the banking system. Banks are continuing to pick up deposits and liquidity (through RBI's liberalism) without much of a book to build. The extent of NPAs is not known because the definition of an NPA itself has gone into moratorium. The state has neither waived the loans nor provided additional capital. Once the lockdown-moratorium on the accounts is over, the NPA virus will strike hard and cause pain and agony. The moratorium helps if the loan book consists of long tenor loans where the client would be able to recover and also service the loan at the tail end. If the tenor of the loan book is shorter (as in the case of most banks) — the tail will be near the end of the moratorium period — a six- to 12-month stretch on a very short horizon, with no relief in terms of obligations. This will bite hard. Widespread economic distress will ensure that the loan book will not grow.

We are not sure when the Covid crisis will end. It has already devastated the economy. This will be the first time possibly that the concerns of solvency would be higher than the concerns of liquidity in the banking system. This will also be the first time when we will see significant shrinkage of the balance sheets of the banks — caused not only by non-recovery of past loans, but also by no uptake of new loan book. We have not experienced such a crisis and therefore there are no lessons from the past. Banks that are adequately capitalised, and have a lesser leverage would have a greater staying power amidst the destruction.

The sectors to watch out — which are staging a quick recovery and are not subject to volatility — are agriculture, and the diversified poverty portfolios. Therefore, the small finance banks and the micro finance institutions may be relatively more insulated from this crisis, and for the first time we may see a better performance from regional rural banks than the public sector commercial banks. The big banks have a greater concentration of loans from sectors embedded strongly with the larger economy.

What should the government do at this stage? The best response would be to look at governance, human resources, morale, autonomy and other softer issues and leave "reform and restructuring" for a better day.

The government has a distorted notion of reform — merging banks on the basis of software used is not a shining example of reform. At this time, when the banking sector is lagging the real sector, it would do better to focus on managing the business than be distracted by distress sale, privatisation and raising capital from the markets. There are other things in the balance sheet that need to be attended to, and change of ownership could wait for a better day.

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