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INDIA RESEARCH

Indian Banks

REGULATORY FORBEARANCE ACCELERATES RESTRUCTURINGS

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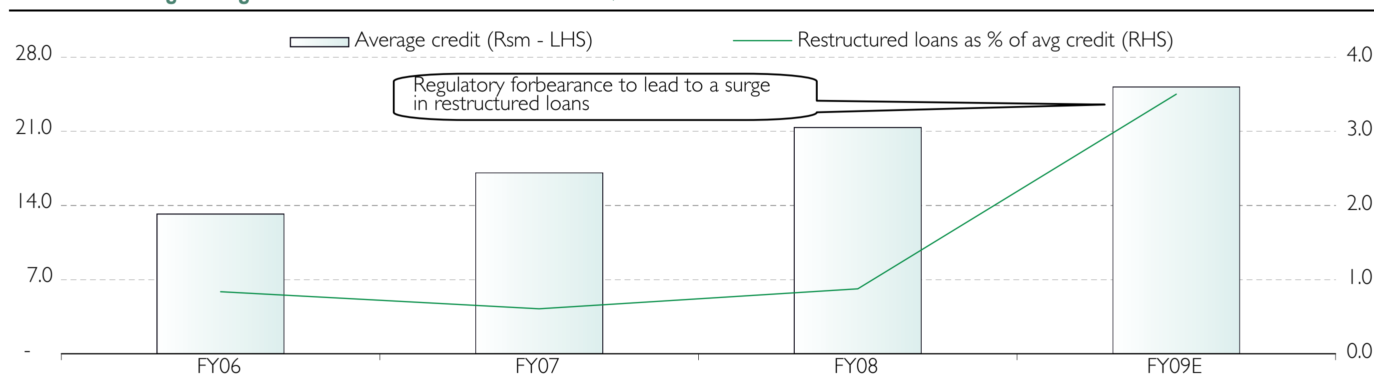
RBI's leeway on restructuring will not only offer a temporary respite to banks and India Inc, but has also accelerated stress recognition in the economy. Anecdotal evidence and our interaction with various banks suggest that 3-4% of the outstanding credit is likely to be restructured in Q4FY09. At over 3% of the outstanding credit, incidence of restructuring is observed to be higher for PSU banks as against ~2% for private banks. We had previously estimated that 15% of the stress would manifest in FY09 and Gross NPAs of the banking system will likely peak at 5.7% in FY11 *(refer to our report "Asset Quality: Hiccup or a crisis" dated 24 February 2009).* However, we now expect a much higher proportion of the stress to manifest in Q4FY09 (40% as against 15% earlier) with regulatory flexibility accelerating the process, and expect Gross NPAs (restructured plus Gross NPAs) in the system to rise to 4.5% in FY09 and peak at 6.4% in FY10 in our base case analysis. Concerns abound on restructuring being used only to delay the manifestation of NPAs and increased opaqueness in banks' balance sheets. However, we believe that in the current environment, only a limited portion of such accounts are likely to slip into NPAs as (i) the current crisis is primarily triggered by liquidity rather than solvency issues; and (ii) recovery in economic growth in the next 2-3 quarters would avert an outsized rise in slippages from such accounts, and (iii) leverage levels for Corporate India are low. Banks are required to make a provision on 'present value loss' incurred on restructured loans. Unless the haircut is very severe, 'present value loss' turns out to be lower than the first year provisions on NPAs. Notably, as the existing RBI guidelines require banks to provide for loss as per the difference between prevailing PLR and the new interest rate, restructuring will invite higher provisions for private banks – typically with higher PLRs – as against PSU banks on comparable loan terms.

❑ A surge in restructuring…

Triggered by the regulatory leeway extended by the Reserve Bank of India (RBI) Indian banks have been flooded with restructuring proposals over the past few weeks. The trend also reflects the sharp deceleration in the Indian economy. Anecdotal evidence (press reports, corporate feedback etc.), as also our interaction with various banks, suggests that loans worth ~3% (i.e. ~Rs800bn) of the outstanding credit are likely to be restructured in the current quarter (Q4FY09).

Exhibit 1: A surge being witnessed in restructured loans in Q4FY09



Source: RBI

PSU banks lead the pack

As there is flexibility to restructure an asset a second time till June 2009 (with the process initiated by March 2009) without having to downgrade the asset, a major portion of the stress in corporate borrowings is likely to get restructured during the period. Our interaction with senior management of various banks reveals that while most PSU banks are undergoing huge restructuring (3-4% of the loan book), the quantum appears to be relatively lower for private sector banks (2-3% of the book).

Restructuring concentrated in specific sectors

As anticipated, a significant portion of the restructured loans is indicated to emanate from SME accounts. Further, these loans are primarily concentrated in the sectors worst hit by the downturn – i.e. export-oriented sectors (textiles, gems & jewellery, auto ancillaries, etc), commodities and commercial real estate.

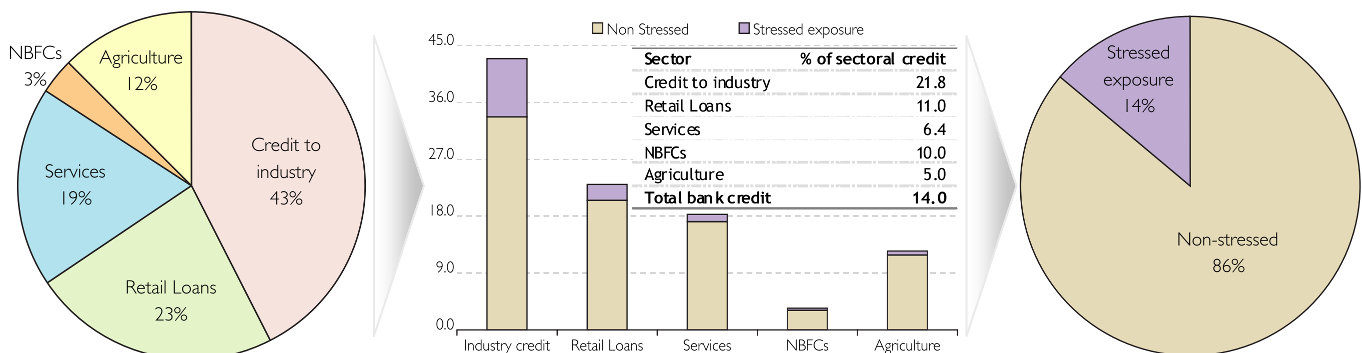
The RBI had issued guidelines (dated 8th December 2008) allowing second restructuring of advances while retaining the asset classification as standard accounts. Later (dated 2nd January 2009) it allowed all accounts which were **standard as on 1 September 2008** to be treated as **standard accounts even after restructuring** subject to (i) the restructuring has been taken up on or before 31 March 2009 (extended from 31 January 2009 earlier); and (ii) the restructuring package is put in place within a period of 120 days from the date of taking up the package.

❑ …to lead to accelerated recognition of stress in the economy

Dimensioning the NPA threat – ~14% of the bank credit appears vulnerable

Slowing growth has dented bottom-lines, and thus debt repayment capability, of all sections of the Indian economy. Consequently, banks are staring at the risk of rapid rise in delinquencies. Our earlier report *"Asset Quality: Hiccup or a Crisis?" dated 24 February 2009* had dimensioned the asset quality threat and deduced that ~14% of the overall bank credit is vulnerable to the risk of defaults. Of this, a proportion is likely to manifest as NPAs or get restructured (50% in our base case) in a staggered manner over the next 2-3 years. We had estimated 15% of incremental stress in the system to accrue in FY09, 60% in FY10 and the remaining 25% in FY11, and consequently expected NPAs (Gross NPAs *plus* restructured loans) to peak at 5.7% in FY11 (7.7% in the worst case).

Exhibit 2: Identifying the stress points



Sector	% of sectoral credit
Credit to industry	21.8
Retail Loans	11.0
Services	6.4
NBFCs	10.0
Agriculture	5.0
Total bank credit	**14.0**

Source: RBI, Capitaline, IDFC SSKI Research

Exhibit 3: Earlier estimates of Gross NPAs

	Base case (50% of stressed debt)			Best case (25% of stressed debt)			Worst case (75% of stressed debt)		
(Rs bn)	**FY09E**	**FY10E**	**FY11E**	**FY09E**	**FY10E**	**FY11E**	**FY09E**	**FY10E**	**FY11E**
Opening Gross NPAs	564	795	1,719	564	680	1,142	564	911	2,297
Allocation of incremental NPAs over yrs (%)	15.0	60.0	25.0	15.0	60.0	25.0	15.0	60.0	25.0
Additions	231	924	385	115	462	192	346	1,386	577
Closing Gross NPAs	795	1,719	2,104	680	1,142	1,334	911	2,297	2,874
Bank Credit	27,419	31,532	37,207	27,419	31,532	37,207	27,419	31,532	37,207
yoy growth (%)	*22.0*	*15.0*	*18.0*	*22.0*	*15.0*	*18.0*	*22.0*	*15.0*	*18.0*
Gross NPA (%)	*2.9*	*5.5*	*5.7*	*2.5*	*3.6*	*3.6*	*3.3*	*7.3*	*7.7*

Source: RBI, IDFC SSKI Research

However, a higher extent to manifest in FY09 – revising the NPA estimates

The process of restructuring of loans has gained pace in the wake of the regulatory flexibility and banks have been flooded with restructuring proposals. Our interaction with banks suggests that loans amounting to 3-4% of the outstanding credit are expected to be restructured in the current quarter (Q4FY09). Consequently, we see the NPA cycle accelerating and expect a greater amount of stressed credit, i.e. 40% (against the 15% estimated earlier) to come to the fore in this quarter. Further, 50% stress is likely to manifest in FY10 and the remaining 10% in FY11. In our base case analysis, Gross NPAs in the economy are likely to rise to 4.5% in FY09, 6.4% in FY10 and subsequently come off to 5.8% in FY11.

Exhibit 4: Revised scenario analysis – Gross NPAs to peak in FY10

	Base case (50% of stressed debt)			Best case (25% of stressed debt)			Worst case (75% of stressed debt)		
(Rs bn)	**FY09E**	**FY10E**	**FY11E**	**FY09E**	**FY10E**	**FY11E**	**FY09E**	**FY10E**	**FY11E**
Opening Gross NPAs	564	1,180	1,950	564	872	1,275	564	1,488	2,643
Allocation of incremental NPAs over yrs (%)	40	50	10	40	50	10	40	50	10
Additions	616	770	154	308	385	77	924	1,155	231
Closing Gross NPAs	1,180	1,950	2,104	872	1,257	1,334	1,488	2,643	2,874
Bank Credit	26,520	30,498	35,987	26,520	30,498	35,987	26,520	30,498	35,987
yoy growth (%)	*18.0*	*15.0*	*18.0*	*18.0*	*15.0*	*18.0*	*18.0*	*15.0*	*18.0*
Gross NPA (%)	4.5	6.4	5.8	3.3	4.1	3.7	5.6	8.7	8.0

Source: RBI, Capitaline, IDFC SSKI Research

❑ Impact of restructuring on banks

RBI's regulatory concession on restructuring is aimed at (i) providing a breather to India Inc suffering from liquidity crunch; and (ii) arresting the rise in banks' NPAs. Restructuring aids a bank's bottom-line to the extent that it can make lower provisions as well as continue to book interest on such loans.

Benefit – lower provisioning requirements on a restructured loan

Restructuring typically involves modification of repayment terms of advances, including alteration of repayment period or repayable amount or the rate of interest. Reduction in the interest rate and /or re-schedulement of principal repayment leads to erosion in the present value of such advances ('present value loss'). Banks have to provide for such 'present value losses' by making additional provisions over and above the normal provisions. The provision on account of present value loss upon restructuring is computed as -

PV loss = PV of future cash flows ***less*** PV of future cash flows (per the restructuring package)

As per the RBI circular, the present value of cash flows of the original loan have to be reckoned on the basis of the **current PLR + term premium + credit risk premium** applicable to the borrower category.

The discounting rate to compute the present value of the cash flows would be = current PLR + term premium + applicable credit risk premium.

The following example illustrates the derivation of PV loss to be incurred by banks:
Loan outstanding at the time of restructuring = Rs1,000 — Term of repayment = 5 years
Interest rate on the loan = 10% — Bank PLR at the time of restructuring = 12%
Term premium = 0.25% — Credit Risk premium = 0.25%
Rate of discount = (PLR i.e. 12% + term premium of 0.25% + risk premium of 0.25%) = 12.5%

Exhibit 5: PV of the original loan

Original loan		Yr 1	Yr 2	Yr 3	Yr 4	Yr 5
Amount outstanding at the beginning of yr	(a)	1000	800	600	400	200
Principal Repayments	(b)	200	200	200	200	200
Amount Outstanding at the end of yr	(a-b)	800	600	400	200	0
Interest @10%	(c)	100	80	60	40	20
Total payments	(b+c)	300	280	260	240	220
Discount Factor (@12.5%)	(d)	0.89	0.80	0.71	0.64	0.57
PV of payments	(b+c)/(d)	268	223	185	153	125
PV of the loan	**Rs 953**					

Present value of the above loan comes to Rs 953. Assuming that the bank restructures the same loan and reduces the interest rate to 8% from 10% earlier while keeping all other terms same, the PV of the loan falls to Rs907 (as explained in the exhibit below) – lower by Rs46. This amount is present value loss for the bank which has to be provided. <u>In case the loan is not restructured and permitted to deteriorate to the NPA category, the bank is required to provide for 10% of the loan outstanding (i.e. Rs100 in this case). However, a lower amount of Rs 46 (4.6% of the outstanding loan) has to provided by the bank after restructuring of this loan. Hence, unless the haircut on restructuring is very severe, 'present value loss' turns out to be lower than the first year provisions on NPAs.</u>

Exhibit 6: Loan restructured by reducing the interest rate to 8%

Restructured at lower interest rate		Yr 1	Yr 2	Yr 3	Yr 4	Yr 5
Amount outstanding at the beginning of yr	(a)	1000	800	600	400	200
Principal Repayments	(b)	200	200	200	200	200
Amount Outstanding at the end of yr	(a-b)	800	600	400	200	0
Interest @8%	(c)	80	64	48	32	16
Total payments	**(b+c)**	**280**	**264**	**248**	**232**	**216**
Discount Factor @12.5%	(d)	0.89	0.80	0.71	0.64	0.57
PV of payments	(b+c)/(d)	250	210	177	147	123
Total PV of loan	**Rs 907**					
PV loss of the bank	Rs 46	(4.6% of the loan)				

In case the interest rate is kept constant, but the term of loan repayment is extended to eight years from five years, the present value of the loan becomes Rs922 – PV loss of Rs16 for the bank (1.6% of the outstanding loan amount), thus further reducing the provisioning impact on the P&L. <u>Currently, banks are preferring to restructure the loans in this manner (i.e. by extending the term of repayment while keeping the rate of interest constant) to minimize the impact on the bottom-line.</u>

Exhibit 7: Loan restructured by extending the tenure of repayment to eight years

Restructured loan - tenure extended to 8 years		Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8
Amount outstanding at the beginning of yr	(a)	1000	875	750	625	500	375	250	125
Principal Repayments	(b)	125	125	125	125	125	125	125	125
Amount Outstanding at the end of yr	(a-b)	875	750	625	500	375	250	125	0
Interest @10%	(c)	100	87.5	75	62.5	50	37.5	25	12.5
Total payments	**(b+c)**	**225**	**212.5**	**200**	**187.5**	**175**	**162.5**	**150**	**137.5**
Discount Factor @12.5%	(d)	0.89	0.80	0.71	0.64	0.57	0.51	0.45	0.40
PV of payments	(b+c)/(d)	201	169	142	119	99	82	68	56
Total PV of loan	**Rs 937**								
PV loss	**Rs 16** (1.6% of the loan)								

Concern – prolonging the crisis?

Prudent application of restructuring can aid the borrowers to tide over temporary cash flow problems and alleviate the asset quality pressure for banks. However, on the flip side, restructured loans are seen to have a higher tendency to slip into NPAs and consequently, aggressive restructuring may just postpone the slippage of an account into the NPA category. Also, banks often extend incremental credit to 'stressed borrowers' after restructuring, which increases the degree of risk in the loan book. However, as the prevailing stress primarily stems from a severe liquidity crunch rather than solvency issues, restructuring can be a useful tool for tiding over the rough period.

Concern – lack of transparency

Though restructuring currently enjoys regulatory concessions for economic reasons, it has led to increased investor skepticism on reported numbers. Restructuring is often criticized on the grounds that it leads to opaqueness as banks disclose restructured loans on an annual and not a quarterly basis.

Current situation may offer an exception

In the current environment, wherein the stress primarily stems from a severe liquidity crunch rather than solvency issues, restructuring can be a prudent measure. There could be circumstances of genuine stress on a company's cash flows, which require a reprieve in the form of a lower rate or longer repayment period to tide over a tough period. We believe that a recovery in economic growth over the next 2-3 quarters and revival in demand would likely lead to performance in bulk of the restructured accounts and ward off slippage into NPAs.

The Catch-22 of private banks

As discussed above, banks are required to calculate the present value of future cash flows of the original loan on the basis of the 'current PLR + term premium + credit risk premium applicable to the borrower category'. As such, the rate used to arrive at the PV as per the original loan (to calculate the sacrifice) is based on the current PLR of the bank and not on the rate of interest charged originally on the loans. As private banks typically have higher PLRs than PSU banks, in case where the loan is restructured by extending the repayment period, the PV loss to be borne by the private bank is likely to be much higher for the same loan.

Exhibit 8: PV of the original loan – PLR = 15.5%

Original loan (Rs)		Yr 1	Yr 2	Yr 3	Yr 4	Yr 5
Amount outstanding at the beginning of yr	(a)	1000	800	600	400	200
Principal repayments	(b)	200	200	200	200	200
Amount outstanding at the end of yr	(a-b)	800	600	400	200	0
Interest @10%	(c)	100	80	60	40	20
Total payments	(b+c)	300	280	260	240	220
Discount factor @16%	(d)	0.86	0.74	0.64	0.55	0.48
PV of payments	(b+c)/(d)	259	208	167	133	105
PV of the loan	**Rs871**					

Exhibit 9: Loan restructured by extending the tenure of repayment to eight years

Restructured loan - tenure extended		Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8
Amount outstanding at the beginning of yr	(a)	1000	875	750	625	500	375	250	125
Principal repayments	(b)	125	125	125	125	125	125	125	125
Amount outstanding at the end of yr	(a-b)	875	750	625	500	375	250	125	0
Interest @ 10%	(c)	100	87.5	75	62.5	50	37.5	25	12.5
Total payments	(b+c)	225	212.5	200	187.5	175	162.5	150	137.5
Discount factor @16%	(d)	0.86	0.74	0.64	0.55	0.48	0.41	0.35	0.31
PV of payments	(b+c)/(d)	194	158	128	104	83	67	53	42
Total PV of loan	**Rs829**								
PV loss	**Rs42**	(4.2% of the loan)							

The PV loss for a bank with higher PLR (assumed at 16%) for the same loan comes to Rs42 as against a loss of Rs16 for a bank with PLR of 12%. As a result, while the sacrifice should be similar on the same loan for the two categories of banks irrespective of the PLR, private banks are likely to be required to provide a higher amount on a similar loan as compared to PSU banks.

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