

CAPITAL

**LOOMING
TROUBLE**

PSU BANKS THAT NEED TO RAISE THE MAXIMUM CAPITAL



**ARUNDHATI
BHATTACHARYA**

Chairman

STATE BANK OF INDIA

GROWTH IN ADVANCES (%) **15.7**

NET NPA RATIO (%) **2.57**

CAR (%) **12.33**

CAPITAL REQUIREMENT (₹ CR)

1,25,813



V.R. IYER

Chairperson and Managing Director

BANK OF INDIA

GROWTH IN ADVANCES (%) **28.12**

NET NPA RATIO (%) **2.00**

CAR (%) **10.97**

CAPITAL REQUIREMENT

29,759



V.S. KRISHNAKUMAR

Managing Director and CEO

CANARA BANK

GROWTH IN ADVANCES (%) **24.32**

NET NPA RATIO (%) **1.98**

CAR (%) **10.19**

CAPITAL REQUIREMENT

27,325

Consolidated CAR as per Basel III. Capital allocation based on market share of current risk weighted assets of PSU banks. Capital includes both tier-I and tier-II. Growth in advances and net NPA ratio (YoY) as on 2013/14; CAR as on Sep 2014. Source: Company annual reports, RBI, BT Research

CRISIS

PSU banks have the onerous task of raising an enormous amount of capital in four years to stay in business.

By ANAND ADHIKARI

The 150-year-old Allahabad Bank has weathered the Swadeshi movement, survived the global monetary crisis of 1913, witnessed two World Wars, seen the nationalisation of banks and fought intense competition from the private sector. But it probably never had to face a situation it is confronted with now.

The Kolkata-based public sector bank stares at an uncertain future with mounting non-performing assets (NPAs), worsening asset quality and a falling capital adequacy ratio (CAR) of just 9.99 (the worst among state-owned banks). It needs to raise an estimated ₹11,000 crore within four years to meet the new CAR norms for banks that have kicked in from April 2013 in a phased manner and are expected to be fully implemented by March 31, 2019. If it fails to do so, it could be asked by the Reserve Bank of India (RBI) to stop handing out any fresh loans. Not a prospect that any bank would relish.

Twenty-five other PSU banks face a similar situation. These banks – including household names such as the State Bank of India (SBI), Punjab National Bank, Bank



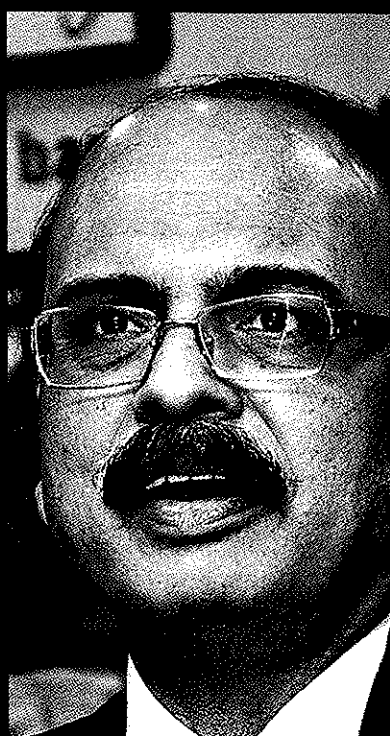
M.S. RAGHAVAN
Chairman and Managing Director

IDBI BANK

0.7
2.48
11.71

CAPITAL REQUIREMENT

23,630



ARUN TIWARI
Chairman and Managing Director

UNION BANK OF INDIA

10.1
2.33
10.23

CAPITAL REQUIREMENT

20,577

BANKS WITH WORST CAR

of India and Canara Bank – need to raise an estimated Rs 4.60 lakh crore capital within the next four years.

CAR is a bank's buffer against current and future losses. Just five years ago, Allahabad Bank's CAR stood at 13.62 per cent. Worsening CAR has a debilitating effect on a bank's capacity to meet liabilities and manage credit and operational risks.

PSU banks account for two-thirds of India's banking system. The capital shortage looming before them threatens the nation's ambition of achieving over 10 per cent GDP growth and having a bustling manufacturing sector through the Narendra Modi government's Make-in-India initiative. It also practically bids adieu to the dream of emerging as a global investment destination, simply because banks that cannot raise enough capital to meet the new CAR norms risk being told by the RBI to stop giving out fresh loans.

"It's like driving a car on a near empty tank," jokes a private banker. Rakesh Sethi, CMD of Allahabad Bank isn't amused by talks of a capital shortage for the bank. "Our capital adequacy at 9.99 per cent is well above the regulatory requirements," says Sethi. Allahabad Bank may meet banking regulator RBI's current floor of 9 per cent, its capital adequacy is nowhere near what is required in the immediate future. Basel III, the third in a series of accords arrived at between the world's economies in 2010 following the global financial crisis in 2008, requires banks around the world to maintain a minimum CAR of 11.50 per cent by March 31, 2019.

Allahabad Bank can't be blamed entirely for its poor CAR. Besides rising NPAs, one main reason for the falling CAR is inadequate capital infusion by the bank's 59 per cent owner – the President of India, who owns the equity on behalf of the government. Successive finance ministers have been stingy about providing capital to state-owned banks. As a result, over the past five years the CAR of almost all the PSU banks have



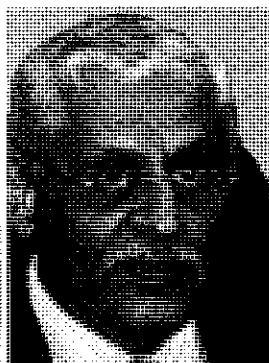
RAJEEV RISHI

CENTRAL BANK OF INDIA



ANIMESH CHAUHAN

ORIENTAL BANK OF INDIA



RAKESH SETHI

ALLAHABAD BANK

GROWTH*	3.1	7.9	6.6
NET NPA RATIO (%)	3.75	2.81	4.15
CAR (%)	10.65	10.88	9.9
CAPITAL REQUIREMENT (₹ CR)	16,493	12,594	11,080

*Growth in advances (%)

Consolidated CAR as per Basel III. Capital allocation based on market share of current risk weighted assets of PSU banks. Capital includes both tier-I and tier-II. Growth in advances and net NPA ratio (YoY) as on 2013/14; CAR as on Sep 2014. Source: Company annual reports, RBI, BT Research

shown a downward trend.

Even though Basel III is a voluntary standard, it urges a country's regulator to bar a bank from carrying on its core business of lending if it doesn't meet the CAR norms by the deadline. It is another matter that the deadline for complying with the norms has been extended twice from March 31, 2015 to March 31, 2018 initially and now further to March 31, 2019. Nothing stops countries from around the world to ask for another extension. Bnt to avoid the ignominy of having a CAR below the new norms in case no further extension is granted, all the PSUs need to start acting immediately. A September 2014 Fitch report says India's banking system needs to raise \$200 billion to continue growing at the current rate and still meet the

Basel III norms. "The core capital position of the Indian banking system is weaker than that of many Asian banking systems that are also migrating towards the Basel III capital norms," says the report.

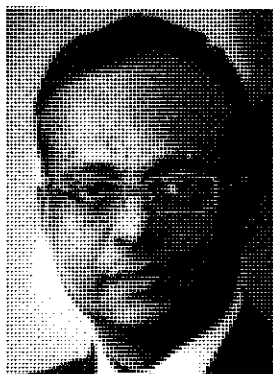
An Uphill Task

For PSU banks, it is a question of survival. Its owner – the government – is in no position to provide the capital since it's already struggling to bridge the widening fiscal deficit.

Of the ₹4.60 lakh crore that the PSU banks need to raise, ₹2.39 lakh crore is the equity capital in the form of Tier-I capital that must either be provided by the government or be raised from the equity market.

Now, given the government's finances, it doesn't have the resources to pump in ₹2.39 lakh crore (close to

BANKS WITH LOW CAPITAL ADEQUACY, HIGH NPAS AND STRESSED ASSETS



C.V.R. RAJENDRAN
Managing Director

ANDHRA BANK

9.4

3.11

10.3

CAPITAL REQUIREMENT

9,729



T.M. BHASIN
Managing Director

INDIAN BANK

15.7

2.26

13.16

CAPITAL REQUIREMENT

9,142

25 per cent of the tax revenue) into the banks over the next four years. Historically, it has allocated less than ₹20,000 crore a year. In 2013/14 budget, out of ₹14,000 crore, the biggest bank SBI cornered around ₹2,000 crore while a small bank like Punjab & Sind bank received around ₹100 crore.

Barring a handful, most PSU banks are gasping for breath as their capital is fast eroding due to deteriorating asset quality. Faced with a crisis, a couple of months ago the government gave the go head to these banks to reduce its stake to a minimum of 52 per cent in phases. In some banks – such as Central Bank of India, United Bank of India, Bank of Maharashtra and IDBI Bank – the government holds up to 80 per cent equity. In others,

including SBI, Oriental Bank of Commerce and Bank of Baroda, its stake is around 60 per cent.

The Centre estimated that the banks could mobilise up to ₹1.60 lakh crore from the capital market over the next four years. It has proposed that the remaining ₹79,000 crore would come from the Union Budget. Since it would earn an estimated ₹34,500 crore through dividends from the banks, the net burden over four years would be no more than ₹44,395 crore, or ₹11,000 crore a year.

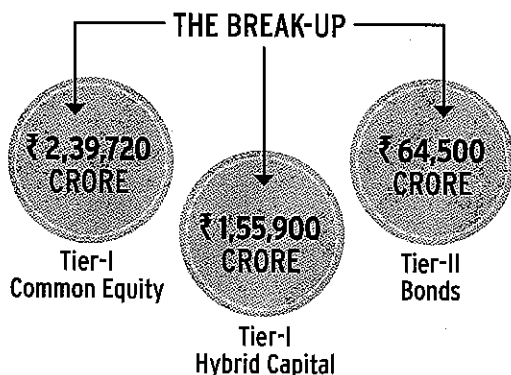
Reality Check

That sounds good and eminently achievable. But look at the reality. Even with the stock markets at a record high and Sensex crossing the 29,000 mark, the current



TOTAL CAPITAL REQUIREMENT IN THE NEXT FOUR YEARS

₹4,60,120 crore



(*Tier-I capital comprises equity, premium, surpluses and hybrid bonds while tier-II capital comprises bonds)

GOVERNMENT CALCULATION

Where the capital will come from

₹1,60,825 crore

Reduction of government stake to at least 52 per cent

₹78,895 crore

Budgetary support

₹2,20,400 crore

Tier-II bonds from the market

value of the PSU banks' dispensable stock above 52 per cent is barely ₹1 lakh crore.

It is because the shares of most PSU banks are dirt cheap with their price-to-book ratio ruling at under 1 (see *Rock Bottom Valuations*). SBI has the best ratio of 1.83. In comparison, India's second-largest private sector lender, HDFC Bank, commands more than five times the book value and the largest private sector bank ICICI Bank just under three times.

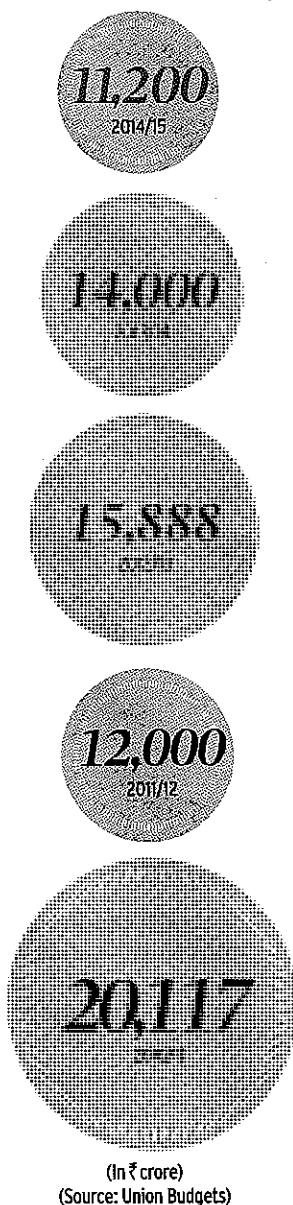
The problem is that investors do not like PSU banks because their NPAs are higher than private sector banks while their profitability is generally much lower. And that is why hitting the capital markets to raise capital is an uphill task. Take, for instance, Allahabad Bank itself where the government holding is 58.9 per cent. The bank has little headroom to raise capital by paring government stake as only about ₹1,000 crore can be mobilised through this route.

"The stake sale exercise would be value destroying for PSU banks," says a private banker. Jayant Sinha, Minister of State for Finance, agrees. "It is our responsibility to ensure that if we are going to dilute our stake, which is the stake of the people, we will do it at an appropriate valuation," he said at a bankers' meet in Pune. Incidentally, it was Sinha's father and former finance minister Yashwant Sinha who once suggested cutting the government stake in PSU banks to 33 per cent. But the younger Sinha, who knows a thing or two about valuations as a former partner of investment firm Omidyaar Network, is treading cautiously.

"The capital position of many PSU banks could be described as weak," says Saswata Guha, Director (Financial Services) at Fitch Ratings. The RBI's recent financial stability report also noted that the capital adequacy of PSU banks could fall to its lowest, 9.2 per cent, by next year under a severe stress scenario.

If the PSU banks do take the plunge to raise equity, the big ques-

WEAK SUPPORT: Budgetary allocation to PSU banks has been falling



tion is whether there is investor appetite for their shares even at fire sale prices. In January last year, SBI's equity sale of ₹8,000 crore could only go through after another state-owned entity Life Insurance Corporation (LIC) pitched in. In fact, LIC has been happily subscribing to the unsold portion of the PSU banks' equity offering. It makes sense because the equity remains within the government eco-

system. But SBI has a better CAR than many of its brethren.

Canara Bank, also trying to raise equity, has struggled for the past year. Its board approved a proposal for ₹80 crore equity offering to qualified institutional investors (QIP) in April last year. The bank started the process in October last year, but without any success so far.

Allahabad Bank has been waiting for better days despite getting a QIP of ₹320 crore approved by its board. Why wait when you need capital? "Issuing shares at less than book value hurts the existing shareholders," explains Sethi. Allahabad Bank has a price-to-book ratio of 0.68. With the RBI recently allowing a new instrument of Tier-I bonds, the bank is now exploring the possibility of raising between ₹500 and ₹1,500 crore through Tier-I and Tier-II bonds, says Sethi. Similarly, Oriental Bank of Commerce cleared a ₹1,000 crore QIP in January. There is a likelihood of LIC chipping in if there is a tepid response to their offering by institutional investors. But LIC's stake in PSU banks is already on the rise.

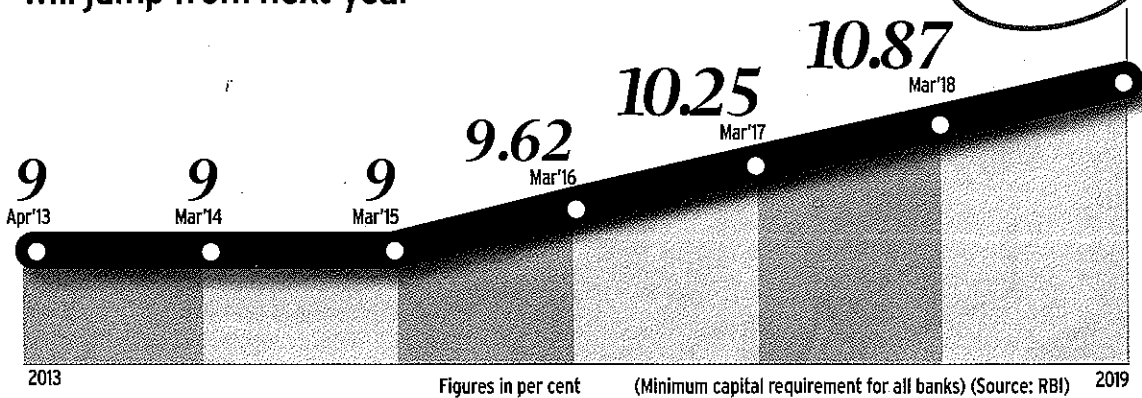
Prithvi Haldea of Prime Database, a database on the primary market, says PSU banks could tap depositors or global markets for raising capital.

RBI Deputy Governor R. Gandhi, however, feels reducing stake won't be sufficient since Basel-III projections are based on minimum capital requirements. While speaking in Kolkata on 'Indian PSU Banking – The Road Ahead', Gandhi said PSU banks will have to chalk out a capital raising plan over the next five years. "The banks should actively consider several options including non-voting rights shares, differential voting rights shares, golden voting rights, etc," says Gandhi, who is responsible for regulations and risk management.

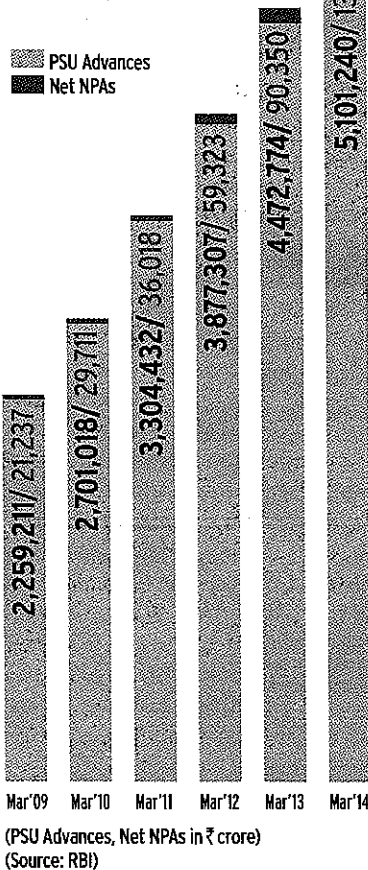
Pressing the Panic Button

Gandhi has set the tone for some tough decisions, most of which are in the government's domain. SBI Chairperson Arundhati

MAXIMUM IMPACT OF BASEL III: Banks' capital burden will jump from next year



CAPITAL GUZZLER: Credit growth is intact while bad loans are rising



Bhattacharya echoed similar views when she said the PSU banks should look at issuing non-voting shares.

But the public sector bankers have already pressed the panic button. In the current depressed equity valuation of PSU banks, Tier-I additional bond is a good option for beefing up capital, according to R.K. Takkar, Executive Director, Dena Bank. Bank of India and Corporation Bank have raised Tier-I bonds, five-year instruments which can be converted into equity later. The other capital is Tier-II capital which cannot be more than 100 per cent of Tier I capital. "The risk element is higher in new additional Tier-I bonds as these are going concern instruments. They are required to absorb losses below a pre-specified common equity tier-I ratio," says Guha of Fitch. The Tier-I bonds are part of loss-absorbing capital – this capital along with common equity has to be wiped out first in case of liquidation of a bank.

Praveen Gupta, Deputy MD of SBI, feels it makes a lot of sense for PSU banks to meet part of their capital requirement by raising these bonds. "It not only opens a new class of investors but is also much cheaper when compared against the expected return on pure equity," says Gupta, who is also the CFO of the bank. The government expects a 15 to 16 per cent return on equity from PSU

banks. The interest rate offered in Tier-I bonds is a healthy 9.5 to 11 per cent. In August last year, Bank of India raised ₹2,500 crore through these bonds at a rate of 11 per cent. In December, Andhra Bank mobilised ₹500 crore at a much lower rate of 9.55 per cent. Similarly, more than half a dozen banks are already in the market – from south India-based Corporation Bank to Delhi-based Oriental Bank of Commerce – to raise capital through Tier-I bonds.

But a PSU bank chief warns against the mad rush to raise Tier-I bonds. "If you are operating in a falling interest rate scenario, it is always desirable to wait," he says. The RBI has started the interest rate easing cycle after a long 20-month wait. There are now expectations of a 50 to 100 basis points reduction in interest rates over the next 12 months. "Given the RBI's monetary easing cycle, this is certainly not the time to lock in such bonds at the current rate," admits the CMD of a Delhi-based PSU bank on condition of anonymity. Raising these bonds today means locking funds at a higher cost. The other big issue is the limited scope of the market for these new bonds. "The potential investors in Tier-I bonds are private insurance companies, LIC and EPFO (Employees' Provident Fund Organisation), which are prohibited from investing in hy-

ROMESH SOBTI
MD & CEO,
INDUSIND BANK

“Capitalisation would no longer be an issue if the government reduces its stake to 33 per cent. The problem could be of absorption in the primary market”



RACHIT GOSWAMI

brid instruments,” says Gupta of SBI.

Meanwhile, banks are also considering selling non-core assets. “The government has advised the bank to dispose of investment in noncore assets to increase internal accruals in order to reduce total capital requirement. The bank is exploring the possibility of such divestment,” says Rajeev Rishi, CMD of Central Bank of India. IDBI Bank has decided to sell its stake in NSE as well as Care Ratings. The stake sale in Care Ratings could generate ₹750 crore. “Banks could also revalue their fixed assets and real estate. This will strengthen Tier-II capital,” says an expert. Among the long-term solutions on the table are proposals to create a holding company structure or merge multiple PSU banks to create four or five large

banks of SBI’s size and balance sheet.

But more than these measures, there is a need for qualitative measures such as improving governance, providing stable management, professionalizing the board with more independent directors, non-interference of the political class and strengthening project appraisal capabilities.

The Genesis

A bulk of the blame for PSU banks’ capital crisis must go to the government. It has starved these banks of capital. While the government’s own finances didn’t permit capital infusion, even the banks failed to generate internal capital because of deteriorating asset quality. Their capital shortfall is now accentuated by the Basel-III guidelines, which require them to raise their capital adequacy every year to absorb any loss from credit, market or operational risks.

The failure of banks globally post the 2008 crash of Lehman Brothers exposed the shortcomings of the Basel-II capital requirement. Under Basel-II, the trading business (equity, bonds, derivatives) required lesser capital than the core banking business of lending to corporates and retail. The banks took advantage of this capital loophole and built large trading books. Similarly, there were other areas, like leverage, where Basel-II had insufficient capital requirements.

Basel-III has been constructed on a more robust framework in terms of capital. “The incremental credit growth will be slow because of capital inadequacy. The future credit will also depend on the ability to raise capital, recovery of NPAs and timely restructuring of assets,” says S. Ravi.

ROCK-BOTTOM VALUATIONS

HDFC Bank has a price-to-book of 5.36 and ICICI Bank has 2.8, much higher than many PSU banks

Govt. Stake	Price-to-book ratio
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Punjab & Sind Bank	79.62%	0.51
Dena Bank	58.1%	0.51
IDBI Bank	76.5%	0.54
Indian Overseas Bank	73.8%	0.51
Bank of India	66.71%	0.68
Corporation Bank	63%	0.55
Andhra Bank	60.14%	0.60
Allahabad Bank	58.9%	0.68

Shareholding figures for December 2014; price-to-book ratios as on January 15, 2015. Price-to-book shows how many times the shareholders equity is valued in the market.

Source: BT Research



**JAYANT
SINHA**
MINISTER OF STATE
FOR FINANCE

“It is our responsibility to ensure that if we are going to dilute our stake, which is the stake of the people, we will do it at an appropriate valuation”

THE WAY OUT:

Other options on the table to improve CAR

Sell corporate portfolio to release capital

Sell non-core assets

Raise additional tier-I capital through perpetual bonds

Revalue fixed assets

Pare lending growth to preserve capital

Focus on assets with low-risk weights like loans to companies with triple A rating

Reduce or stop dividend payments to government

Director, IDBI Bank.

The PSU bank chiefs also just cannot escape the blame for the capital mess. Given the small doses of capital infusion by the government and the deteriorating asset quality every year, the banks should have applied the brakes on their growth ambitions. Every rupee of lending consumes capital. For example, if a bank gives a personal loan of ₹100, the risk weight is 150 per cent of the minimum capital requirement of nine per cent. That's ₹13.5 on every loan of ₹100. Similarly, lending to BBB-rated corporate carries a 100 per cent risk weight. Hence, for every corporate

tribute the problem to the limited vision of the PSU bank chiefs. The CMDs are keener on demonstrating growth during their tenure (about two to three years) without calibrating it against long term needs based on asset quality and internal generation of capital. This is reflected in the growth in advances of PSU banks in the post 2008 period when everyone else around the world was conserving capital.

The PSU banks have also turned a blind eye to the deteriorating asset quality. Take the case of United Bank of India whose net NPAs are at an alarming 7.09 per cent. A year ago,

loan of ₹100, the bank has to provide ₹9 capital. “The banks could have re-balanced their portfolio by focusing largely on assets that require lesser capital,” says Rajesh Mokashi, Deputy MD at Care Ratings. Consider mortgages where the risk weight for capital is 50 per cent for loans up to ₹30 lakh. The high growth between 2009 to 2012 was mainly because of the loans sanctioned in earlier years. Ravi of IDBI defends PSU banks and says there are large term loans where disbursement takes place over a period of time. “The banks cannot turn their back on the commitment on term loans,” says Ravi.

M.D. Mallya, former MD of Bank of Baroda explains that a large component of loans went to the poorly performing infrastructure sector in the last three to four years. “Infrastructure is contributing to the deteriorating asset quality. No one would have anticipated that infra could face such difficulty,” says Mallya. There are some who at-

tributed the problem to the limited vision of the PSU bank chiefs. The CMDs are keener on demonstrating growth during their tenure (about two to three years) without calibrating it against long term needs based on asset quality and internal generation of capital. This is reflected in the growth in advances of PSU banks in the post 2008 period when everyone else around the world was conserving capital.

Another headache is the restructured assets portfolio. Central Bank of India has an outstanding restructured portfolio at 15 per cent of advances, Oriental Bank of Commerce at 12 per cent and Punjab National Bank, Allahabad Bank and Andhra Bank at 10 per cent each.

Thirdly, the Basel-III roll out has kicked in from April 1, 2013, which is putting enormous pressure on these banks. Basel-III requires banks to keep a minimum Tier-I capital of 7 per cent, out of which common equity has to be 5.5 per cent. “The capital requirement is actually lower during the initial years with higher doses of capital starting from March 2016,” says Mokashi of Care Ratings. But given the current state of PSU banks' balance sheet, the RBI is yet to introduce another Basel III guideline

to maintain a 0 to 2.5 per cent buffer that protects banks from risks arising out of excessive credit growth.

A Bleak Future?

The stability of PSU banks is of paramount importance for the government and the economy as a whole. After all, they account for two-third of all deposits and advances in India.

unlimited capital," says the CEO of a PSU bank who attended the event. Many bankers after this meeting are convinced that one solution could be consolidation of PSU banks.

"Capitalisation would no longer be an issue if the government reduces its stake to 33 per cent," says Romesh Sobti, MD & CEO of private sector IndusInd Bank. "The problem could

depend on how economic growth pans out. "If things improve, it is better for banks and if things deteriorate, there will be a challenge," says Kumar.

The RBI's financial stability report has suggested that the ultimate enhancement in valuations could only come from corresponding improvements in asset quality, governance structures and operational efficiencies. But that's a tall order. Meanwhile, the analyst community is already painting a bleak future. The return on equity (ROE), a measure of returns to shareholders, shows a steep decline for PSU banks. At 9.71 per cent, it was woefully short of 17.06 per cent delivered by private banks. Many PSU banks such as Indian Overseas Bank, UCO Bank, Central Bank and Punjab and Sind Bank have an ROE of less than 7 per cent. This makes them far less attractive for investment. "We have been very cautious on PSU banks, except SBI and Bank of Baroda," says Saday Sinha, analyst at



**RAJESH
MOKASHI**
DEPUTY MD,
CARE RATINGS

"The banks should have done re-balancing of portfolio by focusing largely on assets that require lesser capital"

But the government has fiscal constraints as it targets containing fiscal deficit at 4.1 per cent in 2014/15. In fact, the government had adhered to the Fiscal Responsibility Act in the five years ending 2007/08. The deficit figure was at 2.54 per cent of GDP in 2007/08. But the global financial meltdown washed away all the gains.

The new government under Prime Minister Narendra Modi appears serious about sorting out the capital crisis. In early January, Modi himself flew in to Pune to discuss the various issues confronting PSU banks. "We will have to wait and watch on what sort of capital the government would provide. I don't think that the government would be able to provide

be of absorption in the primary market. If the PSU banks improve governance and management quality, the money will certainly flow in from foreign institutional and other investors. But these radical reforms are not going to happen in the next one or two years," says Sobti.

Bankers are pinning their hope on economic revival. It will sustain stock market rally and will help banks raise money at better valuations. It will also have an impact on the portfolio of corporate loans. The credit rating of many companies will improve and hence risk weight assets will go down, thereby freeing more capital. Shinjini Kumar, Financial Services Head, PwC, says the future capital situation de-

Kotak Securities. "The only bank which has a comfortable CAR is the Indian Bank." There is little hope of improvement of ROE as capital requirements and future capital raising would further impact returns.

And if the new capital doesn't arrive, PSU banks will have no option but to halt lending. Time is of essence. If the government's collective wisdom points to raising capital through stake sale, there is no better time than this. If the solution to the capital crisis lies in consolidation, what are we waiting for? ♦

RESEARCH INPUTS BY NITI KIRAN
AND JYOTINDRA DUBEY

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