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Reported NPAs and Capital requirements to decline in near term as banks restructure the stressed loans

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Highlights

- *Unlike the previous loan restructuring scheme of August 2008 which continued till March 31, 2015, the current Reserve bank of India (RBI) notification of August 6, 2020, allows a limited window till December 31, 2020 to identify borrowers that will require resolution plan (RP - including restructuring).*
- *Further a reasonable timeframe of 3 months for individual loans and 6 months for corporate loans has been allowed to implement the RP from the date of identification of need for a resolution in such loans*
- *In addition, only the loans which were overdue by 30 days or lower as on March 1, 2020 will be eligible for such resolution, thereby tightening the criterion for restructuring. The lenders will hence not be able to restructure the chronically overdue accounts and deferring the problem loan recognition*
- *Further safeguards, such as assessment of the RP by an independent credit evaluation (ICE) by a credit rating agency (CRA) for exposure more than Rs 1.0 billion and appointment of "Expert Committee" which will specify norms for preparing RPs will ensure that the RPs are realistic and workable.*
- *A higher upfront provisions of 10% has been stipulated by RBI as against 5% in the earlier restructuring regime, in case the lenders decides to do so*
- *The provision reversals are allowed only when the borrower demonstrates repayment of 30% of the restructured loan*
- *The insolvency and bankruptcy code (IBC) has empowered lenders and a real deterrent for the defaulting promoters. Even if the RP is unrealistic and fails, banks can invoke bankruptcy proceeding against such companies*
- *As per our estimates 70-80% of the earlier restructured loans failed and a large portion of the stressed assets in the corporate segment were recognised as NPAs by banks during FY2016-FY2020 giving lenders sufficient experience of failed restructuring. Further, the recovery rates upon resolution were also much lower in these accounts*
- *The micro small and medium (MSME) loan restructuring scheme has been in place since February 2018 and as per ICRA's estimates less than 2% of the total MSME loans have been restructured by the lenders, reflecting lenders careful approach towards such restructuring*
- *Given the tighter norms, we expect the lenders to be more prudent in approving the restructuring of loans for the borrowers*
- *The loans under moratorium for public banks (PSBs) stood at ~68% and that for private banks (PVBs) stood at 31% as on April 30, 2020 which has declined in subsequent months. The contrasting difference in the moratorium percentages is because of the opt-out approach followed by PSBs as compared to opt-in approach followed by PVBs for moratorium*
- *The moratorium book has further declined to 10-15% among large private banks and ~10-20% in large PSBs in the second phase (June-August) of the moratorium with some lenders continue to have 20-40% of the loan book under moratorium*
- *Earlier we estimated that 10-20% of the moratorium loan book of 30-40% could be vulnerable to slippage, translating in fresh slippages of 3-8% (~5.0-5.5% average slippage) during FY2020*

- ***We expect the moratorium to further reduce to ~10-15% at a system level when the moratorium ends in August 2020. A part of this loan book (3-4%) is likely to slip within FY2021, while 5-8% of these loans could be restructured and the rest is likely to result in an increase of 2-3% in loans in overdue categories such as SMA 1 and SMA2. If the lenders decide to be lenient in restructuring, the increase in overdue loans will be lower and restructured loans can be higher by similar amounts. The overall SMA 1 and SMA 2 for the banking system stood high at ~6.0% of advances as on March 31, 2020. A large part of this SMA 1 and 2 is expected to be included in the moratorium book.***
- ***We had earlier estimated Gross-NPAs (after recovery and write offs) to rise to 11.3-11.6% for banks by March 2021 expecting a gross slippage rate of 5.0-5.5%. With expectation of reduced slippage of 3-4% we expect the increase in GNPAs to 9.8-10.3% by March 31, 2021 from 8.5% as on March 31, 2020.***
- ***We had also estimated capital requirements for PSBs at Rs 460-826 billion for FY2021 and Rs 250-483 billion for PVBs during FY2021-22, which will now decrease. Our broad estimates show that the capital requirements for PSBs could decline to Rs 200-555 billion for FY2021 and Rs 220-334 billion for PVBs during FY2021-22. Some PVBs may however raise capital higher than our estimates as their capital raisings are for next 3 years of growth cycle.***

Past trends of standard restructured assets – such loans peaked at ~6.1% of the banking sector advances in March 2015

EXHIBIT 1: Public sector banks had higher share of restructured loans

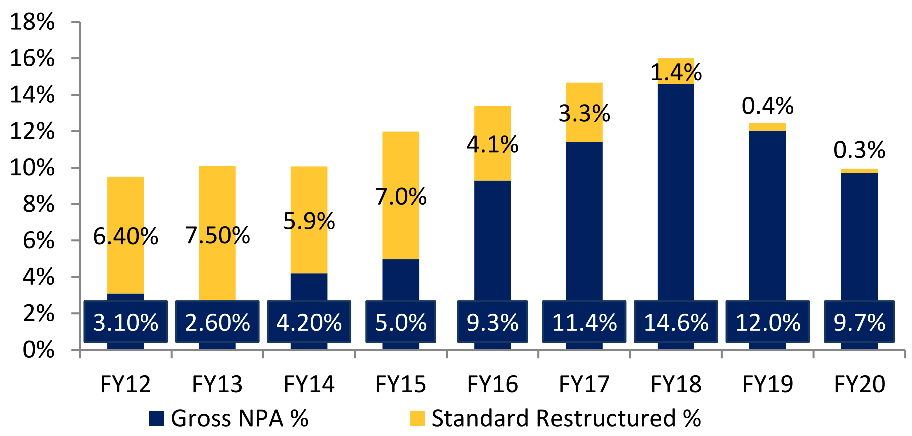
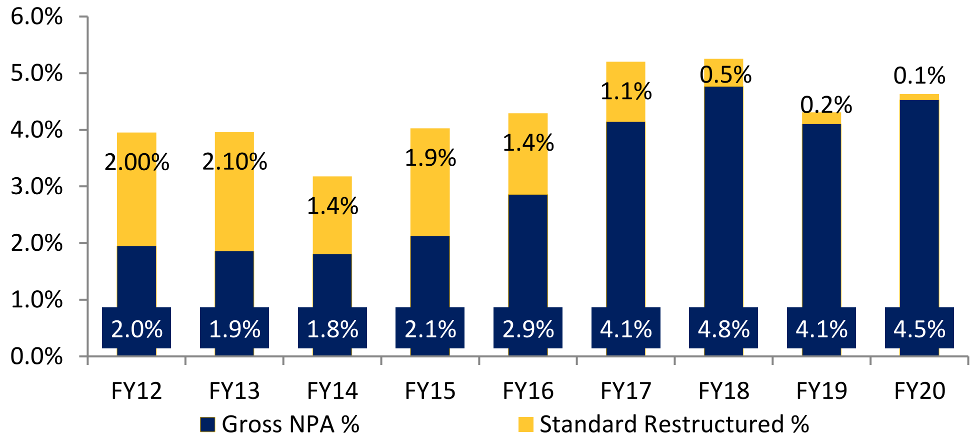


EXHIBIT 2: Private banks also saw rise in NPAs after restructuring was discontinued



Source: Banks, ICRA research.

- As can be seen in exhibit 1 and 2, the share of restructured loans peaked at ~7.5% for PSBs and 2.1% for PVBs during FY13 (5.3% for the overall banking sector).
- The peak level of such restructured loans stood at 6.1% of the banking sector advances in March 2015, the year when further restructuring was discontinued
- Subsequent years witnessed high level of slippages. ICRA estimates shows 70-80% of these restructured loans turned NPAs in subsequent years.
- Banks had largely recognized stressed assets during last five years (FY2016-FY2020) and the incremental stressed asset generation was expected to moderate prior to Covid-19

Exhibit 3: Restructuring guidelines are stricter this time – Now and then (earlier restructuring guidelines)

Parameter	Now	Then	ICRA's comments
Time period	Limited time for identification of stressed loan accounts till December 31, 2020 (invocation date) Resolution plan to be implemented within 90 days of for retail loans and 180 days for corporate loans from the date of decision to implement RP	Loan restructuring continued for almost 6.5 years (Sep 2008-March 2015)	Limited time frame to decide and implement. Likely to result in overall lower volume of debt restructuring.
Recent Track record of lenders	MSME restructuring available since February 2018, however ~2% of the MSME loans have been restructured. Restructuring window has been extended multiple times and now available till March 31, 2021. Lenders required to make 5% provisions on such restructured loans	No such track record	Recent track record in MSME restructuring reflects relatively careful approach towards restructuring
Repayment track record of borrower	Only those borrower accounts are eligible for resolution which were not in default for more than 30 days as on March 1, 2020.	No such cut-off	Borrowers with relatively better track record will be eligible for restructuring
Inter-creditor agreement (ICA)	75% of lenders by exposure and 60% by number to sign an ICA within 30 days of invocation. Non-signing lenders to make 20% provisions within 30 days of invocation	No-such requirement	Faster decision making upon decision of invocation of a RP
External assessment	External committee to decide financial parameters to be factored in for preparing a RP. ICE of the RP by a CRA for exposure >Rs 1 billion	Restructuring was based on techno-economic viability mandated by lenders without an independent assessment	Better credibility of such restructuring plans with independent assessments of RPs. Upon failure of RPs, the RP will not get implemented and lenders will have recognize loans as NPAs
Escrow account	All cash flows of the corporate borrower, shall be routed through an escrow account maintained with one of the lending institutions.	No-such requirements	If a borrower opts for restructuring, then it will cede control on cash flows to lenders leading to lower financial autonomy. This will also lead to better control of lender on borrower's cash flows
Provision requirements	Lenders to make 10% provisions on loans restructured under the framework	The provision requirement was limited to just 5% of the loan	Higher provisioning requirements could act as deterrent for lenders, lenders likely to question borrowers on genuine requirement for restructuring
Provision reversal	50% of the provision could be reversed if 20% of the loan is repaid and balance 50% when 30% of the loan is repaid	-	Borrower has to demonstrate repayment track record before banks could reverse the provisions. This will discourage back-ended repayment structures

Resolution of stressed asset framework	The insolvency and bankruptcy code (IBC) has fairly long track record and has empowered lenders and a real deterrent for the defaulting promoters	Lenders typically resolved the loans with the existing promoter group with limited track record of change in promoters	Upon restructuring, if the borrower turns overdue on repayment, the lenders are required to implement a RP under June 7, 2019 circular including invocation of bankruptcy code. IBC is strong tool with lenders against erring promoters
Post-implementation monitoring	If the borrower defaults within 1 year of implementation of RP or before the 10% of the loan repayment (whichever is later), the account will be treated as NPA from back date. Lenders to again implement fresh RP for such loans under the June 7 circular	The NPA accounts could be upgraded after 1-year track record of timely payment irrespective of amount repaid	The monitoring criterion post implementation is stricter than previous regime.

Source: ICRA Research

Key takeaways: Overall, the restructuring guidelines are relatively tighter this time with necessary safeguards around such restructuring. Additionally, lenders are more empowered today with IBC in place, which will continue as a deterrent for errant promoters to misuse lenders and restructuring window forever.

Loan book under moratorium was high in April 2020 but has declined across various banks by June 2020:

Exhibit 4: Loan book under moratorium as on April 30, 2020 across various lenders

Sector	Corporate		MSME		Individual		Others		Total	
	% of total customers	% of total outstanding	% of total customers	% of total outstanding	% of total customers	% of total outstanding	% of total customers	% of total outstanding	% of total customers	% of total outstanding
PSBs	28.8	58	73.9	81.5	80.3	80	48.8	63.7	66.6	67.9
PVBs	21.6	19.6	20.9	42.5	41.8	33.6	39.1	40.9	49.2	31.1
FBs	32.6	7.7	73.3	50.4	8.4	21.1	75.8	4.8	21.4	11.5
SFBs	78.8	43.7	90.5	52.3	90.9	73.2	64.6	12.3	84.7	62.6
UCBs	63.4	69.3	66.5	65.5	56.8	62	35.6	59.2	56.5	64.5
NBFCs	39.7	56.2	60.7	61.1	32.5	45.9	37.3	41.4	29	49
SCBs	24.7	39.1	43.1	65.3	52.1	56.2	45.7	55.7	55.1	50
System	30.8	41.9	45.8	65	50.4	55.3	45.7	54.6	**48.6**	**50.1**

Source: RBI Financial Stability report – July 2020

As can be seen from above table, PSBs and PVBs, which account for almost 80% of the system wide credit has ~68% and 31% of their loan book under moratorium as on April 30, 2020. The loan book under moratorium has decline in Phase II (June – August 2020) across all the lenders as the lenders have followed opt-in approach to grant moratorium to their customers as compared to opt-out approach in Phase I (especially for PSBs). Change in moratorium approach coupled with gradual lifting of lockdown restrictions and improving economic activity lead to this reduction in moratorium book. A comparison in moratorium under Phase I and Phase II for some of the bank is as under:

Exhibit 5: Loan book under Moratorium – Phase I vs Phase II

Bank	Phase I	Phase II
ICICI	~30%	~17.5%
Axis	25-28%	9.7%
HDFC	NM	~9.0%
SBI	~18%	~9.0%
IDFC	~45%	~28%
RBL	~33%	~13.7%
IDBI	~68%	~56%
Karur	~41%	~37%
DCB	~60%	~26%
Canara	~17%	~22.7%
Bandhan	~71%	24%

Source: Banks, ICRA Research

Above data is based on various dates on which the respective lender declared the data

While the share of loans under moratorium remains high for some lenders, especially the PSBs, however we expect this to decline further by August end as the PSBs have followed opt-out approach and have largely given a blanket moratorium to its customers. We expect the moratorium to further reduce to ~10-15% at a system level when the moratorium ends in August 2020.

Outlook on Slippages:

Exhibit 5: Slippage estimates for FY2021 and asset quality numbers for banking sector

	Earlier estimates	Revised estimates
Fresh Gross slippages	5.0-5.5%	3.0-4.0%
Gross NPAs^	11.3-11.6%	9.8-10.3%

^ Net of recoveries and write offs

Source – ICRA research

Earlier we estimated that 10-20% of the moratorium loan book of 30-40% could be vulnerable to slippage, translating in fresh slippages of 3-8% (~5.0-5.5% average slippage) during FY2021. As the moratorium ends in August 2020, we expect the moratorium to further reduce to ~10-15% of overall loans at a system level. This is going to be the likely pool of stressed assets which will require RP implementation or will possibly slip in NPAs or remain in overdue category.

The system wide SMA 1 and SMA 2 stood at ~6.0% of the loan of the banks as on March 31, 2020 and we expect a large portion of these loans will be part of the moratorium loan book and will be most vulnerable to slippage in FY2021 as the RP under August 6, 2020 circular cannot be implemented to these loans.

We estimate the slippages for FY2021 at 3-4% of the overall loans of bank (largely the SMA1 and SMA 2 pool as on March 31, 2020). Of the 10-15% loans under moratorium FY2021, rest 5-8% of these loans could be restructured and the rest 2-3% is likely to result in an increase in overdue categories loans such as SMA 0, SMA 1 and SMA2. If the lenders decide to be lenient in restructuring, the increase in overdue loans could be lower and restructured loans can be higher.

We had earlier estimated Gross-NPAs (after recovery and write offs) to rise to 11.3-11.6% for banks by March 2021 expecting a gross slippage rate of 5.0-5.5%. With expectation of reduced slippage of 3-4% we expect the increase in GNPAs to 9.8-10.3% by March 31, 2021 from 8.5% as on March 31, 2020.

Our view on restructured loans:

Notwithstanding the “standard” asset classification of the restructured loans under the revised framework, ICRA believes that the loan restructuring by the borrower will reflect the incipient stress in its cash flows, thereby reflecting impairment in its debt servicing ability. Though such impairment may be beyond the control of the borrower as well as of the bank, however, these loans will reflect the pool of potential stressed assets and the monitoring in terms of fresh slippages from this pool will indicate the quality of restructuring undertaken by the bank. A high share of such assets in overall loan book will increase the uncertainty on future asset quality and will be a credit negative for the lenders.

Outlook on Capital:

Notwithstanding the 10% regulatory provisions required on restructured accounts, a lower slippage is expected to translate in lower credit provisioning. During their Q4FY2020 and Q1FY2021, various banks have made provisions of 3-10% of their overall loan books under moratorium. As the moratorium book declines, and banks make further provisions in Q2 FY2021, we expect the provisions as percentage of the loan book under moratorium to increase further. Such provisions are not included in the NPA provisioning and hence, even if the provisioning for banks were to rise, the Net NPAs may not decline materially from March 2020 levels, given our increase in the Gross NPAs for the banks.

Earlier, we had also estimated capital requirements for PSBs at Rs 460-826 billion for FY2021 and Rs 250-483 billion for PVBs during FY2021-22, which will now decrease. Our broad estimates show that the capital requirements for PSBs could decline to Rs 200-555 billion for FY2021 and Rs 220-334 billion for PVBs during FY2021-22. Some PVBs may however raise capital higher than our estimates as their capital raisings are for next 3 years of growth cycle.

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- Assist the regulators in promoting transparency in the financial markets;
- Provide intermediaries with a tool to improve efficiency in the funds raising process.

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