Mumbai: The Reserve Bank of India (RBI) warned on Monday that India's Rs. 81 trillion banking industry faces higher risks because of increasing bad loans and restructuring of debt by stressed corporate borrowers.

Stubbornly high inflation, too, remains a major concern, the central bank said in its biannual financial stability report (FSB).

Risks to the banking sector have increased since the previous FSB was published on 27 June, RBI said.

"All major risk dimensions captured in the banking stability indicator show increase in vulnerabilities in the banking sector," the report said. "Asset quality continues to be a major concern for scheduled commercial banks (SCBs). The gross non-performing assets (NPA) ratio of SCBs as well as their restructured standard advances ratio have increased."

Slowing economic growth, which slumped to 5% in the year ended March, the least in a decade, high borrowing costs and projects stalled because of delays in securing government and regulatory approvals have made it difficult for many borrowers to repay debt, causing an increase in bad loans.

The gross NPAs of 40 listed banks grew 36.95% to Rs.2.29 trillion in the September quarter from Rs.1.67 trillion a year earlier.

Equally worrying is the surge in restructured advances, RBI said.

Indian banks have restructured about Rs.4 trillion in loans of stressed borrowers through the corporate debt restructuring (CDR) mechanism and by way of bilateral agreements.

On a cumulative basis, banks restructured Rs.2.7 trillion worth of loans under the CDR mechanism as of September. Of these, Rs.2 trillion of loans are currently being recast after some borrowers exited the CDR platform.

CDR is a forum of lenders through which a group of banks typically offer a payment holiday to a financially stressed company, extend the period in which the loan has to be repaid, cut the cost of borrowing and sometimes, even reduce the amount of debt the borrower has to pay back. Bilateral recasts are agreed on by a bank and a borrower. Analysts expect 15-20% of such loans to turn bad in the absence of a significant revival in the economy.

"Asset quality remains an issue for Indian banks, even though some banks are talking about an upswing. Most of the bad loans are coming from loans given a few years back when economic growth was robust," said Abizer Diwanji, a partner and head of financial services at audit and consulting firm EY, formerly known as Ernst and Young.

“What we need is a systematic approach to solve this issue. There should be a framework to identify and resolve the bad loan issue at sector levels. Also, as in developed countries, lenders should be given more powers to recover money from defaulters,” Diwanji said. Earlier this month, an RBI discussion paper suggested an array of measures to address the increase in bad loans through early recognition and resolution of sticky assets, stricter action against wilful defaulters, and more freedom for asset reconstruction companies in handling bad loans.

The total stressed advances ratio rose significantly to 10.2% of total loans as of end-September from 9.2% in March, according to RBI. Infrastructure, iron and steel, textiles, aviation and mining sectors together made up 24% to the total advances of SCBs, and account for around 53% of total stressed advances, RBI said.

The apex bank warned that the asset quality in the banking sector may worsen if the economy doesn’t recover. India’s economy grew 4.8% in the September quarter and 4.4% in June quarter.

“Macro stress tests on credit risk suggest that if the adverse macroeconomic conditions persist, the credit quality of commercial banks could deteriorate further,” RBI said in the report.

According to RBI, the largest contribution to the stressed advances came from state-run banks, while “medium and large”-sized industries contributed more towards stressed advances than “micro and small” industries.

As on 18 October, Indian banks’ loans outstanding to medium- and large- sized companies stood at Rs.1.3 trillion and Rs.19.2 trillion, respectively, while that to micro and small companies stood at Rs.3 trillion.

“NPAs continue to be a major issue for the banking system but incremental slippages in the second quarter were lesser than the preceding quarter. But a clear sign will emerge only after the third quarter numbers,” said Hatim Broachwala, an analyst at Karvy Stock Broking Ltd.

According to Broachwala, fresh restructured loans will continue to emerge in the sector unless there is a sustainable revival in the economy.
Inflation still a worry

Cautioning that its fight against high inflation constrained monetary policy, RBI said that on the domestic macroeconomic front, deterioration in the economic outlook was considered to be the most critical.

“Even as some moderation is expected in food inflation going forward, persistence of retail inflation remains a concern,” RBI said, adding that risk from domestic inflation, corporate leverage and household savings also increased marginally.

RBI opted for a status quo on rates in its mid-quarter policy review earlier this month, saying that inflation was showing a declining trend due to a fall in vegetable prices and aided by a stable rupee.

However, the apex bank may raise interest rates one more time if inflation doesn't slow as expected, but that could be the last increase in the current policy cycle, economists said. The repo rate, at which RBI lends short-term funds to banks, is pegged at 7.75%. India's Wholesale Price Index (WPI)-based inflation accelerated to 7.52% in November from 7% the previous month. Retail inflation, measured by the consumer price index, has been on the rise and quickened to 11.24% in November from 10.17% in October.

However, WPI core inflation—the non-food, non-fuel manufacturing inflation measure—a key indicator of price movement, more or less stabilized at 2.66% in November (it was 2.64% in October).

This trend, if it sustains, will give room for RBI to embrace a benign policy environment next year, economists said.

Silver lining

"On the other hand, risks arising from CAD (current account deficit), fiscal, sovereign downgrade and infrastructure were perceived to have receded," the central bank said in the report.

India's CAD stood at 4.37% of gross domestic product in the quarter ended September compared with 5.31% in the June quarter.

Also, the delay in the US Federal Reserve's plan to taper its asset purchase programme gave time to India to bring about adjustments in the CAD and build buffers by replenishing its foreign exchange reserves, RBI said.

The apex bank, however, cautioned that "macroeconomic adjustment is far from complete, with persistence of high inflation amidst growth slowdown", adding that the "fall in domestic savings and high fiscal deficit are other major concerns for India".