India

HIGHER OIL, TIGHTER NORMS TO EXACERBATE CREDIT CRUNCH

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Fears that higher funding costs will prevent shadow banks from servicing their debt obligations have led to investor panic over India's already embattled financial sector. Making matters worse are higher oil prices and the consequent stiff macroeconomic headwinds that will hurt credit growth and the broader economic recovery.

- The government's extraordinary takeover on 1 October of the Infrastructure Leasing & Financial Services (IL&FS) board stems the risk of contagion as it will ensure the lender has adequate liquidity to avert further defaults.
- But liquidity will remain tight due to rising interest rates, a weakening rupee and growing investor risk aversion, resulting in funding challenges for non-banking finance companies (NBFCs).
- The rupee's fall to fresh lows, as we expected, will keep markets jittery about the impact of high oil prices on India's twin deficits and inflation; the government today cut fuel taxes, as we had predicted, and this will result in fiscal slippage.
- The Reserve Bank of India (RBI) will feel compelled to tighten monetary policy; we expect a 25 bp rate hike tomorrow.
- The oil price impact and IL&FS's troubles are a one-two punch for India's already battered financial sector.
- No major lender will be allowed to fail, but regulations will be tightened further to tackle deep-set structural faults in the sector.
- This will delay India's investment revival and ultimately impinge on consumption demand as well.

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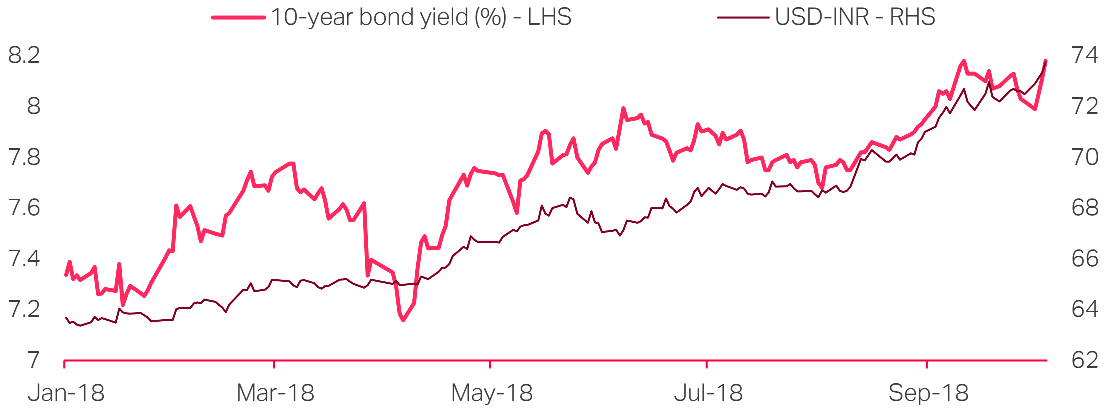
Shadow banks face funding crunch

The troubles at major infrastructure lender IL&FS come at a tough time for India's just recovering economy. The domestic banking sector has been battling high levels of bad debt for the past few years while the economy is currently reeling from a surge in oil prices and growing risk aversion on the part of investors. The rare step earlier this week by the government to replace the IL&FS board with state-appointed directors was aimed at containing the negative feedback loop from recent debt defaults by the shadow bank. The new board will ensure IL&FS has adequate liquidity to avert further defaults and prevent infrastructure projects that it has financed from being derailed. The move calmed nerves – if only temporarily – following a stock market panic on 21 September, when a big mutual fund dumped short-term paper issued by Dewan Housing Finance at a significant discount. The fire sale led investors to speculate about contagion to other NBFCs from IL&FS's troubles. Dewan and other housing finance companies subsequently clarified that their financial position was sound.

Still, structural faults within the financial sector run deep, and current headwinds could blow other institutions off course. The fear is that higher funding costs will prevent NBFCs from rolling over loans and servicing their debts. Interest rates have risen sharply over the past year, with the benchmark 10-year bond yield climbing from 6.7% a year ago to nearly 8.2% now. The fast-falling rupee, along with growing investor risk aversion, has led to liquidity drying up, especially from debt funds. The RBI's cash injections via open market operations and the government's reduced borrowing programme for 2H/FY19 briefly helped shore up sentiment on Monday, but rising oil prices have since led to yet another sell-off across asset classes.

Bond yields vs rupee



Source: Bloomberg.

Macroeconomic headwinds grow

Given India's heavy dependence on energy imports, rising global crude oil prices create a vicious circle: a wider current account deficit hurts the rupee, in turn raising the cost of imports and therefore generating inflationary pressures. As we had forecast in our 20 September report Rupee to face further depreciation pressure, the currency has fallen to new historic lows. With core inflation already hovering stubbornly close to 6%, even though the headline rate has been muted, the rupee's decline will likely compel the RBI to raise rates for the third time since June at its policy review tomorrow.

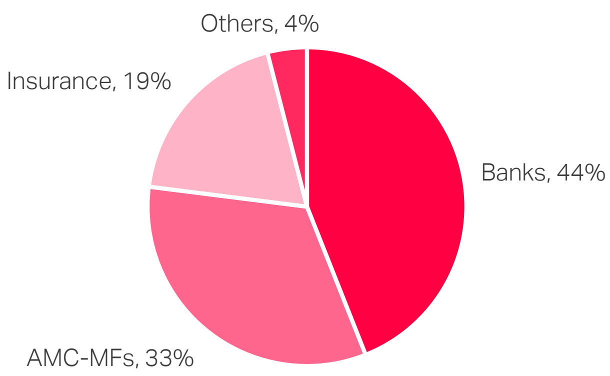
The combination of rising inflation and slowing growth momentum is politically tricky for the government ahead of major state polls at the end of this year and national elections in April-May 2019. With the government under intense political pressure to cut high taxes on fuel, Finance Minister Arun Jaitley finally did just that today, reducing the retail prices of petrol and diesel by Rs2.5/litre. Excise duty on fuel will be cut by Rs1.5/litre, resulting in a loss of Rs105bn to the exchequer, while state-run oil marketing companies will absorb the remainder of the cut, i.e. Rs1/litre.

Jaitley insisted that he would still achieve his fiscal deficit target of 3.3% of GDP, but said that he would ask state governments to reduce fuel prices too. And indeed, several state governments ruled by Jaitley's Bharatiya Janata Party followed suit soon after the minister's announcement. We believe there will be slippage in the combined fiscal deficits of the centre and the states along with a deterioration in the quality of the deficit, resulting in a hard landing for India's nascent growth recovery once the new government is sworn in early in 2019. (For more details, see our 28 September 2018 report The politics of oil prices and our 1 October report What $100 oil would mean for EM).

Tighter regulations to constrain credit

The macroeconomic headwinds spell tough times ahead for the NBFC sector. India's shadow banks have been increasingly relying on issuing debentures and short-term commercial paper for their funding needs. Asset management companies and mutual funds made up 33% of NBFCs' funding mix as of March 2018. Banks too are significant lenders, supplying 44% of total funds, and the threat of contagion spreading to banks was obviously serious enough for policymakers to step in and pre-empt the risk.

NBFC funding mix (as of March '18)

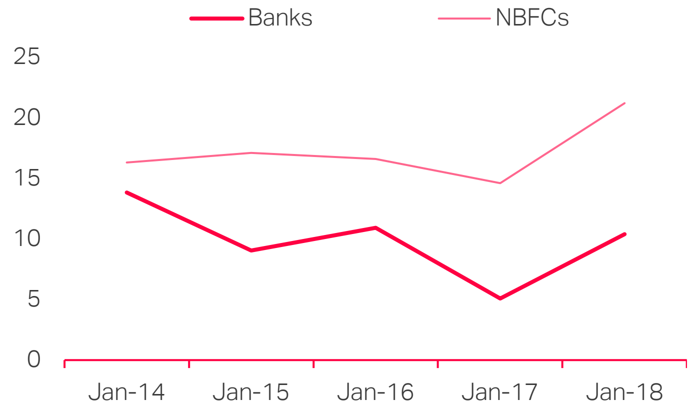


Source: RBI Financial Stability Report, June 2018.

The RBI, which has been tightening regulations for the banking sector, will now have to crack the whip on NBFCs too. These are less closely regulated than banks and have been willing to take on the credit risks that banks had avoided over the past few years due to their mounting bad debt burden. The loan book of shadow banks grew 21.2% in FY18, double the 10.3% rise in bank credit, and the share of NBFCs in India's credit market rose from 13% in 2013 to 16% in 2017.

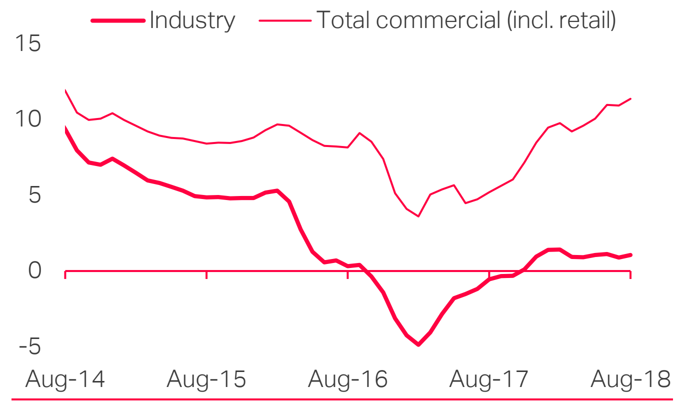
The chart below left shows the rise in credit growth at NBFCs vs bank credit. Even though bank credit growth has been accelerating (as the chart on the right illustrates), it is rising from a low base and industrial credit is still sluggish. In our previous research, we have highlighted how the pick-up in credit growth has been mainly due to retail demand, and how NBFCs have been an important source of funds for the industrial sector, especially small and medium-sized firms (see our 22 March 2018 report Shrinking state banks hit growth).

Bank vs NBFC credit growth (%)



Sources: RBI Financial Stability Reports.

Bank credit growth (3mma, % yoy)



Source: Bloomberg.

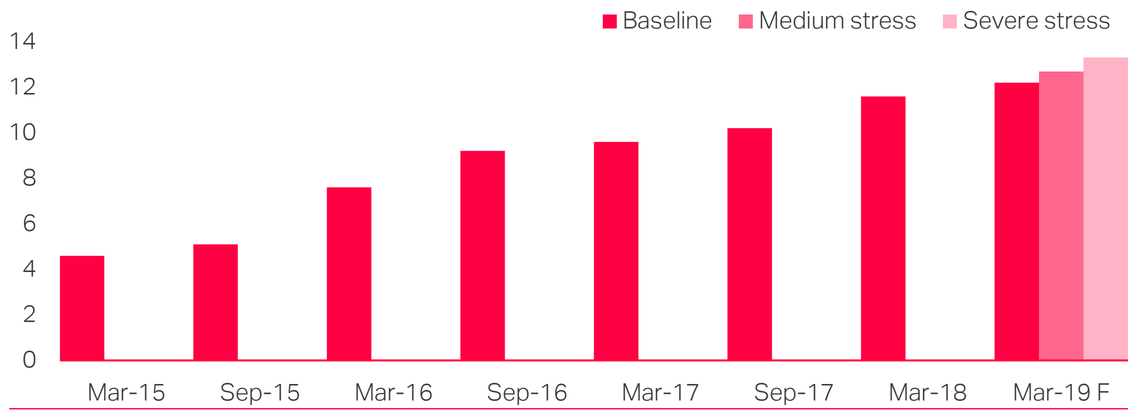
IL&FS had the highest debt ratings just weeks before its default, raising worries about whether the credit scores of other highly rated NBFC debt issuers can be trusted. The RBI had already been tweaking norms for India's roughly 11,000 NBFCs, cautioning in October 2017 that "the growing systemic importance and interconnectedness of this sector calls for regulatory vigil". It has cancelled the licenses of 576 NBFCs so far this year, more than triple the number in all of 2017, for failing to meet regulatory standards. More such cancellations are likely in the coming months because of inadequate capital.

Banks too facing hard times

These circumstances are a big headache for the already beleaguered financial sector. Banks are labouring under a heavy burden of non-performing loans (NPLs), which rose to Rs10.4trn ($150bn) at end-FY18, up from Rs2.5trn four years earlier. The RBI has been forcing banks to clean up their balance sheets, making them recognise and disclose distressed loans instead of ever-greening unviable projects. The NPL ratio has shot up, as have provisioning requirements, resulting in heavy losses for several banks. The losses have been especially severe at state-run lenders, which hold around 70% of India's bank assets and account for 86% of the NPLs. Of the 21 state-run banks, only two posted profits in FY18; the net loss of the others totalled Rs853bn.

The RBI says the NPL ratio will rise further in FY19, which implies that state banks will incur losses this year too. The Rs2.1trn earmarked for bank recapitalisation under a government plan announced in October 2017 will consequently mainly go towards plugging the hole in state lenders' books rather than providing fresh capital for growth.

Gross NPLs (%)



Sources: RBI Financial Stability Reports.

Slow progress on state bank reform…

The government has been taking measures to reform the state banks. In the latest step in its consolidation programme, it announced last month that Dena Bank and Vijaya Bank would be merged into Bank of Baroda. The new lender will be India's third-largest after State Bank of India (SBI) and privately held HDFC Bank. In 2017, SBI subsumed five of its subsidiaries and the smaller Bharatiya Mahila Bank. Bank of Baroda shareholders have reacted negatively to the plan, with the stock trading close to five-year lows. The worry is that the bank's focus will shift from growth towards making a success of the merger; Dena Bank's NPL ratio of 22% will also cause Bank of Baroda's ratio to worsen slightly from 12.4% to around 13%. Earlier this year the RBI put Dena Bank under its Prompt Corrective Action (PCA) framework, along with 10 other state banks, due to their high levels of bad debt. Under the PCA, banks cannot extend new loans or hire new personnel.

Privatisation was never under serious consideration. The one bank that the government had briefly flirted with the idea of selling – IDBI Bank – is being sold to another state-run entity, Life Insurance Corp. (LIC). With an NPL ratio of 28%, IDBI is the worst-performing state bank. However, the capital required to buy IDBI Bank is relatively small for deep-pocketed LIC.

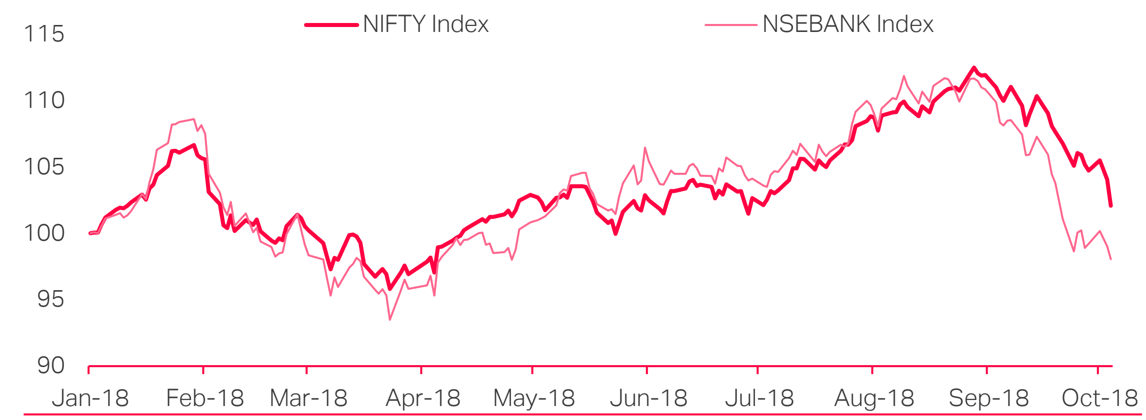
The RBI called earlier this year for exclusive regulatory power over both public and private sector banks, but the government has no plans to comply. The RBI made its pitch following the discovery of a $2bn fraud at state-run Punjab National Bank. In the central bank's June 2018 Financial Stability Report, Deputy RBI Governor Viral Acharya wrote that "governance reforms and market capital-raising appear to have again taken the backseat" at the public sector banks.

…and RBI doesn't spare private banks

For its part, the RBI has been coming down hard on private sector lenders. Last month it rejected private lender Yes Bank's proposal to extend its founder and chief executive Rana Kapoor's term beyond January 2019 because the bank had understated the toxic loans on its books. Earlier this year Shikha Sharma, the head of Axis Bank, the third-largest private sector lender, departed for similar reasons. Meanwhile, Chanda Kochhar, the head of ICICI Bank, the No. 2 private lender, quit amid allegations of conflict of interest (although the RBI was not directly responsible for her ouster).

The RBI last week also barred Bandhan Bank from opening new branches without its approval and ordered a freeze on its chief executive's salary. It penalised the bank for failing to reduce its promoters' stake to 40% by the deadline stipulated when giving it a license. As the chart below shows, investors remain jittery about the financial sector – more than with the broader market.

Benchmark Nifty vs Bank Nifty indexes*



Source: Bloomberg. *Base: 1 January 2018 = 100.

Conclusion

Cleaning up India's financial system is necessary for its long-term robustness, but the process has already proved to be long-drawn-out. Tighter regulations will crimp credit growth, boding ill for the prospect of reviving sluggish investment demand and generating a sustained economic upturn. No major financial institution will be allowed to fail, as we have seen with IL&FS and the poorly performing state banks. But, as there are no quick fixes, the pain will persist.

Authors

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