PHOTOS: SANJAY BORADE

PANEL DISCUSSION

Banking rejigged

It has been 17 years since *Business India* instituted the Best Bank of the Year award. And, each year, a fresh panel has assembled to discuss the state of Indian banking and choose the Best Bank of the Year.

Our panel this year was chaired by Uday Kotak, vice-chairman and managing director, Kotak Mahindra Bank, the winner of Best Bank 2014. Joining him at the table were Milind Kothari, managing partner, BDO India; Niren Shah, managing director, Norwest Venture Partners; Sanjiv Bajaj, vice-chairman, Bajaj Finserv; Shankar Narayanan, managing director & co-head, Caryle Asia Growth Partners; Vishal Kampani, managing director & CEO, institutional securities, JM Financial; and Vishal Mahadevia, managing director, Warburg Pincus.

The task at hand was not easy. Indian bankers have seen better days. Saddled with bad loans and uncomfortably distressed, some await the emergence of the golden period of Indian banking, which they had seen at the turn of the new millennium.

If these bankers were to recognise all existing bad loans and fully provide for them, they might be on the verge of bankruptcy – like United Bank of India was only a year back. The banks mainly blame the state of the Indian economy for their troubles. But, for investors and depositors, that is no answer.

A panel discusses the state of Indian banking to select *Business India*'s Best Bank 2015

Business India BEST BANK 2015

IndusInd Bank

The process to select a single bank as best among the rest is tougher than usual in a weak banking scenario. *Business India* gives only one Best Bank award and the entry point here is set at ₹100,000 crore in assets. Also, the Best Bank must be of a certain size to represent the best of Indian banking.

Every year, we use annual financial statements for guidance. And 20 key parameters including asset, profits, and low cost deposits growth, net interest margin, capital adequacy and non-performing assets, and ratios like cost to income, profit per employee and credit to deposit were taken into consideration.

Numbers, however, can only tell part of a story. They do not factor in customer relationships, brand equity, or corporate governance standards of the bank. In some cases, they do not reflect the actual position. There is so much leverage in banking, said a member of the panel, that the profit-and-loss statement is what a banker would like it to be. And trends in

Indian banking alarmingly point at a deteriorating state of affairs.

It is important to understand the background around which the panel discussion took place. Several of the larger banks are saddled with sour loans linked to infrastructure lending. Many of these projects would not have taken off if the banks had not lent to them; downright detrimental to the nation. But, to protect their balance sheets, bankers have now created new avenues to defer recognition of bad loans.

Take, for instance, the sale of sour loans by banks to asset reconstruction companies (ARCs). Reserve Bank of India regulations require that when bank loans begin to underperform, bankers should set aside capital equivalent to the loan in the likely event that the loan remains unpaid. This is expensive for banks, so they are also allowed to sell down the loan to ARCs, which ask for a discount depending on the state of the loan.

Instead, some bankers have sold loans to ARCs at little or no discount. Only to buy almost the entire loan back in the form of a security. The security is now treated as an investment in financial statements, which is marked-to-market, depending on the strength of the security at the end of one year. It delays NPA recognition for the bank by at least a year.

Those who have built an overseas book have another game at play, by moving on balance sheet loans to off balance sheet exposures. When a borrower's loan falls due, some banks open usance letters of credit – a bank guarantee of payment on behalf of the borrower assuring payment of interest and principal – against which an offshore bank discounts and funnels back funds to repay the issuing bank's loans. The risk for the issuing bank doesn't change much. But to avoid NPA recognition, a corporate exposure turns into a bank exposure.

Or, take fee income numbers, which have increasingly turned deceptive. All panelists agreed that true fee income remains annuity based, like bank or locker charges. Because such fee income carries no risk. But there are banks that charge lower interest income only to record higher fee income, thus letting go of interest (which is charged over a period of time) in return for fees which boost quarterly profits.

Any banker looking for value would choose interest over fees, since there is a straight 14 per cent service tax on all fee income. A bank's foreign exchange earnings can also be boosted to meet short-term results by simply charging a lower spread. "With risk income couched as fee income it is impossible to get the split," said a panel member.

If that were not enough, there is another game at play. After giving bankers ample time to clear restructured loans, the RBI on 1 April asked them to treat all such loans as non-performing assets. For early detection of weakness in the loan, these were categorised as 'Special Mention Accounts'. This is restricted information, but the state of overdue corporate loans is now shared between bankers.

When a loan turns overdue between 61 days and 90 days, banks are required to form a joint lender's forum and take early action on those accounts. In true banking parlance, this should lead to a call for repayment of loans, an increase in promoter equity, a change in management or a winding up of the company. Instead, enters a new word 'rectification'.

Many joint lender forums (JLFs) recommend rectifying the loan by offering the company fresh loans, which covers interest and principal payment for two years. A new form of ever-greening of loans, it turns a sour loan sweet, and delays NPA recognition by two years.

There has been some resistance. But banks that do not want to be offer further loans and be part of the JLF have been asked to take junior debt positions in the forum. Bankers say that only those companies that have a strong management and business model, but were affected purely by factors beyond their control, are eligible for rectification loans. Yet, at least one private sector bank has preferred to sell down its sour loan to an asset reconstruction company at a discount rather than continue with the JLF.

Can time and tide take care of everyone? It was pointed out that a lot of the banks at the turn of the millennium were able to recover and thrive because the rate of inflation was higher than the real rate of interest. Real rates were negative because policy made it negative.

But policy has now said that interest rates have to be 1.5-2 per cent positive. So, the longer a bank chooses to wait, inflation growth will be lower than the rate at which the borrower has taken a loan. Policy has shifted from pro-borrower to pro-saver, and this has significant implications on bank lending.

One panelist said that the newer players are in a position to take it on the chin and move on, but several of the older players were unwilling to change. He said that it is up to the apex body to ensure that no one window was open for play. "We clearly do not have a Chapter 11 system in the country of seizing control of assets and purging the system," said another panelist.

This discussion formed the backdrop for selection of our best bank. The panel agreed that the best bank should be one that is going to make a national impact either now or going

Business India
BEST BANK
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PREVIOUS WINNERS

2014 **Kotak Mahindra Bank**

2013 **HDFC Bank**

2012 **Bank of Baroda**

2011 **Punjab National Bank**

2010 **Bank of Baroda**

2009 **State Bank of India**

2008 **HDFC Bank**

2007 **Axis Bank**

2006 **ICICI Bank**

2005 **State Bank of India**

2004 **ICICI Bank**

2003 **Oriental Bank of Commerce**

2002 **Citibank**

2001 **HDFC Bank, Bank of Baroda, Standard Chartered Bank**

2000 **State Bank of India**

1999 **Corporation Bank**

forward. The award, they said, should be not just about recognition of a bank but also about encouragement.

It acknowledged that over the past few years, some banks had grown fast but messed up. But there were other banks, with stronger management teams, that grew fast during the same time but also delivered on profits. A best bank they said should be one that is trying to reach out to customers differently. One that has strong risk and governance systems in place, and that is leveraging technology to lower costs and further financial inclusion.

The panel acknowledged that good credit lies at the lower end of the pyramid. Also, banks with strong, diversified retail and small and medium enterprise franchises were likely to remain stronger banks.

Based on the financial data, *Business India* shortlisted 10 banks – public, private and foreign – for discussion. Two banks, Kotak Mahindra and HDFC Bank, did not qualify as they had won the award in the preceding two years.

A poll among the panelists at this stage quickly brought the list down to four. Two public sector banks, despite their size and reach, which had qualified them to be within the top 10, were seen as considerably weaker than the others on the list. Two foreign banks also fell off the list, because they were struggling in comparison with peers this year. One had shown a sharp rise in non-performing loans, while the other had made a slow exit from retail and was caught in a tangle around alleged black money accounts.

The next bank to fall off was a private sector bank. The panel acknowledged that the bank was associated with volatility. And, while it had grown fast over the years, it is still largely a corporate bank and a portion of its fee income was not necessarily recurring fee income. And, though the bank had announced a strong push into retail, getting that into place was still sometime away.

Two large private sector banks were discussed next. One of these had a loyal customer base, and was in the process of making a comeback. The other commanded a high valuation, despite its comparable peer having several more subsidiaries under it. Both had an exposure to infrastructure loans with the existing quality and transparency around some of those assets debatable.

Only one foreign bank made it to the Top Four shortlist. It had built a strong retail franchise despite a tough environment. This bank, said a member on the panel, had a strong management team and also one of the cleanest balance sheets in the banking industry. But, while it had managed risk well, it hadn't shown much growth over the last few years in comparison to its Indian peers. While the bank was acknowledged as the only surviving foreign bank this year, it could not make it to the top spot.

Discussions finally boiled down to just two banks: the largest public sector bank and a private sector bank that had, for the first time, crossed ₹100,000 crore in assets. The public sector bank had a strong leader who had brought in a change in mindset. It was cleaning up its balance sheet and not going after growth. It had made new strides in digital banking and had initiated fresh policies in employee training and retention. The lady at its helm had no qualms in speaking her mind and was willing to face issues head on.

But it was not known whether the bank was likely to face a change in management in a year's time. Moreover, the bank was seen as essentially led by the person at the helm. The much smaller private sector bank, on the other hand, had come a long way since the 1990s when it acquired its licence.

It was seen as a management team-led bank, and not as led by an individual. Its commercial vehicle book had done well inspite of a bad cycle. The bank's managing director Romesh Sobti had not inherited a strong brand, unlike his peers, when he took charge eight years back. And, while there was some talk about the true level of promoter ownership, the panel felt that this was clearly the year when the bank stood out from the rest.

For the phenomenal job done at transforming a weak bank into one that commands a premium in the open market, for the value creation done over the past five years and for a management team that delivered, the panel chose IndusInd Bank as *Business India*'s Best Bank 2015.

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THE PANELLISTS

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