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Bank debt should get hit only after equity gets hit (also see in HTML)

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RBI's decision to hike the repo rate has put interest rates on an upward trajectory. However, Aditya Puri, MD of HDFC Bank, in a conversation with **Ira Dugal** *says that rates should start to ease in the medium term. He adds that restructuring norms in India need to be relooked at and a greater onus needs to be placed on equity-holders. Excerpts*:

Is the banking system in a confused state given the recent policy announcement of RBI? And where are we on the interest rate curve right now?

Banks are not in a confused state, but there is unavoidable uncertainty; unavoidable because it is there locally and globally. We have low growth but we also have inflation. We must understand that monetary policy has objectives and limitations. There is too much focus on monetary policy. You can't have a situation where you have easy money with inflation.

In the short-term, say over the next three months, there is an upward bias. Afterwards, rates should ease.

On the exchange rate front, are things seeming more comfortable? What are you hearing from investors you speak to?

Yes, definitely. The general feeling is that CAD this year will stand below-$70 billion. At those levels, it's not very concerning. On the other hand, the FCNR move was a brilliant one. It has done three things. First, it has told those playing around with the currency that there are large inflows likely to come. My own estimate is that more than $15 billion could come in. Second, RBI is clearly stating that the rupee is mis-priced, and it is willing to put its money where its mouth is and say that the forward premiums are wrong. Basically, RBI said—bring the money in, we will give you an off-market rate which we believe is the correct rate, based on the fundamentals, of the dollar-rupee forward. Third, it brings liquidity into the system and doesn't affect your policy rate.

Will HDFC Bank use either the FCNR window or the Tier 1 capital window and how much will you raise?

We will use both. We can't give you a number but it will be a good amount.

Back to the banking system, it seems like the asset quality problem is just not coming under control, both in terms of restructuring and non performing assets.

The main problem is the restructuring, not the increase in NPAs which normally comes with a slowdown. Let us talk about restructuring. The intention of the RBI was that if the economy has slowed, there will be a cash-flow impact. In that scenario, the repayment period has to be increased so that viable projects don't get into trouble. At the same time, a lot of projects were funded with the expectation that problems that existed at the time of the funding would be solved along the way. That assumption has been proved wrong. Then, there may have been some restructuring that was just a deferring of NPAs in the guise of restructuring. Restructuring has gone up from 3% to 5.5% or thereabouts. There are two things I would submit—the fundamental projects, as they stand, are not bad.

Portrait: SHYAM

The fundamental projects, as they stand, are not bad. To presume that all restructuring will become bad debt is an over-estimation

So, if tomorrow I put this asset up for sale after appropriating the equity of the people who were there, and maybe some haircut for the banks, it would be a delightful asset for anyone to buy. So, to presume that all restructuring will become bad debt is an over-estimation.

It is generally assumed that 20% of restructured accounts will turn into NPAs. In the current scenario, isn't that an under-estimation?

From restructured to NPL—that 20% holds. From NPL to sale of asset, I think bankers need to set a time frame telling promoters that if they can't solve it over a certain length of time then all bets are off and the asset will be put up for sale.

Are bankers starting to get aggressive with erring promoters?

Absolutely. It's not just bankers but the whole system. Look at statements from RBI, the banking secretary and even senior bankers, and you would be able to judge the mood. The mood is that if you took money for a project then, like it is worldover, the first thing to take a hit is equity. So, in the case of CDR, why should bank debt be the first thing to be hit? Bank debt should only be hit after the equity gets hit.

We haven't seen that happen in India though. Do regulations need to change to make that happen?

It has to happen although it hasn't happened yet. That's the only way to ensure discipline and fairness and the only way to ensure quick resolution of NPLs. Restructuring norms may need a relook in the sense that the first hit has to be equity and not bank debt. If you look globally, Kodak entered Chapter 11. The moment that happens, a receiver is appointed and the equity-holders become zero. Then, they decide how to make the company viable. Some assets are sold and you are left with a viable asset. The equity-holders take a hit and the difference becomes the haircut on debt. That is the structure to be followed.

Is HDFC Bank adjusting it's strategy to tackle the current environment?

Increase in NPAs when the economy slows is a given. That's some increase built in to your pricing. So, have we seen a 5-10 bps increase in NPAs? Yes. Are we seeing NPAs go beyond the possibility of default that we had built in the program? No. Would we be making some minor adjustments? Yes. Margins also have largely remained in the range of 4.2-4.5%. It may fluctuate in some quarters. If you take this quarter, there could be some effect on the margins based on how quickly the transmission happens. But that will be made up in the remaining part of the year.

And where does the growth now come from?

We straddle the Indian GDP. So if India grows, we grow. We are also going into incremental geographies to gain market share. The construct for us has always been that we will grow partly with the system, and partly, ahead of the system. That has not changed. Superimpose on this the fact that over the last 3-4 years, we have systematically been going into the interior of the country. So, 55% of our branches are now in semi-urban and rural areas while only about 15-17% of our income, at the moment, is coming from these branches because it took time to set them up. It is like we have a major factory running but not at full capacity.

Is the rural banking business profit making? How are you scaling up that business?

Right now, it's not making profits because the expenditure is upfront while the income will start flowing in incrementally as we push products. On a run-rate basis, it's profitable; but on stock, it's not because it takes 2-3 years for a branch to break even. We have already brought 2 million BPL families out of poverty. We plan to do this for 10 million families. We have empowered one crore women and plan to scale it up to 3 crore. We are getting these women together and forming joint-liability self help groups. That model has been working brilliantly. I also believe that this business will become profitable in 5-7 years from today.