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Subir Gokarn: Matters of valuation

Measures to facilitate the resolution of asset quality problems

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The condition of the Indian banking sector's balance sheets, more specifically that of the public sector banks, is a serious threat to reviving and sustaining growth. Bad assets both lead to a diversion of capital for provisioning and deter banks from taking on any further risk on their books. This is undoubtedly a major reason for the extremely sluggish pace of credit growth today. Strategies for repairing these balance sheets, most visibly in the form of asset reconstruction companies (ARCs), do not show signs of working at the necessary scale.

The government's multi-pronged approach, labelled Indradhanush, attempts to address a number of structural problems of public sector banks, including asset quality. In my view, however, the problem of asset quality and the approach to resuscitating balance sheets needs to be fleshed out and fine-tuned. The core issue that needs to be addressed is that of valuation. What is a "bad asset" actually worth? Unless this question is explicitly answered, asset reconstruction is simply not going to take place.

On the face of it, it may seem like a trivial question, but it really is a fundamental one in our regulatory and governance context. Text-book methods of asset valuation basically use the concept of Net Present Value (NPV), which involves anticipated net revenue flows over time and a discount rate, which accommodates the riskiness of the asset. Logically, when assets turn bad, one or both of these factors should have changed in value; either the net revenue flows have not lived up to expectations, or the riskiness of the projects have increased. In any event, the value of the asset has presumably declined. If the owner of the asset - let us presume, for simplicity, that this is now the bank - wants to sell it, the basis of the negotiation must be the revised valuation, based on a reconsideration of both net revenue flows and riskiness.

Economic rationality would dictate that the current market value of the asset is lower than its original value. In the stock market, for example, this is a reality that investors deal with every day. They often sell stocks at prices lower than they paid for them. But, in our context, banks operate within a different incentive framework. To cut a long story short, selling an asset for a lower price than its notional value on the balance sheet could be career-limiting for management. Nobody, and justifiably so, wants to be accused of selling an asset below its notional price, even if market conditions warrant the lower price. This, essentially, is the biggest stumbling block to a market-based approach to repairing banks' balance sheets.

A two-pronged approach is necessary to deal with it. First, a genuine market mechanism for the disposal of assets by banks must be created. ARCs may well be part of that mechanism, as aggregators and intermediaries, but the key reform that is needed is around valuation principles. Ideally, bank managements need to be given the autonomy - i.e. freedom from ex post scrutiny - to determine the values of assets that they are looking to sell. Of course, it is necessary that these values are determined on the basis of generally accepted principles - NPVs or any others. Each formula will require several assumptions about macroeconomic conditions and, importantly, judgements about the role of managerial factors in determining the future performance of the asset. But, eventually, all transactions involve these and banks have all the necessary capabilities.

Realistically, though, the concerns about being accused of deliberate under-valuation cannot be ignored. In order to assuage these, it may help for a set of valuation guidelines to be provided by the government. This can be quickly designed with inputs from the banks themselves and contain a regularly updated medium- to long-term macroeconomic forecast component, which must be uniformly applied by all participants in the process. Relatively consistent valuation outcomes across the banking system will make the process more robust. Also, managements should feel assured that as long as they have adhered to the guidelines, they will not be accused of malfeasance.

Second, the government has to use financial levers to facilitate and support the process. Unquestionably, a reasonable set of valuation guidelines is going to result in a significant proportion of the bad assets being valued at below their notional values. If banks are to liquidate these, it would result in a further blow to their balance sheets on account of capital losses. The government needs to find ways to offset this disincentive. One way to do this is to follow the broad principle of "differentiation" that the Indradhanush initiative proposed. The idea here is to infuse larger amounts of capital into banks that demonstrate better financial performance. In this approach, banks that are successful in selling off bad assets in full compliance with the valuation guidelines could be given extra infusions of capital to offset the capital losses. Of course, this needs to be capped to ensure that banks have an incentive to realise the maximum value for each bad asset sold.

Beyond the organisational incentive, there may be merit in rewarding managements that are successful in realising the best values for their assets. The application of valuation guidelines will generally provide a range of values. The closer each sale price is to the upper end of the range (or even in excess), the better the deal-making capabilities of the management presumably are. More explicit rewards for better performance is an integral component of the Indradhanush reforms. This is one critical performance indicator, which the rewards framework should recognise.

In sum, price flexibility should be recognised as a legitimate and efficient instrument to deal with the massive asset quality problem being faced by Indian public sector banks. This is simply bringing the logic of the market mechanism to bear in a domain from which it has been somewhat excluded. There are concrete steps the government can take to facilitate the process.

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