Lakshmi Vilas Bank Crisis

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Why in News

Recently, the **Reserve Bank of India** (RBI) has decided to impose a **30-day moratorium** on Chennai-based **Lakshmi Vilas Bank Ltd** (LVB).

Key Points

- **Background:**
  - LVB was placed under the **prompt corrective action (PCA) framework** in September 2019 considering the breach of PCA thresholds as on 31st March, 2019.
    - The RBI has specified certain regulatory trigger points, as a part of prompt corrective action (PCA) Framework, in terms of **three parameters,** i.e. **capital to risk weighted assets ratio (CRAR), net non-performing assets (NPA) and Return on Assets (RoA),** for initiation of certain structured and discretionary actions in respect of banks hitting such trigger points.
  - After taking into consideration various developments, the RBI had come to the conclusion that in the absence of a credible revival plan, with a view to protect depositors' interest and in the interest of financial and banking stability, there is no alternative but to apply to the Central Government for imposing a moratorium under **section 45 of the Banking Regulation Act, 1949.**

- **Challenges Faced by LVB:**
  - **Domino Effect of Yes Bank Crisis:** The LVB episode started unfolding after the RBI and banks led by State Bank of India bailed out fraud-hit **Yes Bank** in **March 2020.**
    - Yes Bank illustrated the widening damage from India's **shadow banking crisis**, highlighted by the **collapse of IL&FS in 2018.**
    - On the same lines, **Punjab and Maharashtra Cooperative Bank** was hit by a loan scam highlighting the riskiness of banks, especially **cooperative banks.**
  - **Declining Net Worth:** The financial position of the LVB has undergone a **steady decline, with continuous losses over the last three years** eroding the bank's net worth.

    Almost one-fourth of the bank's advances have turned bad assets.
  - **Inadequacy to Raise Capital:** LVB has **not been able to raise adequate capital** to address the issues and was also **experiencing the continuous withdrawal of deposits** and **low levels of liquidity.**
  - **Governance Issues:** Serious **governance issues** in recent years have led to a deterioration in the performance of the bank.
  - **Lack of Promoters:** The functioning of LVB, along many such banks, has been under scrutiny as most of them **do not have strong promoters,** making them targets for mergers.
  - **Rising NPAs:** Its gross **non-performing assets** (NPAs) stood 25.4% of its advances as of June 2020, as against 17.3% in 2019. Due to which, it was unable to raise capital to shore up its balance sheet.

    NPAs in the banking sector are expected to increase as the **pandemic affects cash flows** of people and companies.
- **Impact on Investors:**
  - **Equity capital will be fully written off,** which means existing shareholders face a **total loss on their investments** unless there are buyers in the secondary market who may ascribe some value to these.
  - Individual investors will face a loss on their investments in **AT-1 bonds.**

    As per RBI rules based on the **Basel-III framework,** AT-1 bonds have **principal loss absorption features,** which can cause a full write-down or conversion to equity.
  - **Shares of LVB closed at 20% lower circuit** which means that there will be **only sellers and no buyers.**
    - The lower circuit is the limit below which a stock price cannot trade on a particular trading day.
    - These regulatory mechanisms put in place to temporarily halt trading on an exchange to curb panic-selling.

- **Measures Taken by RBI:**
  - The RBI monitors the performance of private banks and large **Non-Banking Financial Companies** (NBFCs).
  - On LVB, it has **imposed a moratorium whose cash withdrawal limit** has been capped at **Rs. 25,000.**
  - It has also put in place a **draft scheme for its amalgamation with DBS Bank India.**
    - The combined balance sheet of DBS India and LVB would remain healthy after the proposed amalgamation, with **Capital to Risk Weighted Assets Ratio** (CRAR) at 12.51% and **Common Equity Tier-1** (CET-1) capital at 9.61%, without taking into account the infusion of additional capital.

      CET-1 capital includes equity instruments where returns are linked to the banks' performance and therefore the performance of the share price. They have no maturity.
    - In September 2019, merger of banks, **consolidation of 10 public sector banks into four mega state-owned ones**, was announced ostensibly to help in better management of capital.
  - One **safety net for small depositors** is the **Deposit Insurance and Credit Guarantee Corporation** (DICGC), an RBI subsidiary, which gives **insurance cover on up to Rs. 5 lakh deposits** in banks.
  - RBI may ask for **capital infusion by other banks and financial institutions, putting in equity capital** in the reconstructed entity.

    Budget 2019 had announced a **Rs. 70,000 crore bank recapitalisation** programme to help Public Sector Banks shore up their capital reserves and enhance credit flow into the economy.

Way Forward

- These bank crises are not exactly new or unique and their problems with mounting bad loans reflect the underlying woes in the financial sector ranging from real estate to power and non-banking financial companies.
- In September 2020, an **expert committee headed by K V Kamath** came out with **recommendations on the financial parameters** required for a one-time loan restructuring window for corporate borrowers under stress due to the pandemic which would help to deal with the time-specific concerns.
- The crisis provides an opportunity for the various stakeholders to review their existing frameworks and revise them accordingly suiting to timely needs.

Source: IE