

## Banking health and the 'K Curve' dynamics

### What is the issue?

- Recently, the depositors in [Lakshmi Vilas Bank Limited](#) (LVB) were bailed out.
- In this context, understanding the price performance of individual banks and focusing on the trends in valuation metrics could help in anticipating the financial system dynamics in the coming years.

### What is the P/BV ratio in this regard?

- A key metric for financial companies is the 'Price to Book Value' ratio (P/BV).
- The P/BV reflects two critical attributes that the market values most:
  1. adequacy of current capital
  2. runway available to the entity for profitable growth
- **A P/BV ratio above 1** indicates that the market believes that the company can grow and generate Return on Equity (RoE) above the hurdle rate that investors expect.
- Here, the faster it can grow or the greater the spread of the ROE above the hurdle rate, the greater the P/BV multiple (above 1).
- **A P/BV below 1** indicates that the market either does not believe the bank has recognised all its bad loans or has the business model to deliver returns above the hurdle rate.
- This may be because the bank does not have a good deposit franchise, has bad cost discipline or a broken lending model.

### What does a K Curve mean?

- There are banks that have a P/BV above 4 while some others have much below 1, even at 0.25.
- With NBFCs, the P/BV range is even wider, with some NBFCs being valued in excess of 7.
- The growth trajectories of these entities with dispersed P/BV will be varied, resulting in a classic K Curve.
- In other words, the K Curve **depicts the inequality** existing between different financial entities in terms of their attributes that determine their future growth and profitability.
- Widening of the arms of the 'K' would imply that the inequality is increasing.

- On the other hand, narrowing of the span of the 'K' would mean the opposite.

## What is the current scenario of the banks?

### • **One arm of the K:**

- Among private sector banks, a couple of banks have always had their **P/BV above 3** on a consistent basis.
  - Capital is available in plenty for these banks.
  - Resultantly, the market is betting that these banks will grow much above system average and generate attractive RoE.
  - This would imply that these banks would have disproportionate incremental market share on both assets and liabilities.
- Next comes the set of banks that have had **P/BV of above 1.5** for the most period.
  - The market insight on these banks is that they are long-term bets, and have access to sufficient capital.
  - But, these banks have to demonstrate a business model that works across cycles.
  - As comfort levels increase on the business model, the P/BV should climb, because runway for growth is available for these banks.
- Both the above set of banks (**'Alpha banks'**) have adequate access to capital and the intrinsic ability to grow market share.
- These banks would form one arm of the K.
  - The only constraint for these banks would be their ability to grow their liability franchise.
  - This is so because changes in market share on deposits are much slower than changes on the asset side.
- **The other arm:**
- The other private sector banks have a **P/BV of around 1 or much below 1.**
- For some of them that have demonstrated an ability to raise capital even through COVID-19 times, it is a business model issue.
  - It is also a question of whether they have strengths to grow profitably in a sustained manner.
- The new generation banks amongst these have to demonstrate consistent growth and stability on the liability side for a higher P/BV again.
- Quite a few of the old generation private sector banks have an issue with the credibility of their business model and their ability to generate above hurdle RoE through the cycle.
  - They may have a reasonably stable liability franchise.
  - But, the market perceives issues with their lending practices and thereby, asset quality.
  - That is the reason their P/BV is at very low levels.

- They need to transform themselves by upgrading technology, add skilled manpower and improve management quality and governance.

### **How about the public banks?**

- The current governance model of public sector unit (PSU) banks depresses valuations.
- Their P/BV would better reflect their intrinsic strengths when the banks are run in a professional manner with an ability to decide their own destiny.
- The largest bank in the country is surely part of the Alpha banks as its ability to attract capital and grow profitably is well accepted.
- The other PSU banks are viewed by the market broadly as a homogenous set with similar business models and skill sets.

### **What does this call for?**

- Along with the government move to consolidate PSU banks into few large banks, a new vision needs to be drawn out for these banks.
- This is essential to ensure that they have differing value propositions to offer to the economy and market.
- There needs to be a clear level playing field amongst all banks.
- The government should move to paying transparent and fair compensation for services rendered to various State-sponsored programmes to all players.
- PSU banks should be free to adopt human resource practices to on-board lateral talent to fill in skill set gaps and adapt to the new digital world.
- This, coupled with better governance, is likely to result in higher P/BV for PSU banks.

### **What is the way forward?**

- Certainly, the Alpha banks widen the gap with respect to the rest.
- This, consequently, widens the K Curve even more and squeezes out the weak banks.
- However, there is clearly more room for banks to migrate into the Alpha banks set.
  - The need now is to have more than the current handful of Alpha banks to propel it.
  - It is in all stakeholders' interest to make their own contributions to make that happen.
- [For NBFCs, the problem is complex; would both arms of the 'K' remain is the moot question for them.
- It is also to be seen if the more valued NBFCs would be the ones that become part of the Alpha banks in the long term.]

**Source: The Hindu**

