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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