5 things you need to know about bank write-offs

A primer on the ongoing banking crisis involving bad loans and write-offs

While Indian banking stocks would have fallen regardless, given the global equity market meltdown, a big reason for their fall is their worsening asset quality. The Reserve Bank of India had to arm-twist public sector banks to disclose their toxic assets, and after providing for them start writing them off.

Former Reserve Bank deputy governor K C Chakrabarty has dubbed these technical write-offs by banks as a "scam". Chakrabarty, who handled the supervision department, told *The Indian Express* that "Technical write-offs by Indian banks are inequitable and should be stopped. It is a big scam. Small loans are rarely written off; most of them are big loans."

Public sector banks have written off Rs 114,000 crore over the last three years and a further Rs 50,000 crore or more is expected to be written off this year.

There is a perception that write-offs mean that the banks have given the borrower a clean chit by sacrificing his outstanding amount. Let's try to understand write-offs and a technical write-off in order to understand Chakrabarty's point.

WHAT EXACTLY IS A WRITE-OFF?

Let us assume you have taken a loan of Rs 100,000 from a bank but are unable to repay. From the bank's point of view, the loan is an 'asset' and the interest that would have accrued from you would have been 'income'. In the bank's balance sheet the loan amount will be shown as an asset so long as your account is considered normal.

But if you stop repaying the monthly instalments, the bank will generate lower revenue due to lack of interest payments. But the loan amount remains as an 'asset' in its books since the bank still hopes that you will pay back the money. But beyond a point, as per RBI norms, if there is no income – in this case, interest – coming from an asset, the bank will have to first provide for the loss of the 'asset' and then eliminate it from its balance sheet.

This process of declassifying the loan as an 'asset' in the books is what is termed as write-off.

WHAT HAPPENS TO THE 'ASSET'?

But this write-off does not mean that the bank will not try to recover money from you. They might either try to continue to recover the money themselves or sell your loan to a recovery company. Your debt has been written off from a creditor's book but not from its memory. You continue to owe them money.

HOW DOES IT HELP THE BANK TO REGISTER A LOSS?

So what advantages does a bank have in writing off your loan if it still intends to pursue you to recover it? One, it gives a true and fair picture of the 'assets' that are making money. After all, there is no point in having a huge asset base that doesn't give any returns. And two, by writing off the loan the bank gets a tax break on the losses incurred.

WHO PAYS FOR THE LOSS?

But if you are not giving back the money to the bank, who will pick up the tab? A major portion of it is done by the government which loses tax revenues as the losses are set-off against tax.

But if the government is losing tax revenue, why does it, along with the central bank, encourage write-offs?

Most of the public sector banks were inflating their asset base by continuing to show the defaulting accounts as normal, and not lending money to others who needed it. Before writing off the toxic assets, recapitalisation of banks would not have been of much use as banks would have used this money to hide their losses. In order to encourage lending and kick starting the economy, banks are now being encouraged, rather forced, to clean up their balance sheets and start afresh.

HOW DOES A BAD LOAN AFFECT OTHER DEPOSITORS?

Finally, do write-offs impact other depositors? Yes it does. Banks that have a high level of non-performing asset tend to have low deposit rates and keep lending rates high in order to recover the losses on these assets.

As for technical or prudential write-off, this is the amount of non-performing loans which are outstanding in the books of the branches, but have been written off at the head office level. Chakrabarty's point is valid that smaller defaulting accounts are not given the same leeway that the bigger ones are. But the bigger accounts normally have the clout and other means to prevent a bank from recovering their assets. The same is not true for a smaller account that sooner or later pays up due to pressure tactics.

As per new rules by RBI, even the bigger players who have defaulted will now find it difficult to raise money easily from the banking system if their earlier account is not cleared.

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