

REQUEST FOR FEEDBACK

IiAS periodically seeks feedback from market participants on its voting guidelines, with a view to making these relevant to all stakeholders. In this paper, we propose to change our stance on voting on resolutions towards issue of securities (equity and preference capital) by banks.

To give us your feedback, please write to us on solutions@iias.in and mention "Feedback" in the subject line. Alternatively, please feel free to call us at +91 22 6123 5505 and speak to Ms. Hetal Dalal or Mr. Debanik Basu.

This consultation is open till 10 July 2018.

IiAS' Voting Guidelines

IiAS' Voting Guidelines form the framework based on which we decided our voting recommendations on shareholder resolutions. IiAS' Voting Guidelines have been structured to incorporate good global governance practices keeping in mind their relevance and context to the Indian markets.

[Read our current voting guidelines here](#)

Voting on capital raising by banks: Some banks must not raise more capital

The levels of non-performing assets (NPA) have increased across the banking sector, with some banks reporting gross NPA levels of over 20%. While banks continue to focus on reducing these levels, data shows that such efforts have been unsuccessful. IiAS believes that such banks need to focus on strengthening their processes before raising more capital. Accordingly, IiAS proposes to revise its voting policy to enable recommending voting against capital raising resolutions in banks where the gross NPA levels have steadily risen and are at around 20% or more.

IiAS proposes to change its voting policy on capital raising resolutions for banks (Exhibit 1). Up until now, IiAS has supported capital raising resolutions for banks for two reasons: one, given the nature of the business, capital raising is essential for growth, and two, banks are systemically important in the sense that if they are unable to lend because of lack of capital, it has debilitating consequences for the economy. The underlying principle of the business is that such lending institutions will leverage the capital and then use it to create a lending book responsibly.

Seven of the twenty-one public sector banks have a gross NPA level of about 20% or more on 31 March 2018 (Exhibit 2). These banks' gross NPA levels have only increased over the past three years. Despite the Government of India's (GoI) stance that banks will receive performance-based capital, it has continued to support them through periodic capital infusions. In some instances, funds infusion has come from Life Insurance Corporation of India (LIC), which IiAS considers quasi-government funding. And, while the capital infusion has been unfailing (Exhibit 3), these banks have been unable to stem the NPAs.

Our position in not supporting capital raises by some banks must be not be misconstrued: IiAS recognizes that allowing banks to fail can have far reaching consequences. Beyond the obvious economic impact, there are implications for how India pegs itself in the global economy. At an immediate level, the small investor and the small depositor are affected as well, a situation that is avoidable by all measures.

Our contention is that banks need to earn investor confidence for a capital raise rather than expect the GoI to continuously support them. Some banks have questionable underwriting processes that have led to egregious levels of NPAs and burgeoning operating costs that mar overall profitability; it is time for such banks to rethink their business model and strategy and wind down their operations to manageable levels. Such

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banks should not focus on growth, but essentially degrow both, their lending and deposits to levels that will ensure that capital adequacy remains strong for that level of business and there is greater ability to monitor the lending book. The strategic winding down of the business need not necessarily mean an eventual shut down of the bank – the bank may re-focus on growth once it has strengthened its internal operations and credit underwriting processes.

IiAS' position on this matter is different from the stance taken by [RBI's Prompt Corrective Action \(PCA\) mechanism](#). The PCA uses four parameters – capital adequacy, net NPAs, profitability and leverage – to assess whether prompt action is required. The Level 1 risk under the PCA mechanism requires the parent or controlling shareholder to infuse capital. While this is a reasonable requirement towards supporting a weak bank, we ask if there is a finality to when some of these banks will stop depending upon such capital infusion. It is time for the market to draw a line in the sand.

In one sense, the market has indicated its opinion on public sector banks. Institutional shareholding (other than LIC) is minimal across public sector banks. GoI holds over 80% of the equity in some of the weaker public-sector banks – with LIC, the aggregate shareholding tends to exceed 85% (Exhibit 2).

Given GoI's dominant shareholding in public sector banks, all capital raising resolutions presented by these banks will likely pass. Even so, IiAS believes it is important for the rest of the market to send a signal to GoI that the ongoing support of weak banks is unwarranted: banks must take responsibility for their current situation and fight themselves out of it.

To this extent GoI, as the dominant shareholder, must also support the agenda of self-sustenance. While there is a national policy agenda to be achieved in having public sector banks grow, ensuring that credit quality metrics improve is equally in the interest of the banking sector and the economy.

Exhibit 1: Proposed Revision to IiAS Voting Guidelines

Extract of IiAS' Voting Guidelines 2018-19	Revision in IiAS Voting Guidelines 2018-19
<p>IiAS will generally recommend voting FOR cases where the dilution for minority shareholders is less than 20% (other than the financial services sector), provided the company has adequately disclosed use of proceeds. IiAS will also recommend voting FOR preferential issues for companies in the financial services sector, as they need additional capital to meet Basel III guidelines, write-off of NPAs and to grow.</p>	<p>IiAS will generally recommend voting FOR cases where the dilution for minority shareholders is less than 20% (other than the financial services sector), provided the company has adequately disclosed use of proceeds.</p> <p>IiAS will also recommend voting FOR preferential issues for companies in the financial services sector, as they need additional capital to meet Basel III guidelines, write-off of NPAs and to grow. <i>However, for financial services companies having a gross NPA of about 20% or more, IiAS may consider not supporting any further capital infusion with a view that such entities must strengthen their operations and lending processes before raising further equity.</i></p>

Exhibit 2: Banks with Gross NPA levels of around 20% or more on 31 March 2018

Name of the bank	Gross NPA levels			Shareholding on 31-Mar-2018		
	31-Mar-16	31-Mar-17	31-Mar-18	GoI	LIC	GoI+LIC
IDBI Bank	11.0%	21.3%	28.0%	81.0%	10.8%	91.8%
Indian Overseas Bank	17.4%	22.4%	25.3%	89.7%	5.4%	95.1%
UCO Bank	15.4%	17.1%	24.6%	84.2%	9.8%	94.0%
United Bank of India	13.3%	15.5%	24.1%	93.1%	3.1%	96.3%
Dena Bank	10.0%	16.3%	22.0%	80.7%	6.9%	87.6%
Central Bank of India	12.0%	17.8%	21.5%	86.4%	10.0%	96.4%
Bank of Maharashtra	9.3%	16.9%	19.5%	87.0%	5.7%	92.7%

Source: Annual reports, stock exchange filings, IiAS Research

Exhibit 3: GoI's equity infusion in public sector banks over the past three years

Public Sector Banks in India	FY16 GoI Infusion (Rs. Bn)	FY17 GoI Infusion (Rs. Bn.)	FY18 GoI Infusion (Rs. Bn.)			Gross NPA (%) 31-Mar-18	CRAR (%) Basle III 31-Mar-18	GoI Holding (%) 31-Mar-18
			Direct Infusion (See note)	Recapitalization Bonds (See note)	Total (See note)			
Allahabad Bank	9.7	4.2	15.0	-	15.0	16.0	8.8	64.8
Andhra Bank	3.8	11.0	29.9	-	29.9	17.1	11.1	78.0
Bank of Baroda	17.9	-	-	53.8	53.8	12.3	12.9	64.0
Bank of India	36.1	28.4	92.3	-	92.3	16.6	12.9	83.1
Bank of Maharashtra	3.9	3.0	6.5	25.2	31.7	19.5	11.0	87.0
Canara Bank	9.5	7.5	48.6	-	48.6	11.8	13.2	72.6
Central Bank of India	5.4	18.3	3.2	48.4	51.6	21.5	9.0	86.4
Corporation Bank	8.6	5.1	21.9	-	21.9	16.2	9.2	79.9
Dena Bank	4.1	10.5	30.5	-	30.5	22.0	11.1	80.7
I D B I Bank Ltd.	22.3	19.0	45.9	78.8	124.7	28.0	10.4	81.0
Indian Bank	-	-	-	-	-	7.4	12.6	81.9
Indian Overseas Bank	20.1	26.5	46.9	-	46.9	25.3	9.3	89.7
Oriental Bank of Commerce	3.0	-	-	35.7	35.7	17.6	10.5	77.2
Punjab & Sind Bank	-	-	7.9	-	7.9	11.2	11.3	85.6
Punjab National Bank	17.3	21.1	54.7	-	54.7	18.4	9.8	62.3
State Bank of India	53.9	56.8	88.0	-	88.0	10.9	12.6	58.9
Syndicate Bank	7.4	7.8	-	28.4	28.4	11.5	12.2	73.1
UCO Bank	9.4	19.3	13.8	51.3	65.1	24.6	10.9	84.2
Union Bank of India	10.8	5.4	45.2	-	45.2	15.7	11.6	67.4
United Bank of India	4.8	10.3	26.3	-	26.3	24.1	12.6	93.1
Vijaya Bank	2.2	-	12.8	-	12.8	6.3	13.9	68.8
Total	250.0	254.0	589.4	321.6	911.0			

Source: Annual reports, www.data.gov.in, stock exchange filings, IiAS Research

Note: In the absence of absolute clarity in disclosures, and based on the data available, IiAS has assumed that all investment in recapitalization bonds have been brought back by the GoI as equity infusion in the bank during FY18 itself.

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