Simulated Commercial Bank Case Study

CP and Berar Bank
CPB Bank Towers
Sitabuldi, Nagpur 440012

Mudhoji Bhonsale was a career banker and when he was appointed as the Managing Director and Chief Executive Officer (MD & CEO) of CP & Berar Bank (CPB) at the age of 55 nobody was surprised. Mudhoji was also happy to return to the city of his birth in such a prominent position. He came from a distinguished Nagpur family and it was rumoured that he was a direct descendent of the last Maratha King of Nagpur[54]. He had studied Engineering at the Visvesvaraya Regional College of Engineering (VREC), and joined one of the larger national banks as a probationary officer immediately after his graduation and gradually, over time, he had advanced in his career, had uniformly received good ratings, and was generally known to be a strong banker. Banking had changed from the days when Mudhoji had started his career. When he was a young banker the good name of the client and his social standing was all that really mattered and he had prided himself that he was a good judge of this.

These days however, things had become a lot more uncertain, and before his own eyes he had seen several prominent families of his own city driven to bankruptcy unable to service their debts. Interest rates, which for a long time had remained unchanged, now varied continuously and issues such as interest rate risk had to be taken into account as well. Fortunately, CPB, because of its impeccable pedigree dating right back to the very formation of the Central Provinces in 1861[55], had a strong reputation amongst generations of its depositors and had a vast branch network in every nook and corner of Madhya Pradesh, Vidarbha region of Maharashtra, Chattisgarh, Northern Karnataka, and Telangana. But Mudhoji did not feel as if he was as well prepared for his new responsibilities as he would like to be.

On his second day after taking charge when he arrived into office, his secretary told him that his Executive Director Nirmala Deshpande[56] had sought an urgent meeting. From the tone of the secretary's voice he knew that the news was not likely to be good. From what he had heard about Nirmala and from his first interactions she had struck him as a calm person with a strong character. Unlike himself and most of his other colleagues at CPB, she had had a much wider exposure to modern banking from her stints as a General Manager at a larger Mumbai-based Bank, and the years she had spent as the head of the New York branch of that Bank. He knew he was lucky to have somebody like her as a part of his team. At CPB as its Chief Financial Officer (CFO), she was in-charge of profitability and risk-management of the Bank and he was sure that this urgent meeting had something to do with these aspects of the Bank.

He asked his secretary to clear his calendar for the morning and politely request the number of people who had asked to see him to welcome him to his new position, to come later in the day and to apologise to them for the inconvenience. He wanted to have enough time to get to grips with whatever issues that she wanted to discuss with him. Nirmala arrived as soon as his office gave her the word and in a no-nonsense manner got down to business with the minimal of pleasantries. She informed him that she had received a call from the newly created Stress Testing Advisory Unit of Accurate (a prominent Mumbai based rating agency) that at 10% Capital Adequacy (all Tier 1), while the bank had the requisite amount of capital to meet the Basel III guidelines that were to become applicable shortly, it would fail the Stress Test Capital requirements specified in the draft guidelines that had been circulated last year[57]. While the Bank had a rating of "AAA" because of the expectation of support in case it failed, its current stand-alone rating was "BBB" and the stress tests were being carried out with an aspirational rating of "AA". The bank's stock was trading at a price to book ratio of 0.50, with several analysts having issued a sell recommendation even at this price.

The largest shareholders of the bank had also privately indicated to the Bank that, given all their existing commitments, they were not in a positon to provide any additional capital nor were they willing to dilute their shareholding below current levels, which meant that they were not likely to approve any additional capital raising plans. CPB had a Rs. 300,000 crore balance sheet with a CASA of Rs. 100,000 crore on which the Bank paid an average interest rate of 4%. Nirmala had also brought a summary sheet of numbers for him to mull over during the day. She wanted to resume this meeting the next morning and to arrive at a broad operating strategy on how to deal with the set of issues that CPB faced.

The sheets that Nirmala had left with him gave the following information:

1. The Bank had an estimated duration of assets equal to 1.40 years (on account of the Base Rate-linked pricing for the entire loan portfolio) while the duration of liabilities was 4.26 years.

2. Of the FDs that CPB has, Rs.50,000 crore had come due last year and had been renewed for one more year with an interest rate that had gone down from 9% to 7%. The rest of the FDs were of a 5 year maturity and had an interest rate unchanged at 10% -- since CPB was not planning to grow its portfolio this year, no attempt had been made to add to the FD balances and the one-year FDs had renewed almost instantaneously at the new rate.

3. All of the loans of the Bank were at 11% last year, with the exception of the capital base which was already invested entirely in 5 year government securities.

4. There was also a large table (Annexure 1) which gave the credit exposure of the Bank to various sectors as well as indication of how default rates of each sector were related to each other.

This was a lot of information. And, as Mudhoji sat in cabin which was full of beautiful bouquets of flowers, long after all the well-wishers had gone, mulling over this he realised he need to connect all the information to the following questions that he needed to answer:

1. Why had CPB failed the stress tests?

2. What corrective action would he need to take since he was not going to be able to raise new capital at least in the immediate future?

3. How could he make a convincing argument for a movement towards Matched-Fund-Transfer-Pricing (MFTP) and away from the current Base Rate system?

Annexure 1

CPB Credit Portfolio Distribution

	Portfolio Proportions	**Portfolio Rating**	**Mean Default**	**Default Volatility**
CNX Auto	30.00%	A	1.01%	1.34%
CNX Energy	20.00%	BB	18.66%	24.36%
CNX Finance	0.00%	AA	0.12%	0.18%
CNX FMCG	0.00%	AA	0.12%	0.18%
CNX Infra	20.00%	BB	18.66%	24.36%
CNX IT	0.00%	AA	0.12%	0.18%
CNX Media	0.00%	A	1.01%	1.34%
CNX Metal	20.00%	BBB	5.46%	6.75%
CNX PSU Bank	0.00%	AA	0.12%	0.18%
CNX Realty	10.00%	BB	18.66%	24.36%
CNX MNC	0.00%	AA	0.12%	0.18%
CNX Pharma	0.00%	A	1.01%	1.34%

Sector Default Rate Correlation Matrix[58]

1.000	0.704	0.793	0.520	0.753	0.202	0.659	0.645	0.681	0.708	0.743	0.502
0.704	1.000	0.796	0.381	0.836	0.170	0.714	0.735	0.756	0.829	0.722	0.216
0.793	0.796	1.000	0.524	0.874	0.084	0.761	0.764	0.872	0.836	0.760	0.298
0.520	0.381	0.524	1.000	0.443	0.033	0.461	0.232	0.315	0.361	0.575	0.420
0.753	0.836	0.874	0.443	1.000	0.097	0.821	0.795	0.850	0.876	0.786	0.268
0.202	0.170	0.084	0.033	0.097	1.000	0.204	0.179	-0.043	0.135	0.077	0.311
0.659	0.714	0.761	0.461	0.821	0.204	1.000	0.642	0.726	0.806	0.688	0.337
0.645	0.735	0.764	0.232	0.795	0.179	0.642	1.000	0.734	0.777	0.748	0.162
0.681	0.756	0.872	0.315	0.850	-0.043	0.726	0.734	1.000	0.827	0.639	0.092
0.708	0.829	0.836	0.361	0.876	0.135	0.806	0.777	0.827	1.000	0.723	0.136
0.743	0.722	0.760	0.575	0.786	0.077	0.688	0.748	0.639	0.723	1.000	0.452
0.502	0.216	0.298	0.420	0.268	0.311	0.337	0.162	0.092	0.136	0.452	1.000