Role of RBI in Management of NPAs in Corporate Banking

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Abstract

In a bank-based economy, sound health of the banking system is an imperative for efficient financial intermediation in the context of overall development and financial stability. In the post- global crisis period, the Indian banking system, has suffered growing impairment of asset quality. This paper explores the macro-financial linkages and micro-level sources underlying the asset quality deterioration. In line with the ongoing international intellectual discourse, this paper finds the evidence of procyclicality in the Indian context as reflected in past credit boom-bust episodes as well as economic and interest rate cycles. Anemic external macroeconomic situation post-crisis, high inflation and dwindling asset prices have eroded the debt servicing capacity of borrowers and contributed to the asset quality problems. Sectoral analysis demonstrates rising incidence of loan defaults in infrastructure, particularly power, retail, SSIs and agriculture, across bank groups. Going forward, asset quality could come under greater strains, given the weakening economic backdrop and global headwinds, impinging on the soundness of banks and macro financial stability.

The Indian banking sector accounts for a major portion of financial intermediation and is considered to be the main channel of monetary policy transmission, credit delivery and payment systems. The stability and sound health of the banking system hence is a key pre-requisite for overall economic development and financial stability. The Non-Performing Assets (NPA) is an important prudential indicator to assess the financial health of the banking sector. Besides asset quality, NPAs epitomize the credit risk management and efficacy in the allocation of resources. There is a near unanimity in the literature that asset quality is a critical determinant of sound functioning of the banking system. NPAs affect the operational efficiency, which in turn affects profitability, liquidity and solvency position of banks. The consequences of NPAs would be reduction in interest income, high level of provisioning, stress on profitability, gradual decline in ability to meet steady increase in cost, increased pressure on net interest margin (NIM) thereby reducing competitiveness, steady erosion of capital resources and increased difficulty in augmenting capital resources. This paper plans to study the effect of NPA on the economy and its management by various means by RBI and other regulatory bodies

Key words: RBI, net interest margin, banking system, regulatory bodies, operational efficiency

Introduction

The asset quality problems could be contagious, insidious and they prey on the weak. The contagious nature of loan losses emanates from the fact that their downside impact can quickly transmit to earnings, capital, and liquidity. They are insidious in the sense that it is often difficult to know that there is a problem until it's too late. Moreover, these problems prey on the weak banks, which are vulnerable and have relatively small amounts of capital to absorb unanticipated losses.

The problem of NPAs is related to several internal and external factors confronting the borrowers (Muniappan, 2002). The internal factors are diversion of funds for expansion, diversification and modernisation, taking up new projects, helping/ promoting associate concerns, time/cost overruns during the project implementation stage, business (product, marketing, etc.) failure, inefficient management, strained labour relations, inappropriate technology/technical problems, product obsolescence, etc., while external factors are recession, non-payment in other countries, inputs/power shortage, price escalation, accidents and natural calamities. Kent and D'Arcy (2000), while examining the relationship between cyclical lending behaviour of banks in Australia argued that the potential for banks to experience substantial losses on their loan portfolios increases towards the peak of the expansionary phase of the cycle. However, towards the top of the cycle, banks appear to be relatively healthy; non-performing loans are low and profits are high, reflecting the fact that even the riskiest of borrowers tend to benefit from buoyant economic conditions.

While the risk inherent in banks lending portfolios peaks at the top of the cycle, this risk tends to be realized during the contractionary phase of the business cycle. At this time, banks non-performing loans increase, profits decline and substantial losses to capital may become apparent. There are other reasons why credit growth and loan quality are pro-cyclical aside from a financial accelerator. Herd behavior of bank managers can lead to a deterioration of credit standards during economic booms, as credit mistakes are judged more leniently (De Bock and Demyanets, 2012). Gopalakrishnan (2005) classified the causes for NPAs into political, economic, social and technological and observed that neglect of proper credit appraisal, lack of follow-up and supervision, recessional pressures in economy, change in government policies, infrastructural bottlenecks, and diversion of funds are the major causes of NPAs. The problem of NPAs is not mainly because of lack of strict prudential norms, but due to legal impediments and time consuming nature of asset disposal process, postponement of the problem by the banks to show higher returns and manipulation by the debtors using political influence (Reddy, 2002). According to another study, the major reasons for NPAs include improper selection of borrowers' activities, weak credit appraisal system, industrial problems, inefficient management, slackness in credit management and monitoring, lack of proper follow-up, recessions and natural calamities and other uncertainties (Aggarwal and Mittal, 2012). The clamor for credit risk management can easily be lost in the heat of credit cycles, economic adversity, and intense competition3 . In the context of intense competition, focus on market share leads to lax underwriting standards without enough regard for borrowers' repayment capability4 . The opinion over the relationship between inflation and NPAs is divided. Rinaldi and Sanchis Arellano (2006) find a positive relation between the inflation rate and nonperforming loans, while Shu (2002) reports a negative relation. Negative structural shocks to economic growth, the exchange rate, or debt-creating capital inflows tend to bring down private credit while loan quality deteriorates. It is also said that an increase in asset prices pushes up the net worth of firms, households or countries, improving their capacity to borrow. Through general equilibrium effects, this dynamic can then lead to further increases in asset prices. In this way, strong balance sheets in boom periods may lead to excessive lending against inflated values of collateral (De Bock and Demyanets, 2012).

Objective:

This paper intends study the net impact of NPA on the economy brought through various business / corporate entities and management done by RBI with help of government added mechanism

RBI managing NPA in public sector banks

In the Indian context, it has been pointed out that though public sector banks recorded improvements in profitability, efficiency (in terms of intermediation costs) and asset quality in the 1990s, they continue to have higher interest rate spreads but at the same time earn lower rates of return, reflecting higher operating costs. Private sector banks, on the other hand, appear to have lower spreads as well as lower operating expenses comparable to the banking system in G3 countries (Table 6). At the same time, asset quality is weaker so that loan loss provisions continue to be higher. Restructuring of loans and advances is a procedure to modify the terms and conditions of an existing loan in order to alleviate the difficulties in repayment by the borrower due to temporary cash flow problems or general economic downturn. The Reserve Bank's prudential guidelines on restructuring define a restructured account as one where the bank, for economic or legal reasons relating to the borrower's financial difficulty, grants to the borrower concessions that the bank would not otherwise consider. Restructuring would normally involve modification of terms of the advances/securities, which would generally include, among others, alteration of repayment period/repayable amount/the amount of instalments/rate of interest (due to reasons other than competitive reasons) (Mahapatra Committee, 2012).

The Reserve Bank revised its prudential guidelines regarding restructuring of advances by banks from time to time, mainly in the light of international best practices and the Basel Committee on Banking Supervision (BCBS) guidelines issued in the matter. The modifications in the guidelines for restructuring of advances announced in August 2008 was one of the proactive steps taken by the Reserve Bank in order to arrest the downward spiral in the economy in the aftermath of the global financial turmoil of 2007. The guidelines on restructuring of advances by banks issued in August 2008 allowed banks to restructure accounts of viable entities classified as standard, sub-standard and doubtful. It was prescribed in the August 2008 guidelines that accounts of borrowers engaged in important business activities and classified as standard assets may retain their standard asset classification on restructuring subject to certain conditions.

NPA issue in India: An Analysis

According to RBI October to December report, the gross Non-Performing Assets (NPAs) of Public Sector Banks are just under Rs. 4 lakh crore, and they collectively account for 90% of such rotten apples in the country's banking portfolio. In terms of net NPAs, their share is even higher - at 92% of the total bad loans reported so far in the banking system.

What is NPA?

• The assets of the banks which don't perform (that is - don't bring any return) are called Non Performing Assets (NPA) or bad loans. Bank's assets are the loans and advances given to customers. If customers don't pay either interest or part of principal or both, the loan turns into bad loan.

• According to RBI, terms loans on which interest or installment of principal remain overdue for a period of more than 90 days from the end of a particular quarter is called a Non-performing Asset.

• However, in terms of Agriculture / Farm Loans; the NPA is defined as under-For short duration crop agriculture loans such as paddy, Jowar, Bajra etc. if the loan (installment / interest) is not paid for 2 crop seasons, it would be termed as a NPA. For Long Duration Crops, the above would be 1 Crop season from the due date.

Reasons for the rise in NPA in recent years

• GDP slowdown -Between early 2000's and 2008 Indian economy were in the boom phase. During this period Banks especially Public sector banks lent extensively to corporate. However, the profits of most of the corporate dwindled due to slowdown in the global economy, the ban in mining projects, and delay in environmental related permits affecting power, iron and steel sector, volatility in prices of raw material and the shortage in availability of. This has affected their ability to pay back loans and is the most important reason behind increase in NPA of public sector banks.

• One of the main reasons of rising NPA is the relaxed lending norms especially for corporate honchos when their financial status and credit rating is not analyzed properly. Also, to face competition banks are hugely selling unsecured loans which attributes to the level of NPAs.

• 5 sectors Textile, aviation, mining, Infrastructure contributes to most of the NPA, since most of the loan given in these sector are by PSB, They account for most of the NPA.

• Public Sector banks provide around 80% of the credit to industries and it is this part of the credit distribution that forms a great chunk of NPA. Last year, when kingfisher was marred in financial crisis, SBI provided it huge amount of loan which it is not able to recover from it.

• There is a myth that main reason for rise in NPA in Public sector banks was Priority sector lending, However according to the findings of Standing Committee on Finance NPAs in the corporate sector are far higher than those in the priority or agriculture sector. However, even the PSL sector has contributed substantially to the NPAs. As per the latest estimates by the SBI, education loans constitute 20% of its NPAs.

• The Lack of Bankruptcy code in India and sluggish legal system make it difficult for banks to recover these loans from both corporate and non-corporate.

Other factors

• Banks did not conducted adequate contingency planning, especially for mitigating project risk. They did not factor eventualities like failure of gas projects to ensure supply of gas or failure of land acquisition process for highways.

• Restructuring of loan facility was extended to companies that were facing larger problems of over-leverage& inadequate profitability. This problem was more in the Public sector banks.

• Companies with dwindling debt repayment capacity were raising more & more debt from the system.

Steps taken by RBI and Government in last few years to curb NPA:

• Government has launched 'Mission Indradhanush' to make the working of public sector bank more transparent and professional in order to curb the menace of NPA in future.

• Government has also proposed to introduce Bankruptcy code.

• RBI introduced number of measures in last few years which include tightening the Corporate Debt Restructuring (CDR) mechanism, setting up a Joint Lenders' Forum, prodding banks to disclose the real picture of bad loans, asking them to increase provisioning for stressed assets, introducing a 5:25 scheme where loans are to be amortized over 25 years with refinancing option after every 5 years, and empowering them to take majority control in defaulting companies under the Strategic Debt Restructuring (SDR) scheme.

How to curb the NPA menace of Across Banks

Short Term measures

• Review of NPA'S/Restructured advances- We need to assess the viability case by case. Viable accounts need to be given more finance for turnaround and unviable accounts should either be given to Asset Reconstruction Company or Management/ownership restructuring or permitting banks to take over the units.

• Bankruptcy code should be passed as soon as possible. Bankruptcy code will make it easier for banks to recover loans from unviable enterprises.

• Government should establish Asset Reconstruction Company (ARC) with equity contribution from the government and the Reserve Bank of India (RBI). The established ARC should take the tumor (of non-performing assets or NPAs) out of the banking system. An ARC acquires bad loans from banks and financial institutions, usually at a discount, and works to recover them through a variety of measures, including sale of assets or a turnaround steered by professional management. Relieved of their NPA burden, the banks can focus on their core activity of lending.

Long term Measures

• Improving credit risk management- This includes credit appraisal, credit monitoring and efficient system of fixing accountability and analyzing trends in group leverage to which the borrowing firm belongs to:

• Sources/structure of equity capital-Banks need to see that promoter's contribution is funded through equity and not debt.

• Banks should conduct necessary sensitivity analysis and contingency planning while appraising the projects and it should built adequate safeguards against such external factors.

• Strengthen credit monitoring-Develop an early warning mechanism and comprehensive MIS(Management Information System) can play an important role in it. MIS must enable timely detection of problem accounts, flag early signs of delinquencies and facilitate timely information to management on these aspects.

• Enforce accountability- Till now lower ring officials considered accountable even though loaning decisions are taken at higher level. Thus sanction official should also share the burden of responsibility.

• Restructured accounts should treated as non performing and technical write offs where Banks remove NPA'S from their balance sheets Permanently should be dispensed with.

• Address corporate governance issues in PSB. This include explicit fit and proper criteria for appointment of top executives and instituting system of an open market wide search for Chairman.

India's banks may be sitting on an NPA time bomb, which could be more powerful than the projected Rs 9.5 lakh crore. And, it would start exploding once the moratorium is lifted on March 31 on declaring stressed assets of small and mid-size businesses as non-performing assets.

Mudra loans and SME

Add to that, the NPAs on Mudra loans, which have been piling up every quarter, loans of state electricity distribution companies, which could top Rs 80,000 crore by March, and, the newly added telecom sector dues of Rs 92,000 crore to the government, which the Supreme Court has asked them to pay by January end. The agriculture loan portfolios that are witnessing a rise in bad debt, is yet another cause of concern.

State-owned banks will take the biggest hit because it is these lenders, which have been bearing the brunt of keeping stressed assets of MSMEs out of their loan books after September last year when Finance Minister Nirmala Sitharaman announced measures to lift up the sagging economy by ensuring credit on easy terms.

Rajnish Kumar, Chairman of the largest public-sector lender, the State Bank of India, who might have tried, to assure investors that the country's credit woes were very much under control, now appears to be conceding that the bank credit growth will remain an issue in 2014. But, when the skeletons finally start falling out of the government's closet, he would not be there. His three-year term is coming to an end in October.

His bank may not suffer to that extent as the recoveries from the high profile Essar Steel case may improve the overall NPA coverage and keep the cost of credit under check but ask any banker in private, and they say, "from April 1, the loan books of the lenders will start recognising the missed payments by MSMEs as NPAs. They have gone on a credit binge along with non-banking finance companies and new retail customers since September last year".

Prime Minister Narendra Modi's flagship MUDRA scheme that aims to provide easy credit without collateral to small and micro-enterprises and, issues loans up to Rs 10 lakh under different categories, has generated an NPA of over Rs 17,000 crore in about four-and-a-half years since its inception, besides a loan write-off of about Rs 2 lakh crore.

The RBI, has, from time-to-time, issued instructions to banks to be vigilant on MUDRA loans. Last year, Governor Shaktikanta Das had told the chief executives of PSU banks, in a closed-door meeting, to be cautious while disbursing to MUDRA beneficiaries to avoid a pile-up of NPA accounts. Former RBI governor Raghuram Rajan had already warned the banking system of MUDRA building toxic loans.

A surge in loan waivers

RBI data shows the gross NPA of PSU banks in the farm sector and allied activities touched Rs 1.04 lakh crore by mid-2014 as against a total credit of Rs 9.42 lakh crore. Hence, the proportion of gross NPAs to the total credit stood around 11%. An unprecedented surge in farm loan waivers has been responsible for a general decline in the credit culture. In the last four years, 10 states, including Karnataka, have announced the farm loan waiver to the tune of Rs 2.5 lakh crore.

Besides, the loans were sanctioned in 59 minutes through digital platforms to almost unknown borrowers, could pose another risk to recovery in the coming years, according to banking experts. This scheme for small-ticket loans by the public sector lenders was introduced by the prime minister in November 2014. The banks are yet to take stock of looming NPAs in this segment.

The next is India's shadow lenders. They witnessed stress in their asset quality during the first half of 2014-20. The gross NPA ratio of the NBFC sector increased from 6.1% at end-March 2014 to 6.3% at end-September 2014. While the importance of NBFCs in credit intermediation is growing, the IL&FS episode has brought the focus on the asset-liability mismatches of these lenders, which poses risks to the NBFC sector as well as the financial system as a whole.

To address such concerns, the RBI has introduced requirements such as liquidity coverage ratio and stress tests on the lines of banks, but economists including Modi government's first chief Economic Advisor Arvind Subramanian have been demanding an asset quality review for NBFCs similar to banks.

Conclusion

In its latest Financial Stability Report, the RBI had raised concerns that banks' NPAs could rise to 9.9% of their advances by September this year from 9.3% at present. But experts believe it could be much more than that.Already saddled with bad loans, the state-owned lenders' strength of the loan book have been completely weakened as they are pre-occupied with the merger process.

A United Nations report on Friday has also drawn the attention of rising corporate debt in India, which exceeds 40% of the GDP. Together with a relatively high share of non-performing loans in the banking system in an era of slowing growth and heightened trade tensions, these corporate debts, could represent a major source of financial vulnerability, it said.

Some indicators also show that a significant part of the corporate debt has been channelled neither to productive investments nor high productivity sectors. This trend has adversely impacted medium-term growth and has also raised concerns over debt sustainability in the emerging economies, including India.

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