Stress of NPAs in the banking system: Preventive and Curative Measures

February 13, 2016: A robust banking industry is a vital component in the engine of growth and particularly in India as dependency on banking for lending is very high. Indian banking industry is a vibrant space with multiple players, dominated by public sector banks (PSBs), holding nearly 70% of the assets.

Currently the threat of non-performing assets (NPAs) is looming large overshadowing India's economic growth. It is a prime indicator of the bank's health. NPAs in the system are causing loss of interest income, erosion of core capital and need for additional provisioning. Indicated in two forms: Gross NPAs are the total assets which cease to generate income for banks and net NPAs are the assets left after deduction of provisions from gross NPAs.

NPAs have been plaguing Indian banks since 1980's, fueled by the cut off from international banking practices, poor credit management and recovery issues coupled with a tortuous legal recourse. During this period, recommendations of the Narasimham Committee were considered and Debt Recovery Tribunals (DRTs) was established under the "Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (RDDBFI)". The recovery timings were brought down from nearly seven to one year.

More regulations were introduced such as "Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI)" which envisaged the formation of Asset Reconstruction Companies (ARCs) to help manage NPAs. These regulations led to a marked improvement, with the gross NPA ratio (gross NPAs/gross advances) fell from 14.4% to 11.4% between 1998 and 2001 and INR 52000 Cr of NPAs were cleaned up by banks in 2004. However, these measures were overburdened by the sheer amount of cases.

During 2008, private banks featured among top contributors to NPAs along with PSBs, but towards 2015 their levels of NPAs dropped significantly, indicating better management. The gross NPA ratio of PSBs stood at 5.43 % and of private banks at 2.20 % by 2015. The levels of gross NPAs in the industry continued to shoot upwards, from INR 1.75 lakh Cr in 2013 to INR 2.98 lakh Cr in 2015. This highlighted the inefficiencies at the bank level and recovery agencies.

A muted handling of NPAs were due to complexities riddled in the process. Multiple agencies dealing with insolvency and bankruptcy, namely high courts, Company Law Board, Board for Industrial and Financial Reconstruction (BIFR) and DRTs having overlapping jurisdictions, caused systemic delays.

Furthermore, lack of long term vison and an overtly optimistic view of the economy drove advances, overlooking asset quality and internal capital generation in PSUs. Additionally, poor credit management and monitoring for frauds added to the problem.

In light of these issues, the RBI has set a deadline for banks to clean up their balance sheets and make provisions for NPAs by March 2017. To augment this drive, the minimum investment by ARCs in securities receipts issued increased from 5% to 15%, to curb unrealistic sale of bad loans and improving their accountability. In 2016 budget, the government has proposed changes in the SARFAESI act, permitting sponsors to hold the complete stake in ARCs, allowing non-institutional investors to invest and 100% foreign direct investment.

Promised recapitalization of PSBs by the government and introduction of “Indradhanush” initiative which focuses on creation of Bank Board Bureau (BBB), linking compensation to performance for top management in banks, improving governance standards, focusing on quality over quantity and fresh capital infusion of INR 70000 Cr over a course of 4 years is expected to bring relief to the stressed banking system. The BBB will recommend on appointment of directors in PSBs, fund raising, management of stressed assets and reduction in political interference.

A strong bankruptcy law proposed by the government would serve as an impetuous in supporting the banking industry to speed up decisions on the fate of stressed assets reducing costs and complications involved. Huge capital needs could be the trigger point for consolidation amongst PSBs but only with the support of government.

In combination with the above measures, banks could strengthen internal processes to prevent and better manage NPAs by introducing the following changes: first, they can standardize credit and operational guidelines by automating a significant portion of the loan origination process, ensuring consistency in decisions and detect deviations. Second, exclusive dependence on financial statements should be balanced with other considerable influencers of performance such as strong order book. Third, post disbursement monitoring can be improved by introducing an early warning system, comprised of key indicators and factoring in external data for better risk management. Finally, up-skilling of credit officers and firm adherence to KYC (Know Your Customer) norms will be necessary for the success of the above recommendations.

Externally, banks should move towards digitization of documents, improving collateral management, information sharing among banks and thereby avoiding multi-lien frauds. Furthermore, collaterals need to be evaluated as per Basel II norms and also valued by third party agencies or credit bureaus. Banks could start rating services of such third parties, to improve the general confidence in their findings. Forensic review need to be made a mandatory practice, prior to restructuring of troubled assets to uncover promoter's intent and assist in decision making process. Access to books of clients should be permitted to make this process effective. Development of corporate bond market could reduce the burden on banking system.

With continued efforts towards NPA reduction by the government, regulator and the banks, the banks' balance sheets are expected to become clean in the near future. Let cautious lending approach prevail while not hampering the credit growth heavily, during these times of stress and the years to come.