

Recent Reforms of RBI towards NPA Management in Corporate Banking – An Empirical Study

*Niranjan B Poojar

Abstract

This paper attempts to identify the determinants of NPAs across Indian **Financial Sector** prior to their turning into bad loans. Most academicians have examined NPA determinants, and these determinants are a topic of substantial importance for academia concerned with understanding a bank's management. Second, we focus on the Indian banking system because it has witnessed an increase in the Gross NPA level from 3% in 2014 to 4% in 2015. The level of non-performing assets (NPAs) best indicates the soundness of the banking sector of a country. The purpose of this study is an effort to look into the contribution of the different banks individually to the NPA in the industry by looking into its growth pattern during the period 2010-2016. Further, the study is made to look into the effect of different groups of banks, namely, State Bank of India (SBI) and its associates, nationalised banks and private sector banks on the banking industry in this regard. Non-Performing Assets (NPAs) in the Indian banking sector has become the subject of much discussion and scrutiny. The Standing Committee on Finance recently released a report on the banking sector in India, where it observed that banks' capacity to lend has been severely affected because of mounting NPAs. The Estimates Committee of Lok Sabha is also currently examining the performance of public sector banks with respect to their burgeoning problem of NPAs, and loan recovery mechanisms available. Additionally, guidelines for banks released by the Reserve Bank of India (RBI) in February 2016 regarding timely resolution of stressed assets have come under scrutiny, with multiple cases being filed in courts against the same. In this context, we examine the recent rise of NPAs in the country, some of their underlying causes, and steps taken so far to address the issue.

Non-performing assets (NPA) are assets that cease to generate income through interest earned on the principal loan amount and the repayment of the principal loan amount. Non-Performing assets are an outcome when the borrower intentionally defaults on the loan payment or is unable to repay the loan due to poor economic conditions affecting his business. In either case, for a bank it means that the loan asset may not be fully recovered or may be only partly recovered. Non-performing assets are a reflection of the bank's overall efficiency while performing its business of converting deposits into loans and recovering these loans. Non-recovery or partial recovery of loans has an impact on the bank's balance sheet and income statement items in the form of reduction in interest earned on loan assets, increase in provision on NPAs, increase in capital requirement and lower profits. Hence, rising NPAs are a concern for a bank and determinants of NPAs should be identified prior to loans turning into NPAs.

Key words: Non-performing asset, Loan intermediation, Asset quality, Cost efficiency, Capital adequacy

Introduction

The level of deferrals, availed of by borrowers, is being closely monitored as it reflects the potential stress in the system. Analysts at Macquarie had estimated the extent of loans under moratorium at 25-30% at the end of May. “The regulatory dispensations that the pandemic has necessitated in terms of the moratorium on loan instalments and deferment of interest payments may have implications for the financial health of banks going forward,” RBI cautioned.

The central bank noted that risk aversion and lacklustre demand have impeded the fuller flow of finance from both banks and non-banks into the economy. A systematic risk survey, that it carried out, shows that about 56% of the respondents feel the prospects of the banking sector are going to deteriorate considerably in the next one year. Consequently, the earnings of banks could be impacted due to lower net interest margins, elevated asset quality concerns and a possible increase in provisioning requirements.

The report also highlighted the deleveraging by the private corporate sector over the recent years stalled during the second half of 2016-20 as leverage ratios increased due to higher borrowings. Incremental borrowings, it noted, were used to create financial assets and not for capex formation, as demand conditions remained muted. The performance of the private corporate sector deteriorated in successive quarters of 2016-20 and the contraction during the last quarter was particularly severe due to the Covid-19 pandemic. The ratios over eight years (2007 to 2014). Together, these ratios reflect operating capability, liquidity, solvency, profitability, capital adequacy and business development capacity aspects across Indian banks that affect non-performing assets (NPAs). The data was analysed using a GMM model that dealt with endogeneity issues present in the data. This model captured NPA with an r-square of 85%. We find a negative significant relationship between intermediation cost ratio, Return on Assets and NPAs. Asset growth, lagged NPAs, and total liabilities by total assets are positively related to NPAs. Banks have observed there is a declining trend in the number of borrowers who want to delay repayments. HDFC said the share of its retail loan book, under moratorium, was down to 7% as of June 15 from 21% in May. Axis Bank reported that 9.7% of its outstanding loan book was under moratorium as of June 30; in April this number was 25%. While the disruption due to the lockdown was expected, the report reveals that nearly half of the outstanding credit till April 30, was under moratorium, somewhat higher than estimates provided by bankers. A total of 48.6% customers by number and 50.1% by value had made use of the moratorium till April 30. While 66.6% of borrowers at state-owned banks opted for the deferral, the share for customers at private sector banks was 49.2%. Non-banking financial companies (NBFCs) had granted a moratorium to 49% of their customers. Previously, academicians such as Berger and DeYoung, 1997, Podpiera and Weill, 2008, Klein, 2013 and Breuer (2006) who have investigated determinants of NPAs have focussed on a bank's efficiency (representing operational capability of a bank). The bank's efficiency is studied using a number of bank operational ratios such as operational costs in relation to interest income, net interest income to total assets, and others. These ratios indicated how well the bank used the available resources to generate income, and studies found empirical evidence that lower efficiency and NPAs have a positive relation. Subsequently, academicians such as Klein, 2013, Klein, 2013, Clair (1992), Klein, 2013, Klein, 2013 and Keeton (1999) have examined loan growth

(representing business development capacity of a bank) and its effect on non-performing assets, and found empirical evidence that higher loan growth leads to higher NPAs, i.e., when a bank undertakes aggressive loan growth it may overlook the credit risk undertaken, and these loans may turn into NPAs in the future. A few other authors (such as Bhatia, Mahajan and Chander, 2012) suggested that bank profitability affected NPAs, and found that NPAs and bank profitability had a negative relationship. However, operational capability, business development capacity and bank profits are not the only three aspects that affect bank NPAs. A bank's capital, solvency and liquidity also affect NPAs. Consequently, these determinants were considered as well by researchers. Academicians such as Gonzalez-Hermosillo et al. (1997) and Louiz et al. (2012) suggested that a well-capitalised bank tends to have lower NPAs as the bank tends to keep credit risk levels at a low while lending to borrowers. Similarly, a bank's level of solvency would mean that a bank would not be able to repay its depositors in case NPAs were high. However, extant research has not considered all these determinants together and analysed their effect on NPAs. We extend the literature on NPAs by considering 31 financial ratios that represent determinants under operational capability, business development capacity, liquidity, capital adequacy, profitability, and solvency of banks; and aim to study the effect of these ratios on NPAs.

Objective:

This paper intends to explore . The increasing level of default is leading to rise in **Non-Performing Assets**, reducing the profitability and quality assets in **financial** statements of **financial sector**.

What are Non-Performing Assets (NPA)?

- Money or assets provided by banks to companies as loans sometimes remain unpaid by borrowers. This late or non-payment of loans is defined as Non-Performing Assets (NPA). They are also termed as bad assets.
- In India, the [RBI](#) monitors the entire banking system and, as defined by the country's central bank, if for a period of more than 90 days, the interest or installment amount is overdue then that loan account can be termed a Non-Performing Asset.

The increase in non-performing assets in Indian banks follows the recognition standards being pursued by the banks after the RBI highlighted it in the Asset Quality Review (AQR). Of course, the main reason is inadequate progress in the financial health of the companies.

What is the extent and effect of the NPA problem in India?

Banks give loans and advances to borrowers. Based on the performance of the loan, it may be categorized as: (i) a standard asset (a loan where the borrower is making regular repayments), or (ii) a non-performing asset. NPAs are loans and advances where the borrower has stopped making interest or principal repayments for over 90 days. As of March 31, 2016, provisional estimates suggest that the total volume of gross NPAs in the economy stands at Rs 10.35

lakh crore. About 85% of these NPAs are from loans and advances of public sector banks. For instance, NPAs in the State Bank of India are worth Rs 2.23 lakh crore.

In the last few years, gross NPAs of banks (as a percentage of total loans) have increased from 2.3% of total loans in 2008 to 9.3% in 2016 (Figure 1). This indicates that an increasing proportion of a bank's assets have ceased to generate income for the bank, lowering the bank's profitability and its ability to grant further credit. Escalating NPAs require a bank to make higher provisions for losses in their books. The banks set aside more funds to pay for anticipated future losses; and this, along with several structural issues, leads to low profitability. Profitability of a bank is measured by its Return on Assets (RoA), which is the ratio of the bank's net profits to its net assets. Banks have witnessed a decline in their profitability in the last few years, making them vulnerable to adverse economic shocks and consequently putting consumer deposits at risk.

What led to the rise in NPAs?

Some of the factors leading to the increased occurrence of NPAs are external, such as decreases in global commodity prices leading to slower exports. Some are more intrinsic to the Indian banking sector.

A lot of the loans currently classified as NPAs originated in the mid-2000s, at a time when the economy was booming and business outlook was very positive. Large corporations were granted loans for projects based on extrapolation of their recent growth and performance. With loans being available more easily than before, corporations grew highly leveraged, implying that most financing was through external borrowings rather than internal promoter equity. But as economic growth stagnated following the global financial crisis of 2008, the repayment capability of these corporations decreased. This contributed to what is now known as India's Twin Balance Sheet problem, where both the banking sector (that gives loans) and the corporate sector (that takes and has to repay these loans) have come under financial stress.

When the project for which the loan was taken started underperforming, borrowers lost their capability of paying back the bank. The banks at this time took to the practice of 'evergreening', where fresh loans were given to some promoters to enable them to pay off their interest. This effectively pushed the recognition of these loans as non-performing to a later date, but did not address the root causes of their unprofitability.

Further, recently there have also been frauds of high magnitude that have contributed to rising NPAs. Although the size of frauds relative to the total volume of NPAs is relatively small, these frauds have been increasing, and there have been no instances of high profile fraudsters being penalised.

What is being done to address the problem of growing NPAs?

The measures taken to resolve and prevent NPAs can broadly be classified into two kinds – first, regulatory means of resolving NPAs per various laws (like the Insolvency and Bankruptcy Code), and second, remedial measures for banks prescribed and regulated by the RBI for internal restructuring of stressed assets.

The Insolvency and Bankruptcy Code (IBC) was enacted in May 2016 to provide a time-bound 180-day recovery process for insolvent accounts (where the borrowers are unable to pay their dues). Under the IBC, the creditors of these insolvent accounts, presided over by an insolvency professional, decide whether to restructure the loan, or to sell the defaulter's assets to recover the outstanding amount. If a timely decision is not arrived at, the defaulter's assets are liquidated. Proceedings under the IBC are adjudicated by the Debt Recovery Tribunal for personal insolvencies, and the National Company Law Tribunal (NCLT) for corporate insolvencies. 701 cases have been registered and 176 cases have been resolved as of March 2016 under the IBC.

What changed recently in the RBI's guidelines to banks?

Over the years, the RBI has issued various guidelines aimed at the resolution of stressed assets of banks. These included introduction of certain schemes such as: (i) Strategic Debt Restructuring (which allowed banks to change the management of the defaulting company), and (ii) Joint Lenders' Forum (where lenders evolved a resolution plan and voted on its implementation). In line with the enactment of the IBC, the RBI, through a circular in February 2016, substituted all the specific pre-existing guidelines with a simplified, generic, time-bound framework for the resolution of stressed assets.

In the revised framework which replaced the earlier schemes, the RBI put in place a strict deadline of 180 days during which a resolution plan must be implemented, failing which stressed assets must be referred to the NCLT under IBC within 15 days. The framework also introduced a provision for monitoring of one-day defaults, where incipient stress is identified and flagged immediately when repayments are overdue by a day.

Borrowers whose loans were tagged as NPAs before the release of the circular recently crossed the 180-day deadline for internal resolution by banks. Some of these borrowers, including various power producers and sugar mills, had appealed against the RBI guidelines in various High Courts. A two-judge bench of the Allahabad High Court had recently ruled in favour of the RBI's powers to issue these guidelines, and refused to grant interim relief to power producers from being taken to the NCLT for bankruptcy. All lawsuits against the circular have currently been transferred to the Supreme Court, which has now issued an order to maintain status quo on the same. This means that these cases cannot be referred to the NCLT until the Supreme Court's decision on the circular, although the RBI's

180-day deadline has passed. This effectively provides interim relief to the errant borrowers who had moved to court till the next hearing of the apex court on this matter, which is scheduled for November 2016.

Reasons for the Rise in NPA levels

- From 2000-2008, the Indian economy was in a boom phase and banks, especially public sector banks, started lending extensively to companies.
- However, with the financial crisis in 2008-09, corporate profits decreased and the Government banned mining projects. The situation became serious with the substantial delay in environmental permits, affecting the infrastructure sector – power, iron, and steel – resulting in volatility in prices of raw materials and a shortage of supply.
- Another reason is the relaxed lending norms adopted by banks, especially to the big corporate houses, foregoing analysis of their financials and credit ratings.

Recent Developments and Ways to Tackle NPA

- Insolvency and Bankruptcy Code (IBC) – With the RBI's push for the IBC, the resolution process is expected to quicken while continuing to exercise control over the quality of the assets. There will be changes in the provision requirement, with the requirement for the higher proportion of provisions going to make the books better.
- Credit Risk Management – This involves credit appraisal and monitoring accountability and credit by performing various analyses on profit and loss accounts. While conducting these analyses, banks should also do a sensitivity analysis and should build safeguards against external factors.
- Tightening Credit Monitoring – A proper and effective Management Information System (MIS) needs to be implemented to monitor warnings. The MIS should ideally detect issues and set off timely alerts to management so that necessary actions can be taken.
- Amendments to Banking Law to give RBI more power – The present scenario allows the RBI just to conduct an inspection of a lender but doesn't give them the power to set up an oversight committee. With the amendment to the law, the RBI will be able to monitor large accounts and create oversight committees.
- More "Haircuts" for Banks – For quite some time, PSU lenders have started putting aside a large portion of their profits for provisions and losses because of NPA. The situation is so serious that the RBI may ask them to create a bigger reserve and thus, report lower profits.
- Stricter NPA recovery – It is also discussed that the Government needs to amend the laws and give more power to banks to recover NPA rather than play the game of "wait-and-watch."

- Corporate Governance Issues – Banks, especially the public sector ones, need to come up with proper guidance and framework for appointments to senior-level positions.
- Accountability – Lower-level executives are often made accountable today; however, major decisions are made by senior-level executives. Hence, it becomes very important to make senior executives accountable if Indian banks are to tackle the problem of NPAs.

The banks should also consider “raising capital” to address the problem of NPA.

1. Using unclaimed deposits – Similar to provisions for unclaimed dividends, the government may also create a provision and transfer unclaimed deposits to its account. These funds, in return, can be transferred to banks as capital.
2. Monetization of assets held by Banks – In this case, banks with retail franchisees should create value by auctioning a bank assurance association rather than running it themselves as an insurance company. The current set-up blocks capital inflows and doesn't generate much wealth for the owners.
3. Make Cash Reserve Ratio (CRR) attractive – At present, the RBI asks Indian banks to maintain a certain limit on CRR on which the RBI doesn't pay interest. Hence, banks lose out a lot on interest earnings. If the CRR is made more financially rewarding for banks, it can reduce capital requirements.
4. Refinancing from the Central Bank – The US Federal Reserve spent \$700 billion to purchase stressed assets in 2008-09 under the “Troubled Asset Relief Program.” Indian banks can adopt a similar arrangement by involving the RBI directly or through the creation of a Special Purpose Vehicle (SPV).
5. Structural change to involve private capital – The compensation structure and accountability of banks creates a problem for the market. Banks should be governed by a board while aiming to reduce the government's stake and making the financial institutions attractive to private investors.

With the potential solutions above, the problem of NPAs in Indian banks can be effectively monitored and controlled, thus enabling the banks to achieve a clean balance sheet.

Conclusion

The Indian banking system comprises 26 public sector banks, 20 private sector banks, 43 foreign banks and 51 urban cooperative banks. Leading urban co-operative banks such as Saraswat Co-operative Bank, Cosmos Co-operative Bank and Shamrao Vithal Co-operative Bank form less than 1% of the total lending business

Public sector banks are characterised by a majority equity stake (more than 50%) owned by the Government of India, and State Bank of India is the largest public sector bank according to asset size. Public sector banks include State Bank of India (SBI and its five subsidiaries) Bank of Baroda, Bank of India, Punjab National Bank and others. Bank of India, a bank in our sample study, had written off INR 10.04 billion in relation to farm debt write-off. However, the loan waiver did not impact the bank's ratios as it was waived off in stages, and the total impact was not sudden on the bank's balance sheet. A total of 31 ratios was considered for the study with the first 24 ratios extracted from statistical tables titled Selected Ratios of Commercial Banks. Among 20 private sector banks, Industrial Credit Investment Corporation of India (ICICI) Bank and Housing Development Finance Corporation (HDFC) Bank lead this group according to asset size. Other private sector banks included in the study were Axis Bank and Kotak Mahindra Bank among others.

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