



# Recent Policy on Bank Mergers and its NPA Management – A Study

\*Ayesha Sultana, Assistant Professor of Commerce, Govt. First Grade College, Raichur.

## Abstract

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. 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.

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

## Introduction

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%.

### 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**.

### 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

- 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.

### **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?**

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. 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 penalized.

## **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.

## **Conclusion**

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. 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.

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