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NPA & Related Issues

Table of Content

The issue of NPA has gained immense importance as there is a surge in stressed assets in banking in the recent times.

Total stresses assets = NPAs + Restructured assets

What are Non-Performing Assets (NPA's)?
Non-performing assets, also called non-performing loans, are loans, made by a bank or finance company, on which repayments or interest payments are not being made on time. Generally speaking, NPA is any asset of a bank which is not producing any income. Once the borrower has **failed to make interest or principal payments for 90 days** the loan is considered to be a non-performing asset.
But in terms of Agriculture / Farm Loans; the NPA is defined as under:
Short duration crop loan : Loan is termed as NPA in this scenario if the loan either in terms of installment or interest is not paid for **2 crop seasons**, it would be termed as NPA. Example: Agri loans such as paddy, jowar, Bajra etc.
For **Long Duration Crops**, the above would be **1 Crop season** from the due date.

As on March 2015, amount of NPAs was at 4.62 per cent of the gross advances of the banks and the ratio of restructured standard assets to gross advances grew to 6.44 per cent, leading to a total stressed assets to 11.06% of gross advances

However, if we look a little far back, the asset quality of the Indian banking system was not like this; it had actually been improving significantly since the implementation of reforms in the banking sector and introduction of prudential norms, enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002, Credit Information Companies Act, etc. The gross NPAs ratio steadily declined from 15.7 per cent in 1996-97 to 2.36 per cent in 2010-11.

The rise in NPAs in 2014-15 has been attributed to the effects of global recession coupled with internal factors such as slowdown in the domestic economy.

1 Reasons for NPAs

Borrower's side

- Domestic economy slowdown - Lack of demand for their products as foreseen by the industrialists
- Wilful default
- Diversion of funds by borrowers for purposes other than mentioned in loan documents.
- Global economy slowdown
- volatility in prices of raw material and the shortage in availability of power etc. impacts the performance of the corporate sector

Bank's side

- Bad lending practices.Speculation is one of the major reason behind the default. Sometimes banks provide loans to borrowers with bad credit history. There is high probability of default in these cases.
- Inadequate Capacity to evaluate projects – poor credit appraisal system
- Absence of regular industrial visits.

Other external factors:

- Economic condition of a region effected by natural calamities
- Ineffective recovery tribunals
- Change in government policies – For example – any government scheme diverting manpower of PSBs for its implementation affecting the regular activities of banks.
- Administrative hurdles – delay in getting permits and other clearances affects the cost of project.

2 Impacts of rising NPAs

On banks

- It affects the **profitability & liquidity** of the banks as annual return on assets comes down and also the amount given as loan also gets blocked which could have been used for some return earning asset otherwise
- **Extra time and effort** to handle and manage NPAs with added **cost**
- **Credit loss -** Bank is facing problem of NPA then it adversely affect the value of bank in terms of market credit. It will lose it's goodwill and brand image and credit which have negative impact to the people who are putting their money in the banks..
- The **assets and liability mismatch** will widen.
- Bank **shareholders** are adversely affected
- stocks of state-owned banks will fall further and their **ability to raise equity** will slide.

On borrowers

- The **cost of capital** will go up.
    - Piled-up NPAs become a big constraint for banks to pass on the RBI-induced rate reductions.
- Banks tend to **restrict credit** to small and medium enterprises (SMEs) that are India's potential for prosperity of an entrepreneurial middle class.
- Banks may begin charging **higher interest rates** on some products to compensate Non-performing loan losses

On asset declared as NPA

- Poses threat on quality of asset
- Bad loans imply redirecting of funds from good projects to bad ones. Hence, the economy suffers due to loss of good projects and failure of bad investments.

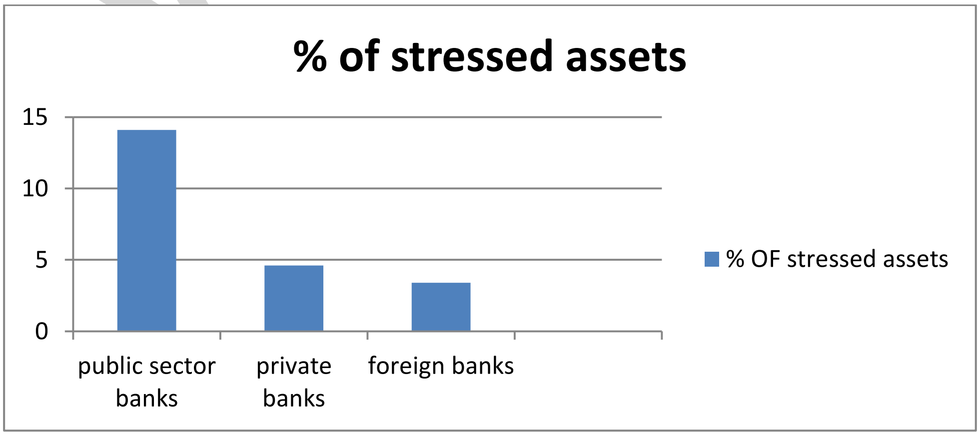
On overall economy

- It leads to a situation of low off take of funds from the security market due to increase in cose of capital. This will hurt the overall demand in the Indian economy. And, finally it will lead to lower growth rates and of course higher inflation because of the higher cost of capital. It becomes a vicious cycle.

3 Major Sectors of the Economy having NPAs

According to RBI's financial stability report December 2015

- The **NPA** as a percentage of total net advances have increased to 2.8% in September 2015 from 2.5% in March 2015
- **Total stressed assets** have increased from 11.06% in March 2015 to 11.1% in September 2015.



- Among banks, Public sector banks are the worst affected with 14.1% of their assets being stressed, followed by private banks at 4.6% and foreign banks at 3.4%

Five sectors which contributes to 54.0% of the total stressed advances.

- Mining
- iron & steel
- infrastructure
- aviation
- textile

- The share of Wilful defaulters in gross NPA has been 21% as of September 2015

4 How to Reduce NPAs

Before giving loans

- **Credit information of the borrowers** - In addition, to address the issue of information asymmetry as also to identify the problem early, a Central Repository of Information on Large Credits (CRILC) to collect, store, and disseminate credit data to lenders, was set up. Under this arrangement, banks are reporting credit information on all their borrowers having aggregate fund-based and non-fund based exposure of ₹50 million and above with them.
- **Cautioned treatment to defaulters** - while considering their support to accounts under stress, banks should make proper distinction between willful – defaulters/non-cooperative/ unscrupulous borrowers on the one hand, and on the other hand, borrowers defaulting on their debt obligations due to circumstances beyond their control.
- **Proper structuring of loans** - To facilitate banks to offer long term project financing, which may ensure long term viability of infrastructure and core industries sector projects by smoothening the cash flow stress in initial years of such projects, the Reserve Bank has issued guidelines on flexible structuring of long term project loans with periodic refinancing option.

After declaring asset as an NPA

- **A comprehensive framework by RBI** - the RBI released a comprehensive 'Framework for Revitalising Distressed Assets in the Economy'. The Framework outlines a corrective action plan which includes:
  - early identification of problem cases,
  - timely restructuring of accounts which are considered to be viable, and
  - taking prompt steps by banks for recovery or sale of unviable accounts.
- **Revival of the viable entities** - timely support through restructuring in genuine cases is called for with the objective to preserve the economic value of viable entities and minimise the losses to the creditors and other stakeholders.
- **Debt Recovery Tribunals –** To recover security interest fastly, these tribunals along with appellate tribunal were established.
- **Invoking legal provisions -** The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act has provisions for the banks to take legal recourse to recover their dues.
- **Selling the NPAs to SCs/RCs** (securitisation companies/ reconstruction companies) registered under the SARFAESI Act. SCs/RCs are expected to do a specialised task of recovering and reconstructing the NPAs thereby reducing the NPAs in the system. Only a few out of 15 registered SCs seem to be successful.
- **JLF (joint lenders' forum):** Borrowers and lenders have to reach a conclusion about the prompt corrective action plan.All lenders under the JLF must collectively hold 51% or more of the equity shares issued by the company.

- **Lok Adalats:** Lok Adalat mechanism offers expeditious, in-expensive and mutually acceptable way of settlement of disputes. Government has advised the public sector banks to utilize this mechanism to its fullest potential for recovery in Non-performing Assets (NPAs) cases.

5 Recent Initiatives

For securitisation companies

- **Transparency in working of SCs**
  - The Reserve Bank has issued various guidelines relating to the operations of SCs/RCs as also to make transactions between them and banks more transparent for prevention of collusions with promoters in buy back deals.
- **Increased FDI cap -** foreign direct investment cap on SCs/RCs has been increased from 49 per cent to 74 per cent under the automatic route.

For banks

- **Capacity building of banks –** There is a need for emergence of additional technical capabilities of banks to undertake evaluation of projects, restructuring schemes, etc. undertaken under JLF. Reserve Bank through the Centre for Advanced Financial Research and Learning has taken initiative to organise capacity building program for bankers.
- **Strategic Debt Restructuring:** - Provide lenders 51% equity control in a company that fails to repay even after its debts are rejigged to give the management a second chance. It will come into force if the corporate debt restructuring (CDR) mechanism fails.
- **5/25 norms:** Permitted banks to structure loans for 25 years while giving them the flexibility to revise rates or sell the asset to another bank every five years in infrastructure.

6 Issues needing further Intervention

- **Effective exit policy –** For accounts which are beyond revival, banks should have a well -defined loan recovery policy which sets down the manner of recovery of dues depending upon the circumstances of each account.
- **Judicial delays -** An important factor affecting recovery performance of SCs/RCs is the delay in judicial process: be it under SARFAESI Act or at the level of debt recovery tribunals. A fast and efficient judicial system is a sine qua non for effective resolution of NPAs
- **Low recovery performance** - On the recovery side, the performance is not very encouraging. As on March 31, 2015, the average recovery rate (assets resolved as a per cent to assets acquired) of SCs/RCs was at 31.0 per cent.
- **Non-transparent auction process by banks for the sale of NPAs to ARCs -** The RBI has also advised that the banks using auction process for sale of NPAs to ARCs should be more transparent.
- **Banks possessing small share in loan forming JLF –**It may not have enough in-house capability for independent analysis and even if it does have, its say will be minute considering the size of shares it owns.
- **Pricing of NPAs -** Investors in stressed asset portfolios expect high returns, based on high-risk, high-reward principle which SCs/RCs find impossible to offer if the assets being acquired are not realistically priced.
- **Transparency in official numbers** - a clear and transparent assessment and communication of the problem. Official numbers on non-performing assets are being questioned by an increasing number of observers; this is a clear manifestation of distrust.
- **Infuse more capital into banks**, even if it is based on performance, is a hugely risky move without full transparency. Apparently well-performing banks may suddenly show themselves to be worse than reported. Any move to re-capitalise the banks should only be made once full transparency is achieved.

- **Improving management and governance of banks -**.There is no action on the recommendations of the committee chaired by P J Nayak, which call for much more fundamental governance reforms.
- **Decentralised decision making from government to PSB boards –** Rajan said more decisions need to be decentralised from the government to the PSB boards, once they have been fully professionalised.
- **Asset reconstruction company (ARC) -** The Union finance ministry and the Niti Aayog have recommended that the government set up an asset reconstruction company (ARC) and transfer troubled assets of the banking sector to its books. This will clean up the balance sheets of banks.

7 Steps Advised by Finance Standing Committee of Parliament

Finance standing committee of parliament's recommendation on NPAs in its report has been adopted on 5th February 2016. Some of its key recommendations include:

Forensic audit

- The committee has called for immediate forensic audit of all restructured loans that had turned into bad debts. Forensic audit is also required for wilful defaults

Revive Development Financial Institutions (DFIs)

- The panel also recommended the development of a "vibrant bond market" to finance infrastructure products.
- Batting for large infrastructural projects, it said the Centre should revive Development Financial Institutions for long-term financing of such projects.

Reveal the names of Wilful defaulters

- The panel asked the apex bank to form empowered committees at the level of RBI, banks and borrowers to monitor large loans.
- Name and shame the defaulters - There is no justification of keeping the names secret and asked the RBI to amend its guidelines.
- It also recommended that a change in management must be made mandatory in cases involving wilful default.

8 Conclusion

According to Raghuram Rajan – "Often, big borrowers are given a royal treatment by the banking system. Banks go out of their way to accommodate the borrowers' failures. Retail borrowers don't have the benefit of such overwhelming courtesy." This difference in the treatment of borrowers of different loan sizes does not augur well as far as the professionalism is concerned.

The march of Indian economy depends upon the resilience of our banking sector which is possible if all the stakeholders get their acts together to bring the banks get out of stressed assets.