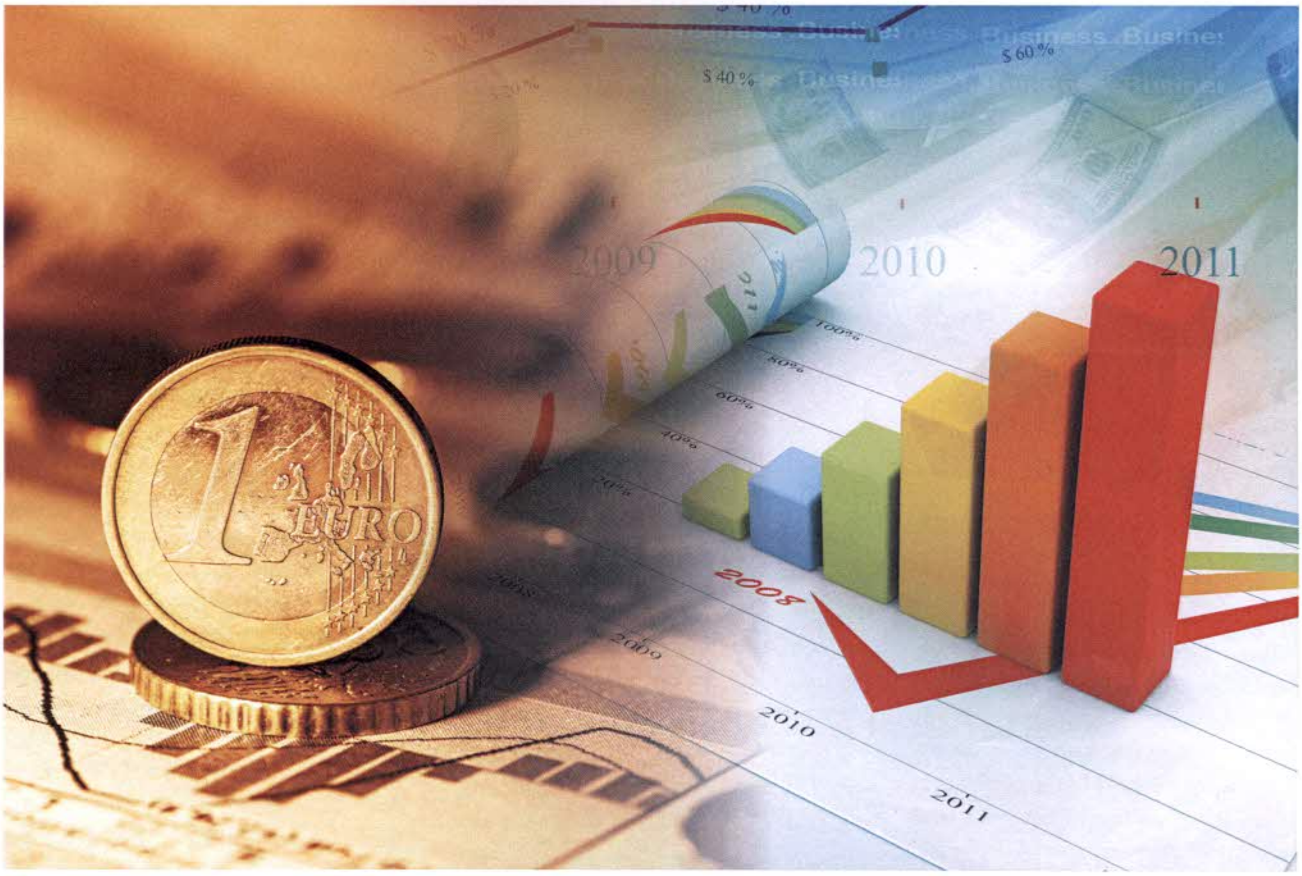

NPA Management in Banks

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The quantum and growth in gross NPA of banks has been inhibiting not just banks profitability, growth, health & solvency but also the overall investments and economic progress of the country. With NPAs surpassing the growth in credit off-take, the deterioration in bank asset quality has emerged as the key issue plaguing the country's banks, surpassing its various other challenges.

The fallout of the bad loan situation of the banks is felt economy wide. The high levels of stressed assets has prompted banks to go slow in their lending and keeping interest rates high. This has been a key reason for credit growth falling to multiyear lows, the direct fallout of which has been the lackluster pick up in investments and tepid economic growth, despite the favorable sentiments the country carries. In case of the banking sector, the increased provisioning that NPAs necessitate has been impacting their overall profitability, liquidity and eroding their capital base especially for public sector banks. It also curtails fresh `lending and thereby the future profits from foregone opportunities. Moreover, high NPA levels of banks dent their credibility and highlight the misallocation of funds by banks. It also impacts its market value which has become important as all of them would have to keep accessing the market to meet capital requirements under Basel III. Further, the shortfalls in liquidity add to the costs and operational difficulties for banks.

The increase in bank NPAs (from 2.4% in Mar'11 to 4.6% in Mar'15) can be attributed to both external and internal factors. If the quantum of restructured assets is added, the number would be in two digits. The persistent weakness in global and domestic demand conditions in recent years coupled with domestic administrative and governance issues have resulted in the buildup of stressed assets in various sector such as steel, power, aviation, real estate, mining to name a few. These being exogenous factors, banks have limited control over them. On the other hand the inefficiencies in the collection & recovery process of banks, flawed lending practices, inadequate post disbursal monitoring, willful defaults by borrowers, shortfalls in the credit appraisal & risk management practices and administrative shortcomings are some of the issue internal to the banks that have been contributing to the buildup of stressed assets of banks, all of which require to be addressed in a time bound manner.

Although at the aggregate level, the NPA and stressed asset levels are high for the Indian Banking system, the same is not uniform across the bank groups (public and private banks) in the country. It is notably higher in the case of public sector banks. The public sector banks, owing to their large size and domination position in the banking space carry larger NPA burden than private sector banks as they have also tended to lend more to the non-retail segment which involves larger investments and hence higher exposures which become vulnerable to business cycle. Also, the debt management policies, practices and administration adopted by the private and public banks differ significantly, and can be in part credited for the private banks having lower NPAs.

Adequately addressing and managing the stressed assets of the banks is essential for the health of the country's banking system. The banking sector is in a way the barometer of the economy and any revival in the latter hinges on the health of its banking sector.

Tackling NPAs

With banks having the liberty to devise their own policies and framework for the debt management and recovery, a multi-pronged approach and strategies need to be adopted to deal with NPAs. At the policy level too i.e. RBI and government, concerted efforts need to be taken to improve the situation. Although various regulatory and policy initiatives have been taken, the implementation of these need to be focused upon.

All the measures in essence should be effective in preventing assets from turning bad and offer remedial and corrective solutions. Although all banks do have in place measures in preventing and dealing with NPA, at times they are found to be inept.

Enumerated here are some of the ways for dealing with banks NPAs

1. Scrutiny and Appraisal

As NPAs reflect the quality of loans extended, banks need to have a detailed scrutiny and appraisal of the client profile as well as the project for which loan is being extended. Inadequacies in the appraisal process have been one of the main factors leading to NPA. In case of project appraisal, banks are found to be in need of adequate relevant technical expertise. Banks should develop this. Some banks have been relying progressively on the credit ratings given by the external credit rating agencies, which is pragmatic as it offers an independent view on the credit worthiness of the borrower which is free from commercial bias. Banks should also have a mechanism for strict monitoring of the end-use of credit and curtail the diversion of funds borrowed from banks for activities other than for which it was sanctioned.

2. Early Identification of stress

Regular monitoring of the performance of the loan account could help in the early identification of stress and suitable measures can be undertaken for the recovery of bank dues and revival/restructuring of the account. Efficient MIS systems of banks should be designed and maintained. Banks need to recognize the benefits of early identification as it would mean detecting the problems before they set in. again here the monitoring done by the credit rating agencies through the surveillance exercise could be a useful pointer for banks.

3. Addressing default effectively

While willful defaulters need to be dealt with strict and tough actions, defaults that are due to genuine constraints need to be treated differently and addressed in sensitive and responsive manner. Banks should use their resources (staff who possess expertise in evaluation/investigation of the financial transaction and factors that have led to stress and prospects for revival) to identify the borrowers with genuine commitments

and those who carry potential for revival, extend their support in a prompt and timely manner by way of additional funds/ restructuring to help in their revival. For non-viable cases, banks should device appropriate compromise and recovery solution. This may involve selling of asset, adjustment with collaterals, partial write-off and taking over the management (converting debt to equity)

4. Risk Management

Risk management in banks should involve proper quantification of risk (expected and unexpected) and the pricing of risk should have a sound scientific basis. For effective credit risk management, banks should conduct at period intervals in-depth industry studies have credit audits of borrowers, visits to client business/ plant sites and conduct periodic review meetings for assets, all of which should have the active involvement of the top management. The risk management should also focus on the proper (realistic) structuring of the loan and advances based on an analysis of the cash flows of individual clients. This would greatly facilitate in timely repayment by borrowers. Having a standardized structure for all clients of the banks would not be in the interest of banks or the clients. In case of long term loans the bank would do well to have flexible structuring with option of refinance from time to time as well as to accommodate cost overruns.

5. Debt recovery

Debt recovery has all along been a challenge for banks, more so during troubled economic times. Data shows that banks do not recover more than 20% of the NPV when a default takes place. The recovery policies of banks should be based on the reasons for the loan turning bad rather than adopting a uniform policy for all stressed assets. In cases where recovery is not possible, they should look to exiting the account. Bank can choose to tap legal options as a means of exit. They could also arrive at a comprise and decide on a settlement which could involve write-off. This option should only be exercise as a last resort and such settlement should be done in a transparent manner. Bank management should have a policy which frames the conditions and circumstances for write-offs.

6. Restructuring

Restructuring of loans is the most sought option in dealing with stressed assets. It should essentially be used only for those borrowers who were faced with financial constraints on account of factors (internal and external) out of their control. Restructuring should involve an in-depth evaluation of the viability and potential for revival of the account. Only following a thorough and objective assessment, banks should take upon the restructuring. The aim of restructuring should be to facilitate the revival of viable entities and thereby lower the losses to lenders.

7. Selling to ARCs and other financial institutions

Banks can sell their NPAs to other financial institutions viz. others banks, securitization and asset reconstruction companies (ARCs) who have the expertise in recovering and dealing with stressed assets and thereby reducing the level of NPAs in the banking system. ARCs by buying stressed debt of banks help them improve their balance sheets and also make available funds to banks. There has been an increase in the sale of bank NPA's in the last 2 fiscals (from around Rs.10,000 crs to around Rs.50,000 crs). Although ARCs and securitization companies help banks with their stressed loans, owing to their low capital base and difficulty in raising capital provide for limited relief- the net worth of ARCs is around Rs.4000 crs while the NPAs of Scheduled Commercial Banks was Rs.3,09,408 crs as of Mar'15. Also, the high acquisition cost of assets, which has nearly doubled in the last 2 years, has been an inhibiting factor. Purchase by these companies (ARC and Securitization) accounted for only around 16% of bank NPAs.

8. Undertake Credit Rating of clients

Credit ratings evaluate the debt servicing ability of borrowers and serve as an effective and vital tool for risk measurement. Credit Rating, treat the debt as being in default/stressed (and subsequently downgrade the rating to default category) if the debt servicing is delayed by even a single day, as opposed to banks who have a 90 day timeframe and thus can provide for the early warning signals to banks about weakness in asset.

The bank loan rating (BLR) undertaken by credit rating agencies is used by banks to determine risk weights for their loan exposures, as per the RBIs capital adequacy framework. Bank stand to earn capital relief by getting the exposures rated, provided the rating falls in the investment grade. This in turn helps banks save on cost incurred for raising capital to meet its capital adequacy requirements. In addition, banks can leverage the additional capital and earn margins on such lending

The rating exercise assesses future cash generation capability and their adequacy to meet debt obligations as per the repayment terms. It also covers the analysis of the fundamentals of the business and the industry and the probabilities of change in these fundamentals, which could affect the creditworthiness of the borrower. In addition to this, qualitative factors such as management capabilities too are analyzed. The credit rating thus arrived at is a superior indicator of the credit quality of the borrower/account.

The bank loan rating by credit rating agencies typically includes the rating of all fund-based and non-fund based facilities sanctioned by Banks (this include cash credit, working capital demand loans, Letter of Credit, Bank guarantees, Bill discounting, Project loans, Loans for general corporate purposes etc.).

9. Debt recovery tribunals

Banks have the option of approaching the debt recovery tribunals and apply the SARFESI Act (Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act) when the other methods of debt recovery and management fail.

10. Information sharing

Sharing of information about borrowers with other lenders (other banks and financial institutions) will help in the management of stressed assets at the system level.

Concluding remarks

The delays in processes viz. judicial, results in delays in the resolution of NPAs, which is also a factor that has come in the way of India's rank in the ease of doing business. The country needs to have a bankruptcy framework, which the government is currently working on. The proposed bankruptcy law does enumerate a way out whereby all creditors are involved which take a decision on such companies. A resolution process would run for 180 days after which a majority view of 75% of creditors would come into force. What is of essence is that banks must have in place processes to ensure that NPAs do not get created through careful credit appraisal and monitoring until the loans is repaid. At the government and institution level, there need to be strictures in place to ensure that these NPAs do not proliferate and that when they do, are addressed through suitable resolution measures, as in the bankruptcy code. This is essential to maintain the sanctity of the banking system.

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D R Dogra is Managing Director and CEO of CARE Ratings, which is the second largest credit rating agency in India in terms of rating income. After a stint of 15 years in Dena Bank, he joined CARE in 1993.

Born in September 1954, he has over 37 years of experience in the financial sector in the areas of banking and credit rating. He has been instrumental in driving CARE Ratings to the position which it has attained in the last few years and has also taken the company to the bourses where it got listed in December 2012. Several initiatives have been successfully taken under his leadership such as acquisition of Kalypto Risk Technologies (a risk management solutions company), opening of first global branch in the Republic of Maldives, setting up the first credit rating agency in Mauritius, forging ties with other global rating agencies in creation of a global rating agency, ARC Ratings (with partners from Brazil, Malaysia, Portugal and South Africa). He also worked closely with the Ministry of Finance, where CARE has prepared a dossier on the Indian Economy as well as white papers on both the equity and debt markets for the Ministry.

By means of qualification, he holds a Bachelor's and a Master's degree in Agriculture from Himachal Pradesh University and MBA from Faculty of Management Studies, University of Delhi. He is a certified associate of the Indian Institute of Bankers.