Breaking Shackles of NPA Management: New Age Risk Outlook

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Foreword

I am extremely delighted to write a few words, or a foreword, to this excellent article, *Breaking Shackles of NPA Management: New Age Risk Outlook*, because the authors have made a boring and, by now, the most clichéd subject on NPA management in banks, such an interesting reading.

The way the literature is developed speaks volumes about the professionalism of the authors, who work for Pinkerton. Pinkerton is a consulting and investigating agency in risk management. Their professionalism is very obvious in telling a story of old risk in lending with a fresh perspective. The modern outlook of the causes for NPAs, viz. the manifestation of strategic and operational risks, in additional to financial risk, is juxtaposed with the traditional outlook of NPAs caused by financial turnarounds that increase the borrowers' liability.

The authors suggest that banks need to have a relook at the entire process of credit due diligence at various stages of loan life cycle — pre-lending, on-going monitoring and stress assessment — so as to have a 'viability check' to ensure a robust lending-borrowing model.

Taking the NPA bull by its horns is a challenge, but not impossible if the internal processes are modelled on a more preemptive framework where due diligence is the key at every stage of the loan life cycle.

A good read for any banker and general reader!

B. Mahapatra is a retired career central banker. He retired as Executive Director of the Reserve Bank of India at the end of August 2014. Most of his career in the Reserve Bank was in the areas of banking regulation, policy, and supervision. He bring on table his vast experience and insight into banking policy making. Policy on NPA management is one such area he has worked intensively.

He has represented the Reserve Bank of India at various national and international fora; the most important being at the Policy Development Group of the Basel Committee on Banking Supervision.

He has chaired many committees; the oft spoken one is his report on prudential treatment of restructuring of problem loans by banks and financial institutions.

Mahapatra has co-authored a book on Derivatives Simplified : An Introduction to Risk Management.

He holds a Master's degree in Management from the Arthur D. Little Management Education Institute, Cambridge, Massachusetts, USA.

Foreword

The Indian economy is facing a much coveted bullish trend in terms of investor potential. Globally there is a growing sense of optimism on India. This depicts a healthy sign for a growing economy, yet there is a need to be cautious while making investments to ensure that the money is secure. There are always risks of potential frauds and India is not ignorant to such happenings. Drawing on lessons from the past, investors need to be cautious and ensure that a thorough due diligence is conducted on potential investees to ensure that the funds are channelized appropriately and are utilized in the best interests of all stakeholders.

It is exciting to be part of an economy where entrepreneurship and new joint ventures are booming. However, in the rush to support such ventures, often critical compliances, such as operational and strategic intelligence gathering and due diligence, are not carried out in an optimal manner. If bad loans and NPAs are to be curbed, then there is a need to build a robust monitoring and preventive action plan that would enable investors to safeguard their interests.

Keeping in mind limits in terms of internal manpower, the financial sector needs to open up to newer, innovative techniques and work more closely with high caliber third party agencies/external teams in order to help them make better informed decisions while investing. Such arrangements would also enable investors to keep a watchful eye on the entire transaction during its lifetime.

Deepak Parekh is the Chairman of Housing Development Finance Corporation, India's leading housing finance company. He is also the Non-Executive Chairman of Glaxo India Ltd & Burroughs Wellcome (India) Ltd and on the Board of Castrol India Limited, Hindustan Unilever, Siemens Ltd, Mahindra & Mahindra, Indian Hotels Company and SingTel. Mr. Parekh is also an advisory board member of AIESEC India and US Engineering consultancy giant, AECOM.

Parekh has been a member of various Committees set up by the Government of India. He was appointed Chairman of the high level expert committee formed to recommend measures for strengthening the Unit Scheme in 1964. The Reserve Bank of India appointed him Chairman of the Advisory Group for Securities Market Regulation, which was tasked to compare the level of adherence to international standards in India with that in other countries. He was also Chairman of the Expert Committee constituted by the Ministry of Power to look into the reform efforts in the power sector.

Non-performing assets (NPAs) are not a new guest in the tinsel town. They have been around ever since the Tulip Mania of 1600s and witnessed many a change in economies and lending patterns. Perhaps the most resilient of all pitfalls, they have survived the birth and fall of nations, policies and even witnessed the most dramatic change of the economic tapestry. Several studies, comparative analysis and review methodologies have been drawn up to structure policies pertaining to NPA management and while the views have been divergent, they all seem to be crying for attention now when a country like India is all set to categorize NPAs as one of the largest looming threats affecting the corporate tapestry of the land.

Traditional Versus Modern Outlook

A traditional outlook towards the non-performing assets (NPAs) in the financial world would attribute them to be the predictable and typical by products of a financial crisis. Reasons around rise in interest rates, economic slowdown and exchange rate depreciations have all being attributed to increase of liabilities of borrowers and thereby causing a sharp rise in NPAs.

Modern studies have however gone a step ahead to also assess the operational and strategic risks associated with the NPAs and how they have contributed to the rising portfolio in an emerging country like India. While it is not of doubt that financial turnarounds constitute to be the most apparent reasons behind building of a loss portfolio, the modern times have awakened us to the concept of non financial risks that also need to be paid heed to for building a robust structure of debt management.

MODERN OUTLOOK
NPAs caused by Operational and Strategic Risks in addition to Financial Risks

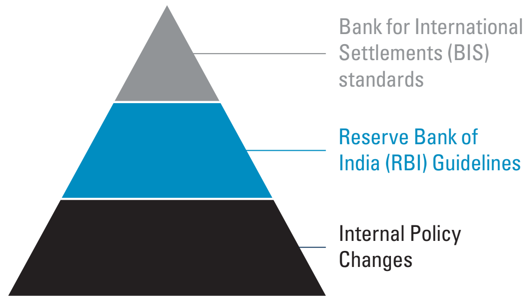
TRADITIONAL OUTLOOK
NPAs caused purely by financial turnarounds that increase the borrower's liability

A steady realization and acceptance of the influence of non financial risks as key areas of concerns has led researchers in various developed and emerging countries to consider inclusion of key strategic changes while considering a revisit of policies for NPA management.

Non-performing Assets — Indian Perspective

NPA has been of a prime concern with all banks of the Indian subcontinent. With the recent media reports being focused on the increasing number of bad loans within the banking industry, it has indeed caught the attention of even the public at large. However, our study of the comparative scenarios of NPA management across the globe indicates that while trends are increasing and India being a growing economy capable of influencing the world trend, is impacting the global

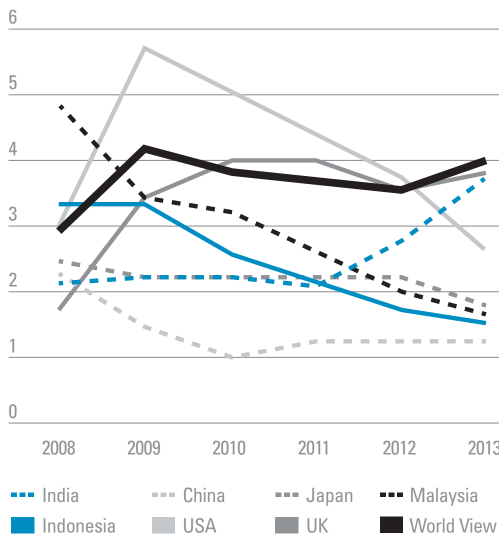
numbers – we indeed are not at such a grim position as we are positioned to be.



Armed with formal definitions, the continuous efforts to meet the Bank for International Settlements (BIS) standards and the continuous attempts by the Reserve Bank of India (RBI) to monitor the lending portfolio of the banks, India has come a long way to take measures in combating bad loans.

When compared to economies of China, United States (US) and United Kingdom (UK) India seems to be in a much elevated and transparent platform to deal with bad borrowings rather than just trying to portray better numbers on the balance sheets.

Overview of NPLs Ratio

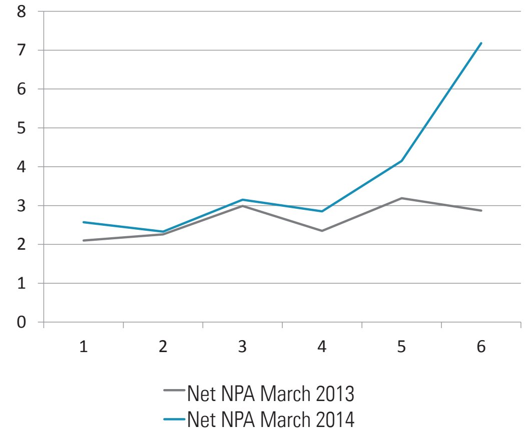


Though the overall world view reflects rising trends in the Indian NPA regime, one must not forget that unlike other countries (China, US, Malaysia mainly) India ranks higher in stringent policies pertaining to:

- Strict and Standard Regulatory Definitions Governing Categorization of Loans
- Government Bail Outs
- Provisioning for Bad Loan Write Offs

Waking Up to a Few Indian Dichotomies

While it is true that the Indian position in terms of stringent Government measures looks to be better when it comes to NPA management, one cannot but ignore the growing numbers and trends that are being reflected over the last 2 years.



Source: RBI

As per the latest published industry reports of 2014 round 36 banks have reported gross NPA's of INR 2,340 billion (approx USD 39 billion) as compared to a similarly placed previous year's figure of INR 1,718 billion[1] (approx USD 28 billion). As per the recently published data of RBI, the top 30 NPAs of state-owned banks account for 40.2 percent of their gross bad loans[2].

The fourth quarter ending March 31, 2014 displayed alarming trends with regards to NPAs across all major public sector Banks in India, despite profit figures showing different stories.

On an average the trend was a steady decline of profit margins on account of higher provisioning against bad loans and increase in the net NPA by a range of 2.3 – 7.2 percent as compared to the preceding year's range of 2.10 – 3.19 percent.

The trends have also made us awaken to two major dichotomies that surround the debate around NPAs in India: 1.) The Public – Private Sector Analysis and 2.) The Priority – Non Priority Sector Analysis.

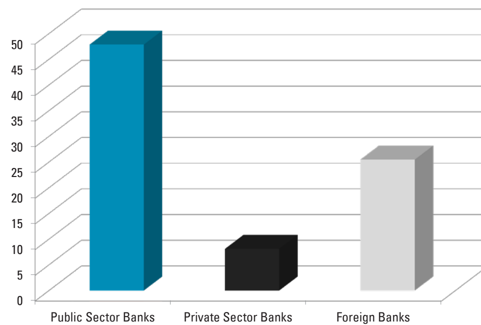
1. The Public Sector and Private Sector Dichotomy

The trend analysis study for Indian banks over the years has shown steady indications pertaining to the private sector banks being in a comparatively stable position when compared to their public sector counterparts in terms of NPAs. In terms of numbers, the trends are substantiated when one accounts for the quarter

ending March 2014, where the Gross NPAs of the public sector banks reflected an increase of around 41.41 percentage as compared to an increase of 12.91 percentage for private sector banks[3].

Further, the 9th Financial Stability Report of RBI has clearly highlighted that stress tests indicate vulnerability for public sector banks as compared to their private sector counterparts when it comes to bad loans and NPAs[4].

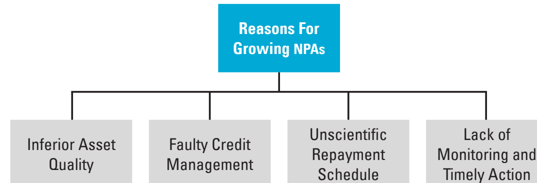
Compounded Growth of NPAs (%)



Source: ASSOCHAM

Studies over the years pertaining to the portfolio of bad debts, indicate differences in asset quality, faulty credit management, lack of professionalism in the workforce, unscientific repayment schedule, mis-utilisation of loans by borrower, lack of timely legal solution to cases, political interference at local levels and waiver of loans by government – as the major reason behind the growing portfolio of NPAs. Similar research also indicates that owing to its much critiqued stringent policies, the private sector scores more in NPA management owing to their ability to combat the above mentioned factors better than their public counterparts.

However, it would be injustice to not highlight a couple of exception stories culled out by a few public sector banks in India, who despite the overall leniency in their

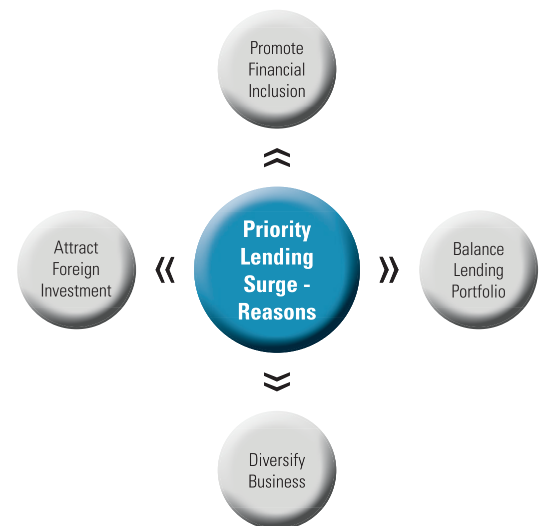


similarly placed counterparts, have at their own end established policies and watchlists in order to curb bad borrowings and ensure that the lending is disbursed to deserving borrowers. The trend of such public sector banks as being successful is not only reflected in their recent increase of profit margins but also in the decline in their net NPA ratio.

2. The Priority Sector and Non Priority Sector Dichotomy

For long the traditional school of thought has attributed the large scale corporate sector to be the main sector where majority of the bad loan portfolios lay. However, modern studies around the various policies pertaining to disbursement, the views of the Government to enhance credit in the agriculture and related SME (Small and Medium Enterprises) sectors have forced us to rethink on the corporate loan tapestry overall.

While it is true that the agrarian backbone of the country has forced us to stop and re think if we are diverging out of our core economic expertise and the attempts of the Government in order to restore balance has been in terms of prioritization of lending, it cannot be ignored that it has created a huge pressure in terms of the numbers to be achieved from the banking perspective.



The recent trends of priority sector gaining edge over the established and traditional sectors of manufacturing, iron and steel and cement industry in terms of increasing number of NPAs needs to be viewed as an alarm to help put a few preventive steps in place, in time.

At the same time it must be understood that the priority sector is important for consideration keeping in mind the bigger goals for financial inclusion and to attract foreign investments in sectors that have been ignored for long. What is required is perhaps a holistic balance where banks do not feel pressurized to lend and the borrowers are aware of a stringent scrutiny and risk analysis process that is in place before they are adjudged to be worthy of credit facility disbursements.

NPA Management: A Story of Old Risk — Fresh Perspective?

Worldwide trend analysis of the growth of NPAs has clearly indicated that India has surpassed the expectations of regional growth. India over the last 6 years has shown a steady increase in NPAs when compared with other emerging countries, who on the contrary have displayed a decline in their NPA buckets. According to the last available 2012 - 2013 report of World Bank, the Indian NPA ratio stands as 3.6 percent as compared to Japan's 2.4 percent and a South Asian average of 2.2 percent.

The mention of Japan is not only enough for its decline in NPA percentage but also for the preventative steps and the advanced risk management regulatory approach adopted by the country as a whole. While "Risk Management Loans" are used to classify non-performing loans and the number of days in arrears is used as the primary indicator for this classification, the other parameters of assessment includes:

- Bad Borrowers (NPLs) - Self Assessment + Bad Loans
- Self Assessment - loans that are to "bankrupt" and "de facto bankrupt" borrowers correspond to "unrecoverable or valueless" loans
- Risk Loans - loans that are "in danger of bankruptcy"
- Doubtful Borrowers (quasi NPLs) - those classified within the self-assessment as needing "attention" but not "special attention"

A deeper analysis into the above would reveal that this when compared to the Indian standards is in lines with the single risk window approach suggested by RBI through multiple Guidelines and Circulars. The 2013 "Report of the Financial Sector Legislative Reforms Commission" backs the recent recommendations of the RBI Deputy Governor and recommends a "professional diligence" to be conducted on the borrower that takes into account important parameters pertaining to his honest market practice, the principle of good faith, business expertise and analysis of the risk involved in his project.

The various guidelines of RBI that prescribe proactive and preventive risk management to prevent bad lending provides advisory with relation to:

a.) **Holistic data capture and proactive risk assessment** for new applicants and existing customers

b.) Comprehensive profiles with **single view of risk factors** for enhanced investigations and customer understanding

c.) A**daptive workflows** for effective incident resolution, process compliance, and operational management

Keeping the above in mind, banks need to have a relook at the entire process of Due Diligence at various stages of the loan lifecycle – namely Pre Lending, On Going Monitoring and Stressed Assessment.

Stage	Parameters
Pre-lending	The process of pre lending due diligence and enhanced checks not only helps provide a detailed background of the customers but also helps to know more about their business and third party associations. It helps take a call on whether the feedback on various parameters present a want of the proposal to be a: • **Deal Maker** – a good position to be in • **Deal Cautioner** – a fairly positive feedback, with just a few points of caution that need a special look out • **Deal Diluter** – a deal worthy of going forward only if certain terms are re adjusted to make the facility more secured for the lender • **Deal Breaker** – a no go outlook right at the outset
Ongoing Monitoring	The process of on-going monitoring serves a dual fold purpose • Helps keep a tab on the **compliance and regulatory processes** that are needed to be abided by the borrower and also keep a record of the business health and other activities of the promoters • Helps pick up **early warning signals** pertaining to an account keeping in mind the evolving market conditions and change in business patterns of the company. • Helps a bank consider the existing market conditions and **take a call on exit or negotiation** in order to secure its dues at the first sign of stress.
Stressed Assessment	The process of due diligence for a stressed account, helps the banks take a call on the future methodologies to be adopted with respect to recovery of dues from the account. This can be achieved through a dual fold approach of: 1. **Physical Asset Management** that involves finding out movable and immovable assets belonging to the creditors or the related parties that have not been disclosed in either the declared asset register, balance sheet or the collateral details submitted by the borrower with the bank. 2. **Advanced Business Probing** that involves culling of crucial business information pertaining to the holding of the promoter company in other companies and their unknown continuing business interests.

Regular Business Health Check Up — Key to Robustness?

Like every aspect of business, a 'viability check' is the key to ensure a robust credit – borrowing model. However, this needs to be supplemented with a strong monitoring mechanism in order to ensure that all pointers of early detection of problem are in place and an effective risk mitigation strategy has been preempted and put to action. It is well understood that the position of a banker is very different from his counterparts like that of an equity investor. Unlike the latter, a banker cannot often afford to have a personal watch on the borrower account for the want of crunch of time, resources and the sheer number of lending accounts to handle looking at the volume of business at stake.

Saying that but, one cannot absolve the liability of a banker to put in place a risk monitoring mechanism at every stage of the credit facility. While a pre disbursement analysis would provide an overview of the business health of a company and its promoters to help take a call on the investment, a continuous tab on the business viability and health changes would enable early detection of problem to mitigate risks at a manageable level. This is important not only to ensure that the repayment cycle of debts is regular but also to enable bucketing of those accounts at the outset, that stand the chance of going the stressed route.

Further, a continuous monitoring mechanism with the borrowers helps banks be aware of the changes being brought by him in business, the investments being made by him and thus be better armed for a timely call for exit or a one-time settlement amount early at the time of need and before the credit worthiness of the borrower is completely lost. Change in economic tapestry that affects the business viability of a promoter often forces him to be defensive and secure his own personal assets at the cost of the company at large. This creates a 'waterfall mechanism' in the entire credit structure and as a result banks find themselves to be the first affected parties, with majority of the promoters going the bankrupt or the willful default route.

The key is to assess and monitor the activities of the business at an ongoing level at various jurisdictions and take timely actions that do not allow the borrow to slide away and in order avoid lengthy and tedious legal battles or arrange for provisions of write offs in balance sheets.

Tackling the Roaring (NPA) Bull

There is no denying that the issue of bad loans is of concern to the entire nation as a whole. However, it is also comforting to understand the regulatory policies in India are adept to manage NPAs provide strength to the financial structure and economy. The thrust now is to back up the regulatory policies with advanced and innovative practices by banks to bring about added controls and precautionary and preventive practices, of advanced due diligence, creditor assessment, investigative scoping of warranties and representations, that look to innovatively influence the overall credit disbursement including lending to sectors that are vulnerable and in recent times have indicated a high probability of default / poised to contribute maximum to NPAs.

The internal processes are now to be modelled on a more preemptive framework where due diligence is conducted on parameters beyond financial analysis both at the credit appraisal (pre borrowing) and extension stage. Further, processes are also to be aligned for a continuous monitoring framework for critical and high value accounts to pick up early warning signals that are to serve as alarms for an impending and probable crisis. If implemented through the entire cycle of credit appraisal to monitoring of disbursed loans, the proposed policies shall not only go a long way to bring the numbers of NPA down to a manageable level but also make a difference to the credit policies and overall economic health of the nation.

As a nation with the youngest workforce in the world, it is not a matter of debate that such a cleansing would go a long way to attract new investors and position ourselves an inch closer to the economic super power dream that the new Government is inspiring us to dream about. The key question is about implementation and it needs to be seen how the banks take on the bull called "NPA" by the horns now using the recommended innovative measures.

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About Pinkerton

Pinkerton traces its roots to 1850 when Allan Pinkerton founded the Pinkerton National Detective Agency. Today, Pinkerton offers organizations a range of corporate risk management services from security consulting and investigations to executive protection, employment screening and security intelligence. With employees and offices worldwide, Pinkerton maintains an unmatched reputation for protecting clients and their assets around the globe.

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