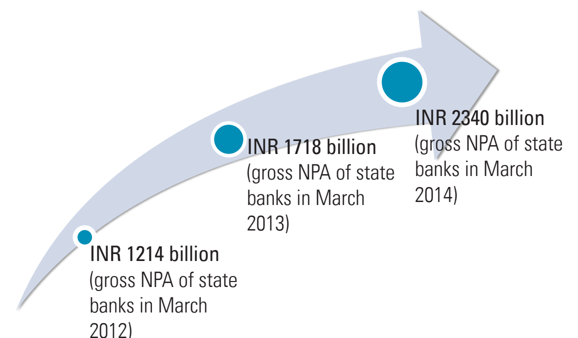
Have NPAs Become “Non Provocative Alarms”?

NPA – A Tunnel Without Light at the End?

Non Performing Assets (NPAs) maybe differently defined across various countries yet the key factors defining NPAs' health can be commonly attributed to economic environment, regulatory and institutional mechanism to deal with the situation and lastly but surely of high prominence than other factors are internal protocols of the financial institutions. Stress on the economic environment has always increased the NPA size and financial institutions have been dealing with such scenarios through defined tools and experts for many years. The contemporary intricacies adversely impacting understanding veracity and administration of NPAs include labyrinth organizational structures, international operations of companies linking countries difficult to obtain financial information, pretense on part of entrepreneurs and degree of timely due diligence and monitoring initiated by the financial institutions.

In the Indian scenario NPAs have steadily increased in the last few years and can be considered to be one of the main cause of deterioration of capital, liquidity and profitability. Studies post September 2013 have clearly indicated that while the capital adequacy of the banks have remained robust, the deteriorating asset quality of the banking sector has emerged as a major cause of concern to the banks, with their gross NPA levels depicting a sharp increase, as especially true for public sector banks.

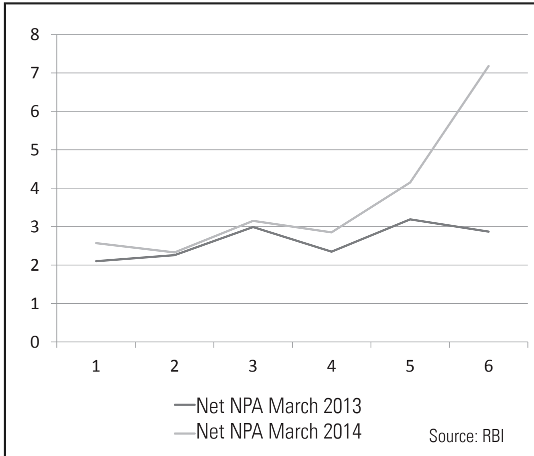
With a year on year growth of NPAs reflecting a more upward trend than growth in credit, the Indian banking industry has been brought under the scanner in recent times for the bad loans and inability to recover large debts. Data released by Reserve Bank of India (Indian regulatory body) and as quoted by other industry bodies indicated further deterioration of situation in terms of total NPA size and its management. The propensity of financial institutions to get mitigation strategy in place in near term is not very encouraging. Putatively, there are only few institutions having identified NPAs as distress and also have started working on specific plans to control it.



Source: ASSOCHAM

The last 2 years has reflected a steep rise in the figures pertaining to NPA. As per the latest published industry reports of 2014, around 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 (approx USD 28 billion).[1] As per the recently published data of RBI, the top 30 NPAs of state-owned banks account for 40.2 per cent of their gross bad loans.[2]

The fourth quarter, which ended 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 Public Sector - Private Sector Dichotomy

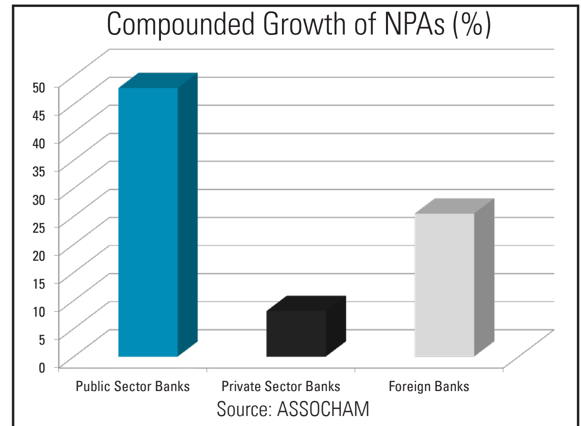
As initially indicated, internal protocols of a financial institution substantially contribute to make NPAs a menace or make an organization of the winning side. The criticality of the internal protocols can be gauged by a fact that they are in much better control of financial institutions rather the other contributing factors, such as economic environment and regulatory remedies. The trend analysis study for Indian banks has clearly highlighted that private sector banks are better off compared to their public sector counterparts when it comes to NPAs. For the quarter ending March 2014, the Gross NPAs of the public sector banks reflected an increase of around 41.41 percentage as compared to an increase of 12.91percentage for private sector banks.[3]

The above mentioned figures do not reflect any new trend pertaining to the Indian banking industry. A thorough study of various reports published by the RBI shows that the same has been consistent for almost a decade4 and even the major reasons for the difference remain the same.

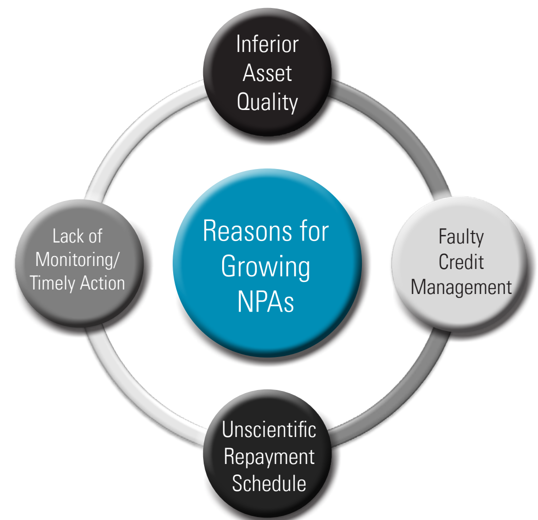
Years	Public Sector		Private Sector	
	Gross NPA (%)	Net NPA (%)	Gross NPA (%)	Net NPA (%)
2001 - 2002	11.09	5.82	9.64	5.73
2002 - 2003	9.36	4.54	8.08	4.45
2003 - 2004	7.80	3.00	5.85	2.80
2004 - 2005	5.50	2.00	6.00	2.70
2005 - 2006	3.60	1.30	4.40	1.70
2006 - 2007	2.70	1.10	3.10	1.00
2007 - 2008	2.20	1.00	2.30	0.70
2008 - 2009	2.00	0.94	2.36	0.90
2009 - 2010	2.20	1.09	2.32	0.82
2010 - 2011	2.40	1.20	1.97	0.53
2011 - 2012	3.30	1.70	1.80	0.60
2012 - 2013	3.59	2.00	1.96	0.36

In addition to higher NPAs, the public sector banks also have a large amount of restructured advances (accounts under stress) that have a greater probability of turning into NPAs.

Studies note that over the last year restructured accounts have grown at a compounded annual growth rate of 47.86 percent in public sector banks. The corresponding figures for private sector and foreign banks are 8.12 percent and 25.48 percent respectively.[5]



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.[6]



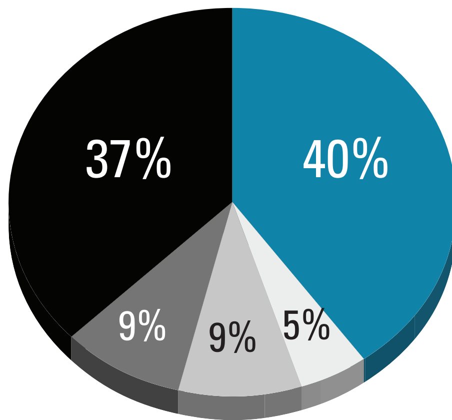
The major reasons attributed by various industry experts and studies for such a dichotomy pertains to the difference in asset quality, faulty credit management, lack of professionalism in the workforce, unscientific repayment schedule, mis-utilisation of loans by borrower, lack of timely legal solution to cases, political interference at local levels, and waiver of loans by government.

While the private sector is often critiqued for its stringent policies that make availing of credit policies a long drawn process, the above mentioned lacunae of the public sector clearly highlights why the stringency has proven to be effective in NPA management.

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.

The Regions of Stress



Others
Textile
Iron & Steel
Aviation
Infrastructure (including power)

Source: RBI

The study of the Indian banking system in detail reflects that NPAs and/ or restructured accounts differ in quantum not only across various industries but also across the lending sectors overall. As per the data shared by the Standing Committee (appointed by the RBI Governor to monitor NPAs) NPAs / restructured accounts in the corporate sector are found to be much higher than those in the priority or agricultural sector.[7]

A study of the sector wise analysis through 2013 revealed that Infrastructure, Power, Iron & Steel, Textiles and Aviation industries accounted for approximately 60 percent of the NPA/ restructured assets in the Indian banking regime.

A parallel study of the reports published by CDR pertaining to 2013 shows that the above mentioned sectors match those wherein the maximum cases of restructuring have been approved – with maximum distress in debt being witnessed in iron & steel sector and infrastructure sector.[8,9] (See Appendix, Figure 1.)

RBI study of Supervisory Returns and Staff Calculations reveals that for the projections pertaining to 2014 and 2015, the Construction sector is expected to have the highest NPA ratio followed by Iron and Steel. (See Appendix, Figure 2.)

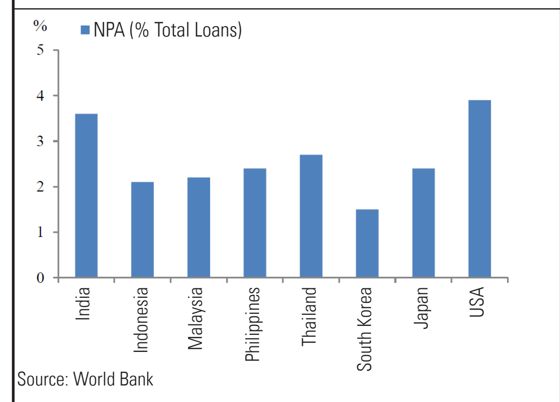
Global Trends of NPA and Indian Position

Worldwide trend analysis of the growth of NPAs has clearly indicated that India has surpassed the expectations of regional growth. (See Appendix, Figure 3.) 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.

Study shows that in 2006, India's ratio was at global levels and was better than several emerging market economies such as Brazil, Indonesia, Malaysia, Philippines and Thailand. However, a similarly placed study of 2012 reveals that all mentioned nations with the singular exception of India have experienced a reduction in their Non Performing Loans (NPLs) as a percentage of total loans ratio[10].

According to the last available 2012 - 2013 report of World Bank[11], 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. When compared to both the developed and developing world having similar banking systems, USA emerges to be the only country with a NPA exposure and vulnerability more than India, standing at 3.8 percent in its NPA ratio.

Figure 1: India's NPAs exceed regional averages, but is lower than the NPA ratio in USA



Source: World Bank

Establishing a Control Environment and Timely Alarm System

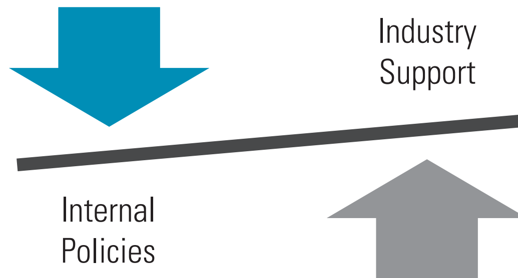
There is a prudent need for contribution from the regulators to a create favorable environment for the financial institutions and to ensure that they have stringent internal protocols to manage the situation. A team approach partnership from both the sides is need of the hour rather envisaging help will be rendered from any other direction.

The recent report by Flitch, which downgraded the viability ratings (VRs) of many state-owned banks in 2012 and 2013, clearly reflects that there is no expectancy in the market for any improvement in the performance of NPAs. Further, various studies including that of RBI and other bodies, reflect a clear upward swing in the probable NPA numbers, with the 2015 projection going as high as INR 13,637 billion (approx USD 224 billion).[12]

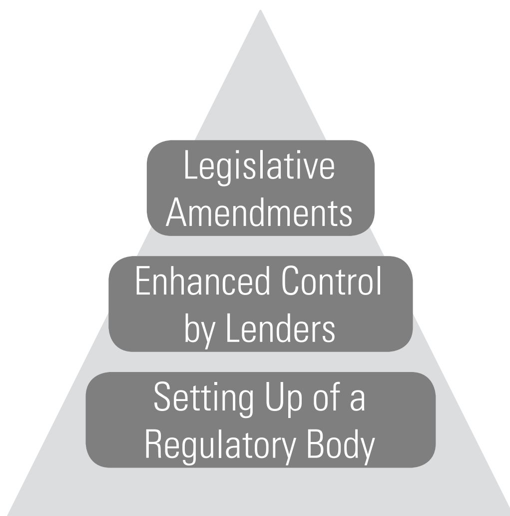
With regard to the increasing rise in NPAs, RBI in its "Report on Trend and progress of Banking in India" has clearly highlighted lapses pertaining to inadequate

credit appraisal processes of Banks, that has added to the woes.[13]

Reports pertaining to reckless lending to infrastructure, power sectors and extension of facilities backed by political pressures have also been highlighted as one of the major reasons for increase in bad borrowings.[14,15]



Overall, the various studies clearly indicate that there is both an external (industry) and internal (intra organization) focus that is required in order to tackle the growing menace of bad borrowings.



Industry Outlook

The industry is looking forward to broad macro level suggestions pertaining to setting up of a National Asset Management Company (NAMCo) to take over bad loans of the banks and help revive sick units. Apart from NAMCo, suggestions have also been tabled to set up dedicated Asset Reconstruction Companies (ARCs), particularly for the power and road sectors in order to bring down the NPAs of banks.[16] Recent suggestions by the Finance Ministry also include opting for changes in the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) and DRT Acts.[17] On a micro level, the Finance Ministry allowing public sector banks the power to go in for a change of management for defaulting companies seems pertinent and encouraging.[18]

Time To Walk a New Path?

The financial institutions must do a compressive review to augment their overall mechanism to obtain an early alarm for a possible default and also to convalesce decision making during confirmed defaults. RBI vide various circular, mandates and reports has been vocal about the requirement for Banks to minimise the risk of default by strengthening their internal credit appraisal system and risk management mechanisms. There have been some cases when lack of due diligence before disbursement of loans (now turned NPAs) was found to be a root cause to let loans go NPA route. To bring in element of neutrality and higher degree of professional approach, RBI has in recent times spoken about how banks should consider using external credit appraisals in addition to their own internal assessments.[19] 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 predictive model at work at present, based on historical data to preempt customer behaviour and analysis of the business health of the borrower through third party provided credit scores, now needs to undergo a process of refinement.

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.

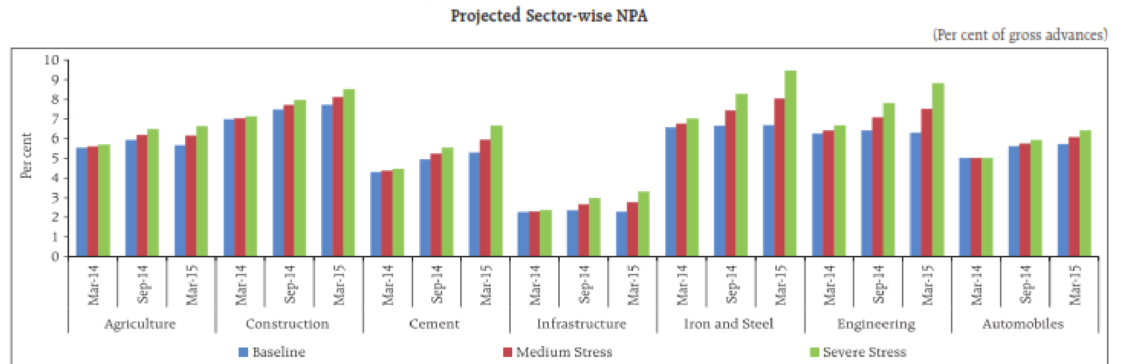
Appendix

Figure 1

Industry	31-MAR-13 (INR CRORE)	% SHARE	30-JUN-13 (INR CRORE)	% SHARE	30-SEP-13 (INR CRORE)	% SHARE
Iron & Steel	52,682	23.00	53,543	21.39	41,812	21.30
Infrastructure	21,912	9.60	34,676	13.85	35,543	18.11
Textiles	17,767	7.80	20,662	8.26	19,545	9.96
Power	18,460	8.10	18,460	7.38	17,225	8.78
Total	229,014	100.00	250,279	100.00	196,267	100.00

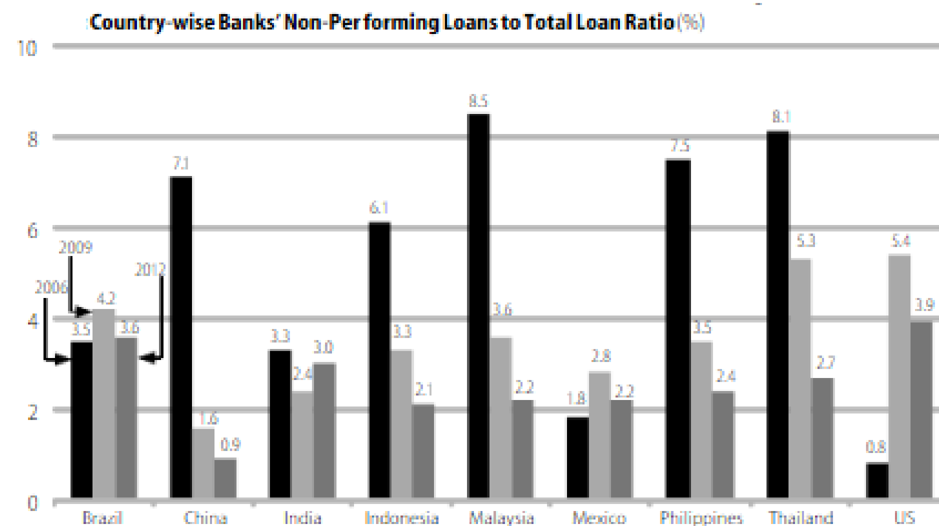
Source: CDR

Figure 2



Source: RBI Supervisory Returns and Staff Calculations

Figure 3



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