Some key lessons from the NPA crisis

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Credit outstanding					
Non-food credit	8.04	23.17	45.30	71.44	97.3
Infrastructure	0.37	2.02	6.30	9.6	10.55
a) Power	0.19	0.93	3.30	5.79	5.68
b) Telecom	0.08	0.38	0.93	0.91	1.15
Iron & steel	0.26	0.82	1.95	3.11	2.82
Textiles	0.34	0.91	1.59	2.05	2.03
Construction	0.05	0.27	0.48	0.90	0.99
Gross NPA ratio	7.20	2.30	2.90	7.50	9.30
Credit (growth rate %)	21.00	30.30	18.30	12.06	10.84

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The banking system’s strength hinges on good judgment. For this, RBI, government and banks need to be clear on their roles

Despite the introduction of prudential norms and a stringent regulatory mechanism, the Indian banking system is under strain. As of March 2018, non-performing loans at commercial banks peaked at Rs. 10.3 trillion or 11.2 per cent of total advances. The corresponding figures for public sector banks are Rs. 8.9 trillion and 14.6 per cent.

These ratios have come down slightly since then. As of 2007-08, the ratio was only 2.26 per cent. How did this happen? An analysis will help to identify the areas which need attention and reform. Table 1 provides a set of data which will help our analysis.

The rise in NPA ratio

Part of the reason lies in the extraordinary credit boom that the country witnessed since 2003-04. Between 2003-04 and 2007-08, the outstanding non-food credit expanded by three times. Between 2007-08 and 2011-12, it again doubled. During the next four years, it increased by 1.5 times. In absolute figures, the increase in three successive periods is Rs. 15 trillion, Rs. 22 trillion and Rs. 26 trillion and during the three-year period (2016-19) by Rs. 26 trillion.

In addition, the assets under management of mutual funds and credit extended by NBFCs have also expanded enormously. The nominal GDP during these periods increased by 15.08 per cent, 15.56 per cent, 12.05 per cent and 11.3 per cent respectively. It must also be noted that there was considerable tightening of monetary policy between 2004 and 2008.

The repo rate was increased from 6 per cent in March 2004 to 9 per cent in August 2008. During this period, the CRR was also raised from 4.75 per cent to 9 per cent. Thus the credit expansion happened despite tightening between 2004 and 2008. However, during 2008, the repo rate and CRR were lowered substantially in response to the global financial crisis. There was a mild reversal of this between 2009 and 2012. There was a reduction in repo rate during 2014-19. This period was marked by a slowdown in real growth.

Credit booms are generally succeeded by stress in the banking system. This has happened in India also. Credit expansion was phenomenal, with average annual growth rate at 18.69 per cent while nominal GDP growth rates were 12.62. It is true in a period of economic expansion, every project looks rosy. Exuberance becomes all embracing, partly rational and partly irrational. It is also seen that there was substantial flow of credit to certain sectors like infrastructure (roads, power, telecom), iron and steel, mining and

aviation. While all these sectors are important for growth, these were also subject to severe output fluctuations.

Court judgments had an impact on mining, power and steel sectors. Large Chinese imports affected the iron and steel industry. What led to the large expansion of credit? Was it out of free will of bankers or were they nudged by the government? Were they afraid of being labelled as 'lazy bankers'? Private sector banks were as 'exuberant as public sector banks. Some of the private banks including foreign banks had non-performing assets ratio comparable to public sector banks.

Many banks, small and big, public, private and foreign were in the same consortium and thus attributing the problem to lack of skills only at public sector banks is an over simplification of the problem. There was also some regulatory forbearance. Asset Quality Review introduced in 2015 tightened the situation and brought out greater transparency. It led to a doubling of the NPA ratio in one year. But, by that time, damage had been done and the banks were left with a huge problem with no immediate relief. The resolution process is taking time.

Looking ahead

It is always possible to be wiser after the event. However, we need to study the past to draw appropriate lessons for the future. The lessons are there for the regulator, which is the RBI, the government and the banks. As far as the RBI is concerned, some of the lessons are:

The regulator has the responsibility to monitor macro-prudential indicators such as overall credit growth and also to spot excesses, if any, to certain sectors, and groups. This has implications when the RBI tightens or loosens monetary policy. The RBI's concerns must be communicated to the government/owners, and made public.

Regulation is no substitute for good governance. Regulatory design needs to reckon financial and business cycles and take remedial measures in time. This is not to deny the challenges faced by the RBI on account of external factors like the global financial crisis (2008-09) and taper tantrum (2013).

Notwithstanding several measures taken by the RBI, including the 2016 guidelines, the performance of the resolution process has been slow and needs to be reviewed and remedial measures taken. The Insolvency and Bankruptcy Code (IBC) is an important innovation. But glitches need to be ironed out.

As international experience shows, increase in compliance cost does not automatically translate to better regulation. The regulatory regime needs to pinpoint parameters that need special attention.

The lessons for the government are:

The government certainly has the responsibility for overall management of the economy and being the owner of the banks, it may push the banks in certain directions. This may have immediate benefits but may cause problems in the medium term.

The government may ensure that banks are run in the larger national interest but commercial decisions are best left to bank boards. Improvement in governance of the boards has been talked for long, but much needs to be done.

The relationship between the government and the boards/CEO is still an unresolved question. There is no clear definition of ‘arm’s length’.

The government and regulators need to promote specialised institutions for project finance. This is a throwback in time but is worth considering. The promotion of corporate debt markets both for performing loans as well as distressed loans needs special attention. Reliance on a project appraisal by just one single institution has entailed

losses to a number of small and medium banks. These banks should not piggyback on project appraisal of other agencies.

Banks boards must be empowered to decide on capital raising plans from the market within a well-defined framework. It is a well accepted axiom that organisations raise capital when they don't need it immediately.

Recapitalisation may be done in cash rather than through bonds or in some combination.

The lessons for the banks are:

Banks need to take responsibility for the soundness of credit decisions. They need to define their own risk appetite rather than lean on the big lenders' appraisal. Project appraisal and working capital assessment are quite distinct though related. Banks need to significantly upgrade their appraisal and monitoring skills and invest heavily in training. These cannot be sporadic and one-off but well planned for the long term. Risk management must improve at all levels.

Assurance systems (internal and external audits and credit rating) need to be strengthened. Given the reported large scale siphoning of funds, round tripping of debt as equity through dozens of shell companies needs to be checked through forensic audits at annual reviews.

Ultimately the strength of the banking system depends on good judgment. Banking need not be either 'boring' or 'adventurous'. Similarly, bankers need not be either 'lazy' or 'hasty'. A proper balance needs to be struck.

Rangarajan is former Chairman of the Economic Advisory Council to the Prime Minister and a former RBI Governor, and Sambamurthy is formerly Director and CEO, IDRBT