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Preventing the pile up of NPAs — I

Strengthening due diligence, monitoring and governance will go a long way in curbing bad loans' toxic impact

C RANGARAJAN/B SAMBAMURTHY

Table 1

Bank Credit Growth Trends – 2008-2020

Year	Outstanding (Lakhs of Crore)				Growth Absolute (Lakhs of Crore)			Growth Percentage		
Bank	2008	2013	2018	2020	2008 2013	2013 2018	2018 2020	2013 over 2008	2018 over 2013	2020 over 2018
Scheduled Commercial Banks	24.7	58.7	87.4	103	34	28.7	15.6	137.7	48.9	17.8
PSU Banks	18	44.7	57	61.5	26.7	12.3	4.5	148.3	27.5	7.9
Pvt. Sector Banks	6.7	14	26	36.2	7.3	12	10.2	109	85.7	39.2

Table 2

Bank Credit to Infrastructure & Other Sectors

Year	Outstanding (Lakhs of Crore)				Growth Absolute (Lakhs of Crore)			Growth Percentage		
Bank	2008	2013	2018	2020	2008 over 2013	2013 over 2018	2018 over 2020	2013 over 2008	2018 over 2013	2020 over 2018
Infrastructure of Which	2.1	7.2	8.9	10.9	5.1	1.7	2	246.2	23.6	22.5
Power	0.9	4.1	5.2	5.7	3.2	1.1	0.5	355.6	26.8	9.6
Personal Loans	2	9	19.1	28.1	7	10.1	9	350	112.2	47.1

Much has been written and said about resolving and recovering mounting NPAs that banking system is saddled with. The purpose of this article is different.

It is addressed on how to prevent the accumulation of non-performing assets. Otherwise, we will be faced with the problem of resolving NPAs every few years.

Current Status of NPAs

Gross NPAs which piled up as high as 11.2 per cent in FY 2018 had come down to 7.5 per cent by March 2021. However, RBI's latest Financial Stability Report (FSR) warns that NPA levels are likely to get worse again. NPA levels may see a spike from 7.5 per cent in 2021 to 11.2 per cent in March 2022 under severe stress scenario. This high level was seen in 2018. However this projection is much less than the prognosis in the previous (January 2021) FSR at over 14.8 per cent under severe stress and even less than Baseline projection of 13.5 per cent.

Large advances contributed to over 77.9 per cent of these bad loans. This article focuses on this segment. However it may be noted that according to latest FSR, MSME are showing signs of severe stress even after special restructuring packages of about ₹58,000 crore. The impact of ferocious Covid second wave on businesses particularly MSME is a matter of concern.

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Fix legal ecosystem

In the most recent case resolved under IBC, lenders suffered a 95 per cent haircut. Debt of over ₹45,000 crore is settled for a paltry 5 per cent and down payment of a measly ₹300 crore and the rest to be repaid after several years. Huge haircuts of over 60-70 per cent are seen in many large NPA accounts leading to write offs of over ₹4 lakh crore during the last 4-5 years. This is largely a reflection of weak and dilatory legal ecosystem even after introduction of IBC.

If this is left unchecked, it may demotivate genuine borrowers and create a wrong climate. Government and RBI need to strengthen the entire legal ecosystem including the institution of Resolution Professionals.

Contributory factors: Credit growth

As several reports bear it out, excessive lending, lax credit standards, poor monitoring, diversion or siphoning off funds besides malfeasance and frauds have contributed to the high level of NPAs. This is not to dismiss genuine business failures.

It is said time and again that all bad loans are given in good times or hey days when animal spirits run high. This time too, it is no different. Some of the salient features of the credit scenario in this context are noted below.

As can be seen from Table-1, during the 5-year period ending FY2013, the banking system credit grew by 137.7 per cent only to crash to 48.9 per cent in the next five-year period ending 2018. During the same period credit of PSU banks grew by 148.3 per cent only to plummet in the next five-year period to 27.5 per cent and to decelerate further.

The credit bubble is too evident as seen from Table-2, bank credit to Infrastructure grew by over 246.2 per cent during 2008-13 and that of power sector spurted by a whopping 355.6 per cent.

These bouts of credit excesses, followed by credit declines have only harmed both lenders as well as the development of these sectors. Such excessive credit growth needs to be avoided and requires the primary attention of regulators, bank boards and credit dispersing functionaries.

Credit growth rate beyond a level must come to the immediate attention of regulators and Bank boards. There is a heavy concentration in terms of borrowers' group as well. In many banks, default of just three groups was sufficient to impair Tier One Capital. The regulator's role is particularly important in cautioning the government about excessive lending even to infrastructure sector. Terms like 'lazy banking' should be used rarely.

The '3 C' Framework

As evident from the huge pile up of NPAs and several audit and investigation reports, banks need to significantly improve credit appraisal techniques and processes and also strengthen monitoring system.

To begin with, a sound credit appraisal essentially involves assessment of Character, Capacity, and Capital of the prospective borrower. The most difficult to evaluate is Character and Intent of the borrower and this may be gauged from the fact that banks classified a whopping ₹4 lakh crore (approx) as frauds and wilful defaults during the last 3-4 years. This is a manifestation of Conduct risk which appears to overwhelm all other risks in causing damage.

Secondly the Capacity of the borrower to successfully operate frequent expansions and run diverse businesses is overestimated. Many a time ambitions and dreams of entrepreneurs are not backed up by adequate capacity to operate businesses in this VUCA (Volatile, Uncertain, Complex and Ambiguous) world. This is not captured in typical Excel projections. In real world, capacity to successfully run business and repay is a moving target. The lenders need to track these developments in near real time.

Thirdly the forensic audit reports now reveal that in many cases of bad loans, borrowers have not brought in adequate capital and they only circulated debt from one bank as equity in another project through a web of affiliates.

Some of these errant borrowers have dozens of these affiliates and even hundreds of bank accounts. This makes tracking movement of funds in real time difficult, if not impossible. This remains still a challenge and needs to be addressed both by banks and regulators or government.

These 3Cs need to be evaluated not only at the entry level but at regular intervals. Banks may co source external experts. This framework looks blindingly obvious but has a lot of subtle nuances which requires a lot of expertise.

A well designed framework is an aid and not a hindrance to fund disciplined risk taking by entrepreneurs.

Monitoring: Connect the Dots

The information flow from the borrower is often delayed, scanty and many a time unreliable. Banks deploy over 20 monitoring tools right from the humble stock movement statement to analysts' reports. There are over 20 parameters like basic sales reports, end use of funds to evolving market dynamics, competitive position of the borrowers etc. Lenders need to connect the dots to effectively strengthen monitoring tools and enforce remedial measures. (To be continued)

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Preventing the pile up of NPAs — II

Banks need to reset their loan appraisal processes. Regulators should step in to curb excess lending in exuberant times

C RANGARAJAN/B SAMBAMURTHY

In continuation of the article published yesterday (August 3), we examine further the factors that may be contributing to the accumulation of NPAs in banks and the steps to be taken to prevent it.

Outsourcing credit monitoring

Many banks have started engaging external Credit Monitoring Agencies (CMA) to help address these issues. It is seen that some of the banks have provided a check list to these agencies that contain as many as 60 parameters (to be precise 63 parameters in the case of one bank). But this should not be reduced to ticking the box compliance. It is important to separate signals from noise so that effective remedial interventions are designed and enforced at the right time and this can be done only by the lenders and cannot be outsourced.

The current threshold of ₹250 crore for outsourcing may be reduced to ₹100 crore as this segment has also its fair share of NPAs, frauds and bedevilled with similar problems.

Early warning signals framework

RBI introduced SMA (Special Mention Accounts) framework in 2002 to identify incipient stress. But this framework has not helped in stemming the build-up of NPAs. Probably these signals are not aligned with monitoring tools or business performance parameters. Signals should lead to a deeper Root Cause Analysis.

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Role of supervision

Regulatory forbearance needs to be nuanced to distinguish between cyclical and secular factors impacting some of the industries. For instance, steel prices reached a peak of nearly $1,000 per tonne and crashed to as low as $300 by 2012. This had pushed a good number of steel units into deep red and the units turned NPAs. Many of these units were disposed of to other units through Insolvency and Bankruptcy Process and in the process lenders suffered huge haircuts of over ₹1 lakh crore. But now the prices have again spurted to over $1,000 per tonne.

On the other hand power producers have suffered huge losses as the power prices crashed by almost 70 per cent and never to recover and in fact further deteriorated. Now with emphasis on renewable power and carbon reduction obligation most of the fossil fuel based plants have only bad days ahead. This is a classic case of secular decline and banks have suffered massive haircuts.

RBI mooted the idea of Risk Based Supervisor during 2004. This was implemented in some of the banks in 2014. The time gap between idea and implementation can be shortened.

RBI may consider exchange of its officials with commercial banks for 2-3 years to gain a better operational perspective.

Banks have set up specialised branches for corporate and industrial finance. But this model did not help as evident from the pile up of NPAs at these branches. Many of these specialised branches have turned major NPA centres.

Governance and High Conduct Risk

RBI in April 2021 came out with a series of measures to improve governance. These measures include enhanced role to Independent Directors (IE), the manner of their appointment, reconstitution and chairing the committees, frequency of the meetings, avoiding conflicts of interest and intense scrutiny of related party transactions, accountability for lapses etc. But many positions of Non-Executive Chairman and Directors are lying vacant for long. In the absence of adequate number of Directors, these guidelines are beyond effective implementation. Banking Bureau (BBB) may be entrusted with the responsibilities to fill up all vacancies of non executive chairmen, Independent and Non-executive directors. Without full complement of the Board, good governance may be a casualty.

Reviving the health of the banking sector is of utmost importance REUTERS

The new Governance advisory lists out 30 Dos and Don'ts for Directors. But in practice just one risk — Conduct Risk — overshadows all other risks and compliance of all other responsibilities and duties. Recent major governance failures at some of the major banks and NBFC are illustrative.

The performance, behaviour, attitudes, Key Responsibility Areas (KRAs) of all the Non- Executive directors shall be appraised annually both by the board and by independent agencies and their continuance or otherwise may be decided by BBB.

Accountability of the Board

Boards may not be accountable for each and every credit decision unless there is malfeasance. But the massive build up of NPAs over these years, is a reflection of major fault lines in business strategy, risk management strategy, risk appetite articulation, capital management etc. These strategic and tactical issues are fundamental elements of board oversight.

Role of DFS

The need for Department of Financial Services cannot be questioned. As the owner of different types of financial institutions, government needs a set up to look at their performance. In a sense, the relationship between banks and DFS is the same as that between the departments of government and the public sector units related to that department.

In the literature, the 'arm's length' relationship has been talked about.

But there is no clear definition of the term. DFS should only issue broad policy guidelines and should refrain from issuing borrower specific advisories either formal or informal. Unless this principle is adhered to in letter and spirit, public sector banks cannot be held responsible for their performance.

Infrastructure Finance

The government's decision to set up a specialised Development Finance Institution is a welcome move. But one DFI will not be able to cater to the needs of the entire sector.

As commercial bankers learnt much to their chagrin, that probability of default and loss given default are very high in project finance. This has been a near universal phenomenon. So far as PSU banks are concerned, only a small number of major banks may be designated to participate in project finance of big entities.

The way forward

The key recommendations can be summarised as follows:

1. It cannot be business as usual. Lenders, supervisors and the government have their task cut out to minimise probability of default and loss given default particularly for large advances.

2. Banks need to revisit and reset their appraisal process and monitoring by probing more deeply the character, capacity and capital contribution by the borrowers on an ongoing basis. They need to upgrade their skills.

3. Regulators need to identify excesses in lending, including credit concentrations, well in time and intervene to moderate lending in exuberant times. Some well defined indicators like credit growth in relation to GDP etc may be put in place.

4. While forbearance cannot be avoided totally, a distinction needs to be made between cyclical and secular declines of industries. More safeguards are needed in granting forbearance in secular decline scenarios.

5. Boards need to play a better role in identifying and mitigating strategic risks and restrain exuberance.

6. Government as the owner needs to redefine its engagement with PSU bank managements and boards as recommended by several Committees. Customer Specific Advisories should be avoided. *(Concluded)*

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