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NPAs: Functional autonomy to banks is the way forward

A ray of hope can be ascribed to the fact that now with improved capitalisation of public sector banks, there could be a decline in contagion losses to the financial system.

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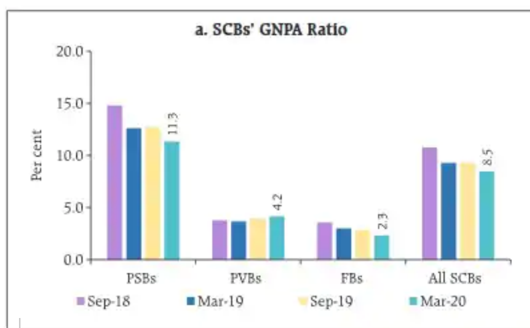
A stable financial sector is a prerequisite for the smooth functioning of any business and provides confidence to investors and consumers. With the COVID-19 pandemic adversely affecting the GDP of countries across the world and resulting in an ever-changing environment, risk prudence is reflective of being sagacious but risk aversion is also not advisable.

In light of the pandemic, the 21st issue of the Financial Stability Report (FSR), July 2020 of the Reserve Bank of India, presented a grim picture of the status of Non-Performing Assets (NPAs) in India. The stress test conducted by the Reserve Bank of India (RBI) is indicative of the fact that the challenging situation posed by COVID-19 could result in the Gross Non-Performing Assets (GNPA) increasing to 12.5 percent by March 2021 as against 8.5 percent in March 2020. As per Standard and Poor's estimates (June 2020), gross NPA could rise to 13-14 percent for India.



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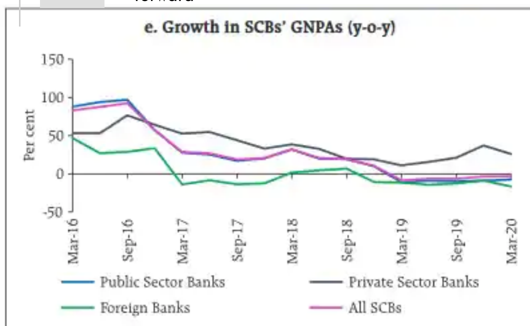

(Source: RBI)

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The FSR is an evaluation of the risks associated with financial stability and measures the resilience of the financial system of the country in light of the current changing environment and issues existing in the financial ecosystem. The report is prepared by the collective evaluation of the Financial Stability and Development Council (FSDC) and studies the issues

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concerning the development and regulation of the financial economy. The report highlighted the fact that in response to the pandemic, an amalgamation of fiscal, monetary and regulatory interventions have ensured a close to normal functioning of the Indian financial markets. In addition to the pandemic, factors such as an overleveraged non-financial sector, geopolitical tensions in reference to the US-China trade war and economic losses incurred due to the lockdown imposed resulted in the economy being abruptly brought to a halt and negatively impacting growth prospects of the country.

The FSR of July 2020 states that the capital to risks weighted assets ratio (CRAR) of scheduled commercial banks (SCBs) in March 2020 had declined to 14.8 percent as against 15.0 percent (September 2019) and Gross Non-Performing Assets (GNPA) had decreased from 9.3 percent to 8.5 percent for the same period. However, macro stress tests for credit risks are now indicative of the fact that the GNPA ratio could rise to 12.5 percent (March 2021) from 8.5 percent (March 2020) keeping in mind the existing challenging economic scenario posed by COVID-19. The worst-case scenario as spelt out by the RBI is that the GNPA could even rise to as high as 14.7 percent by March 2021. However, a positive ray of hope can be ascribed to the fact that now with improved capitalisation of public sector banks, there could be a decline in contagion losses to the financial system.

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The grim scenario can be attributed to the pandemic resulting in an economic downturn. The RBI in response to this worrisome situation had proposed a three-month moratorium in March 2020 along with a freeze on ratings of customers who were availing of the loan so that it would not impact their credit scores. The moratorium period was further increased to August 31, 2020, as a part of the stimulus package. However, financial stalwarts such as Rajnish Kumar (**SBI (https://www.moneycontrol.com/india/stockpricequote/banks-public-sector/statebankindia/SBI)** Chairman) and Deepak Parekh (**HDFC (https://www.moneycontrol.com/india/stockpricequote/finance-housing/housingdevelopmentfinancecorporation/HDF)** Chairman) have opined that the RBI should not extend the interest moratorium beyond August 2020. Their advice is that banks be permitted for a one-time restructuring on loans. Data shows that while in end April 2020, 50 percent of the debtors had availed of this moratorium facility, the numbers have considerably improved since then. As of end June 2020, only 30 percent are shown to have availed of this facility. Thus, what is needed now is a calibrated approach of stimulus to be provided by the RBI to those sectors only which are still bearing the brunt of the pandemic and a blanket approach to all is not advisable as individuals and corporates are taking undue advantage and unnecessarily deferring payments.

Archaic laws to be done away with...

India's banking sector plays a predominant role in the financing of projects and working capital for businesses. Credit availability and smooth flow of funds to businesses aid economic growth. Non-performing assets and a presence of weak recovery of credit in the system can undermine credit availability. However, not all NPAs are an outcome of wilful default. It is vital that banks identify bad

loans as per standards applicable globally. An ineffective management, inappropriate handling of projects, managerial deficiencies, a poor credit appraisal system and lack of adequate resources could lead to a business venture failing and ending up as a non-performing asset.

According to former RBI governor Raghuram Rajan, factors such as explosive expansion without due diligence, slower GDP growth resulting in industrial demand falling short of projections, promoters and banks conspiring to hide the true NPA numbers by ever-greening of loans and fraud and divergence of funds could be some of the factors which led to rising NPAs. Thus, what is needed is an enabling environment facilitating smooth entry and exit for firms. This would ensure that firms which are tending towards industrial sickness and being non-performing have policy measures to take recourse to and enable them for a smooth exit option.

As per the Industrial Disputes Act, of 1947 and subsequent amendment in 1982, a firm with 100 or more workers (for States like Maharashtra, Madhya Pradesh, etc. the stipulation is of 300 or more workers) requires permission from the state government for retrenchment, closures and layoffs. For state governments to grant approval for closure and retrenchment, political will and backing are required. Thus, for a business tending towards industrial sickness, exiting from the industry is a long and tedious process. For companies which are operating at their 'shut-down' points and not being able to also recover their variable costs, it is advisable for them to close operations. However, the lengthy process of initiating closure formalities discourages the promoter from closing down and he/she opts for the easier path of borrowing more from banks, thereby getting into a debt trap resulting in higher NPAs for the banking industry. To further add fuel to the fire, with regards to enforcing of contracts under the Ease of Doing business rankings, India ranks 163rd amongst 190 countries which is a reflection of the state of the Indian judiciary. Thus, closing down operation is not an easy option for a sick business unit.

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The need of the hour is for a policy amendment to the Industrial Disputes Act of 1947. Yes, the present government did find an alternate solution by way of the Insolvency and Bankruptcy Code (IBC) of 2016 – 'a gamechanger, a transformational reform'. This Code is a one-stop solution for resolving insolvencies thereby offering an economically viable solution. The IBC can be initiated by the debtors or creditors and has shown amazing results with regards to NPAs after its implementation.

As per the RBI's report titled **Trend and Progress of Banking in India 2018-19 (https://www.rbi.org.in/scripts/AnnualPublications.aspx?head=Trend%20and%20Progress%20of%20Banking%20in%20India)**, the amount recovered as a percentage of the amount involved has been much higher for IBC at 49.6 percent in 2017-18 and 42.5 percent in 2018-19 as compared to recovery by traditional bodies such as Lok Adalats and Debt Recovery Tribunals. Data is reflective of the fact that, IBC has proved to be a deterrent and a masterstroke in curbing bad loans be it of big industrial houses or small businesses. Rather, as per the rankings of the World Bank for 'Ease of Doing Business' India under the 'resolving insolvency' parameter leaped 56 places to 52nd rank in 2020 from 108 previously. The recovery rate in terms of cents on the dollar recovered for India has improved to 71.6 in 2020 as against 25.7 in 2016 and in terms of time period has improved to 1.6 years in 2020 as against 4.3 years in 2016 under the IBC. The restructuring and liquidation of bad loans have opened up new vistas for foreign and domestic investors to invest in distressed Indian assets. Resolving insolvencies in a time-bound manner creates a conducive environment for industrialists, attracts foreign portfolio investments and boosts economic growth of the country.

However, we also need to bear in mind that in response to the blow dealt by the pandemic the Insolvency and Bankruptcy Code proceedings under the stimulus announced in May 2020 have been suspended for one year so that companies are not dragged into judiciary proceedings at this untoward point of time and debts related to the coronavirus will not be a part of the default category under IBC. Also, the minimum payment threshold for triggering bankruptcy proceedings has been increased to Rs 1 crore as against Rs 1 lakh. While it is understandable that the calamity requires such out-of-the-box decisions, to keep NPAs in check the government should ensure that they are able to do away with these relaxations at the earliest and bring the IBC back into force as soon as possible. The same will be possible only once the country starts gaining momentum and re-treading the path of economic growth. The revival of the economy will anyway act as an automatic stabiliser for NPAs.

Last but not the least, it must be kept in mind that the IBC is not an answer to all banking issues. Additional structural reforms in the financial ecosystem will be a catalyst to financial stability and boosting of business confidence. With Know Your Customer (KYC) norms in place, it is possible for banks to ensure that their customers have the capacity to service the loan. Bankers should be consistently monitoring and assessing risks associated with their customers through the KYC norms and taking action accordingly.

Thus, bankers should be ever vigilant and try to minimise cases of wilful defaulters. Also, they should be given adequate functional autonomy so that they can ensure that NPAs are kept to a minimum. Rather, the RBI’s suggestion for reducing shareholding of the government in public sector banks to 26 percent is worth serious deliberations. Importantly, political discretion in allocations should be discouraged and all efforts should be aimed at curbing cronyism.

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