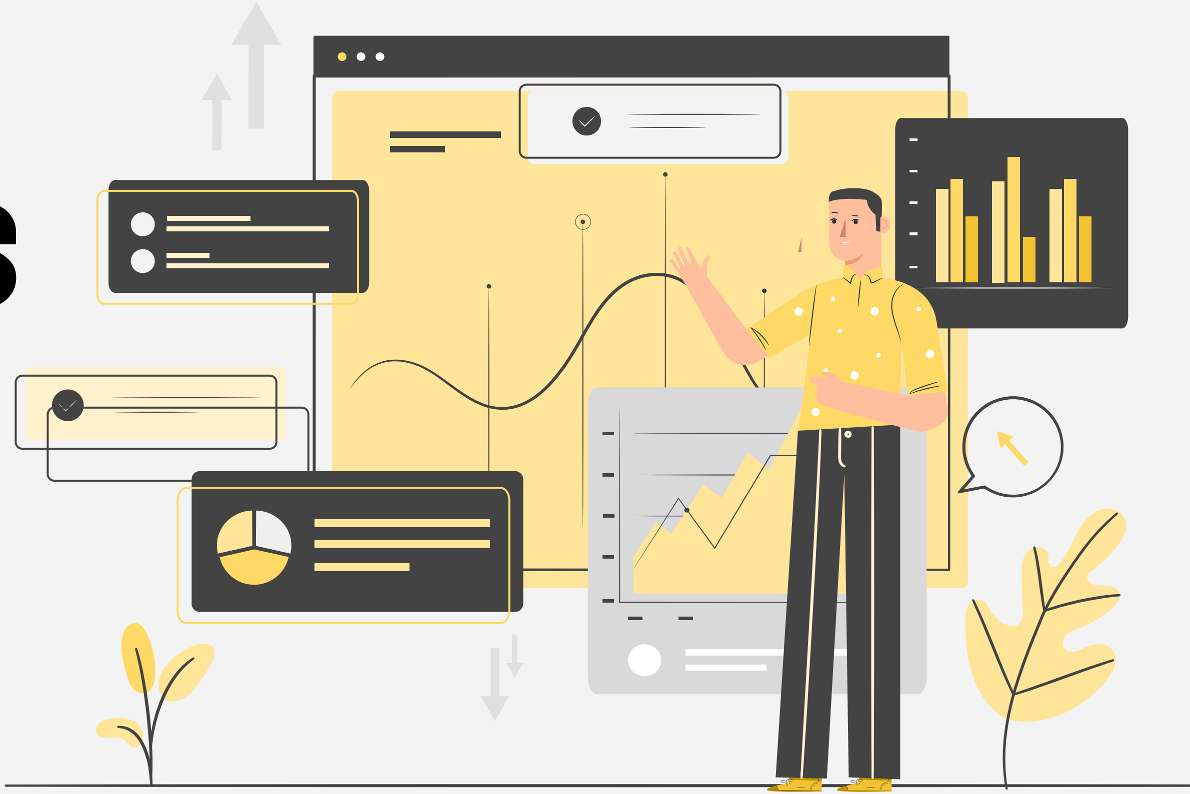
ECONOMICS PROJECT

Reasons of Non Performing Assets and its impact on Economy



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WHAT IS A NPA?

- A loan or lease that is not meeting its stated principal and interest payments
- A loan is an asset for a bank as the interest payments and the repayment of the principal amount create a stream of cash flows.
- If a payment has not been made as of its due date, then, it gets classified as past due.
- Once a payment becomes really late, the loan gets classified as non-performing. A **non-performing asset (NPA)** is a loan or advance of which the principal or interest payment remained overdue for a period of **90 days**.

TYPES OF NPA'S

- **Substandard assets (10 - 20 % provisioning required)**
  - Assets which have remained NPA for a period of less than or equal to **12 months**
- **Doubtful assets (30 - 100 % provisioning required)**
  - An asset would be classified as doubtful if it remained in the substandard category for a period of 12 months.
- **Loss assets (100% provisioning required)**
  - As per RBI, "Loss asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted, although there may be some salvage or recovery value."

THE SEED - TWIN BALANCE SHEET PROBLEM

Twin balance sheet problem (TBS) deals with two balance sheet problems - One with Indian Companies and the other with Indian Banks

- **Overleveraged Companies**
  - Debt accumulation on companies is very high and thus, they are unable to pay interest payments on loans.
  - 40% of corporate debt is owed by companies who are not earning enough to pay back their interest payments.

- **Bad-loan-encumbered-banks**
  - NPA of the banks is 9% for the total banking system in India.
  - It is as high as 12.1% for Public Sector Banks (PSB's)

THE ORIGINS OF TBS PROBLEM IN THE INDIAN ECONOMY

- In the 2007-08, the investment-GDP ratio has soared over 38%. Thus, non-food bank credit doubled and capital inflows reached 9% of GDP.
- Due to such a boom, firms started taking risks and leveraged themselves up to take advantage of the upcoming opportunities.
- But, the **Global Financial Crisis (2007-08)** reduced growth rates and thus, revenues from the investment.
- Firms that borrowed domestically suffered when the RBI increased interest rates to avoid inflation increasing financial costs.
- Thus, **higher cost, lower revenues, greater financial costs - All squeezed corporate cash flow leading to NPAs in the banking sector**.

GROWTH OF NPA'S IN THE INDIAN BANKING SYSTEM

The reasons for the growth of NPA's can be classified into four major categories

- **Governance Issues**
- **Economic Reasons**
- **Political Reasons**
- **Problems of Exit**

GOVERNANCE ISSUES

- Due diligence not done in initial disbursement of loans
- Diversion of funds by companies for purposes other than for which loans were taken
- Inefficiencies in post disbursement monitoring of the problem
- Restructuring of loans by banks earlier to avoid provisioning. Now, banks are forced to clear their asset books which has led to sudden spurt in NPAs.
- During the time of economic boom,optimism shown by corporates was taken on face value by banks and adequate background check was not done in advancing loan.
- In absence of adequate governance mechanism, double Leveraging by corporates, as pointed out by RBI's Financial Stability Report.

ECONOMIC REASONS

- Economic downturn seen since 2008 has been a reason for increasing bad loan.
- Global demand is still low due to which exports across all sectors have shown a declining trend for a long time.
- In case of sectors like electricity, the poor financial condition of most State Electricity Boards (SEBs) is the problem.
- In areas like steel, the collapse in global prices can lead to stressed loans.
- Economic survey 2015 mentioned over-leveraging by corporate as one of the reasons behind rising bad loans.

POLITICAL REASONS

- Policy Paralysis affects several PPP (Public Private Partnership) projects and key economic decisions may be delayed which could in turn affect the macroeconomic stability leading to a poorer corporate performance.
- Obsessive capitalism
- Under political pressure, banks are compelled to provide loans for certain sectors which are mostly stressed.

PROBLEMS OF EXIT

- In the absence of a proper bankruptcy law, corporate faced exit barriers which led to piling up of bad loans.
- Corporates often take the legal route which is time consuming leading to problems for banks.
- Wilful defaulters are at an advantage.

IMPACT OF NPA'S

- The higher the amount of NPA, **the weaker will be the bank's revenue stream**.
- As the NPAs of the banks will rise, **it will bring a scarcity of funds in the Indian Markets**. The number of banks willing to lend will decrease as they will not be sure of the recovery of their money.
- **The shareholders of the banks will lose money** as banks themselves will find it tough to survive in the market.
- **Crisis situation in the market**.
- **The price of loans, interest rates will shoot up badly.** Shooting of interest rates will directly impact the investors who wish to take loans for setting up infrastructural, industrial projects, etc.
- **Impact retail consumers** as they'll have to shell out a higher interest rate for a loan.
- **All these factors hurt the overall demand in the Indian economy.**
- **It will lead to lower growth and higher inflation because of higher cost of capital.**

WHAT ARE RESTRUCTURED LOANS?

- These are assets which got an extended repayment period, reduced interest rate, converting a part of the loan into equity, providing additional financing.
- Under restructuring, a bad loan is modified as a new loan.
- Banks are also profited by this because, the loan was a past NPA and it has been modified into a new loan.
- **Corporate Debt Restructuring Mechanism (CDM)** allows restructuring of loans.

WHAT ARE WRITTEN OFF ASSETS?

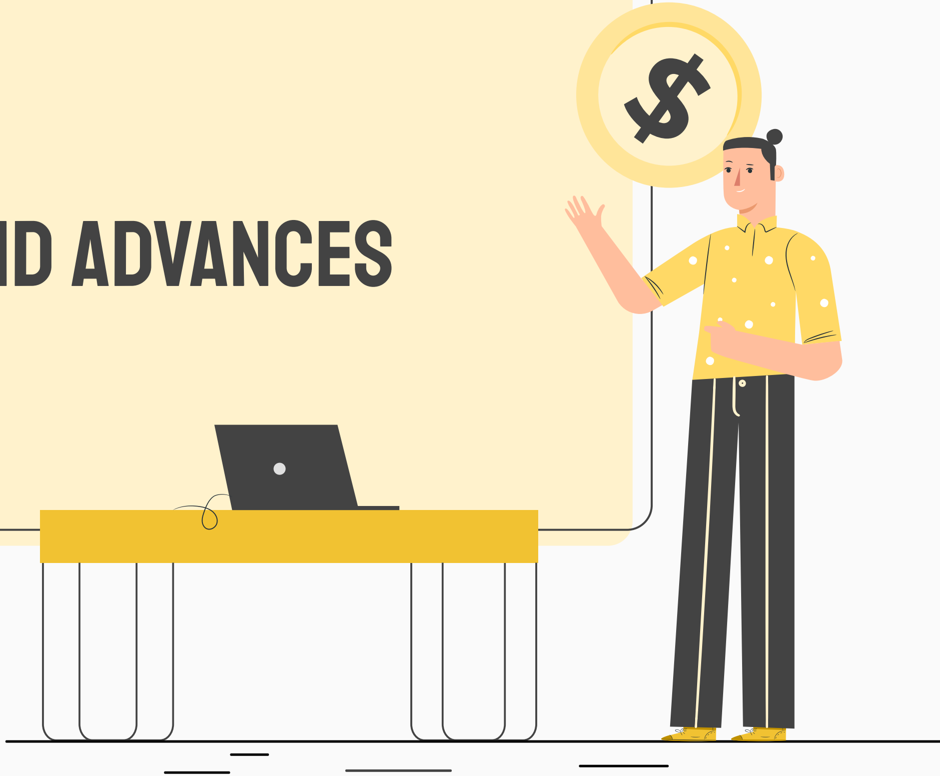
- In this type, the bank or lender doesn’t count the money borrower owes to it.
- The financial statement of the bank will indicate that the written off loans are compensated through some other way.

HOW NPA'S ARE DIFFERENT FROM STRESSED ASSETS?

Stressed Assets:

- A stressed asset is an indicator of the health of the banking system.
- It is a combination of **NPA, Restructured Loans and Written off Assets.**
- Quality of the asset indicates how much of the loans taken by the borrowers are repaid in the form of interests and principal.

SOLUTIONS AND ADVANCES



STEPS PROPOSED BY RBI

- RBI has directed banks to give loans by looking at **CIBIL score** and is encouraging banks to start sharing information amongst themselves.
- RBI has directed banks to report to **Central Repository of Information on Large Credit (CRILC)** when principal / interest payment is not paid between 61-90 days.
- RBI has asked banks to conduct sector wise / activity wise analysis of NPA.

5/25 SCHEME

- For existing and new projects greater than 500 crores and also for existing projects which have been classified as bad debt or stressed asset, bank can provide longer amortization periods of 25 years with the option of restructuring loans every 5 or 7 years
- **The advantage** - It provides for longer period with inbuilt flexibility. Shorter lending periods leads to companies stretching their balance sheet to pay back loan.
- From bank’s point of view, it is helpful as freshly restructured asset is considered as bad debt and requires 15% provisioning by banks against such loans leading to erosion of profitability for banks.

GOVERNMENT INITIATIVES TO TACKLE NPA'S

- Incorporation of **SARFAESI ACT: The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002** empowers the banking systems to auction residential or commercial properties (except agricultural land) to recover their loans.

- **Debt Recovery Acts (The Recovery of Debts and Bankruptcy Act, 1993):** These laws established debt recovery tribunals with the power to recover debts of Banks and Financial Institutions.

- **Concept of Bad Banks:** In this concept, the banking institutions sell their bad loans to an intermediary and thus, they write off their bad loan and intermediary has to recover the loan from the defaulter.

- **Strategic Debt Restructuring:** Under SDR, banks who have given loans to a corporate borrower gets the right to convert the full or part of their loans into equity shares in the company which borrows the loan. Creditors could take over the assets of the firms and sell them to new owners.

PUBLIC ASSET RECONSTRUCTION AGENCY (PARA)

The Public Sector Asset Rehabilitation Agency (PARA) aka the **"Bad Bank"** is proposed agency to assume the NPA of public sector banks in India and to deal with the recovery of the bas loans.

Working

- Solve the coordination problem - Since debts would be centralised in one agency
- It could be set up with proper incentives by giving it an explicit mandate to maximise recoveries within a defined time.
- Separate loan resolution process from concerns about bank capital
- It would purchase specified loans from banks and then work them out, depending on professional assessments of the value-maximising strategy.
- Once the loans are off the hooks of the public sector banks, the government would recapitalise them, thereby restoring them to financial health.
- Similarly, once the financial viability of the over-indebted enterprises is restored, they will be able to focus on their operations, rather than their finances.

CONCLUSION

- NPAs pose a big threat to the macro-economic stability of the Indian Economy.
- The problem of NPA has its roots in economic slowdown, deteriorating business climate in India, shortages in the legal system, operational shortcoming of the banks, etc.
- The recommendations given by RBI are a welcome step in this regard.

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