Chapter VII

Conclusions and Suggestions
Summary of Findings and Suggestions

7.1 Introduction

The Indian banking system underwent a metamorphic change in the nineties as India embarked on liberalization, privatization and globalization. Reforms were initiated to transform the age-old Indian financial system built on the mixed economy principles. The face of banking has changed in the light of these financial reforms. Banking system is being toned upto international standards so that Indian banks can play a major role in the new global economy. The financial reforms ushered in an era of commercial banking that is true to the sense of the word. The Government of India is off-loading its stake in the public sector banks to make them autonomous and create a level playing field for the banks along with the private ones. In the changed scenario, to ensure prudence in banking business, new regulations based on the best international practices with respect to income recognition, asset classification, capital adequacy, risk management and corporate governance were implemented in a phased manner in the industry. This has brought to the surface the problem of sticky loans in the Indian public sector banks. The stock of NPAs is quite huge in magnitude and posed a real challenge for the regulators, banks and government.

The Government of India took the onus of restructuring the public sector banks as it played a major role in the progress and problems of these banks in the past. In order to tackle the problem, new legal machinery was created exclusively for the bank suits, banks were encouraged to go for compromise settlements, a special law giving the banks all pervasive powers to takeover assets of defaulter was enacted and banks' internal processes were revamped to be more effective in addressing the issue of loan performance.
Much has been done but the problem is yet there showing up its awkward face in the balance sheets of major banks.

In this backdrop, the present study is conducted to assess the progress made by the PSBs in managing their non-performing loan portfolios. The study explored the trends in the stock and composition of non-performing assets in the PSBs over a period of eight years from 1996-97 to 2003-04 and also examined their impact on the banks performance. The study examined the effectiveness of various measures initiated by the Government of India at the operational level. A survey of bank managers and defaulters is undertaken in Cuddapah district to probe the reasons for non-performance and to understand the attitudes of these major groups towards the aspect of NPAs.

The following section presents the conclusions drawn from the analysis of the secondary and primary data collected for the purpose of the study along with the suggestions for better management of non-performing assets in the Indian public sector banks.

7.2 India in the global context

- The stock of non-performing loans in Indian banks represents 2 per cent of the global non-performing loans as at the end of financial year 2003. The neighbouring East Asian countries are combating with the abnormal NPLs in their banks since the end of worst economic crisis. China, Japan, Bangladesh, Pakistan, Germany and Argentina are the countries that are facing a similar problem along with India.

- The USA leads all the nations with the lowest gross NPLs to advances ratio of around 1 per cent followed by Chile (1.8 per cent), and the U.K. (2.2 per cent). India had a ratio of 8.8 per cent in the corresponding period 2002-03 faring better than China (22 per cent).
• Reasons for NPLs differ from country to country but state ownership, directed lending, slack income recognition and asset classification norms, and inadequate controls have featured commonly across the board in the countries suffering with NPL problem.

• Norms related to income recognition, asset classification and provisioning in India are on par with best international practices in the field. The overdue period for recognition of NPA is set as 90 days from March 2004 in line with international standards. In some aspects, like provisioning for NPAs, norms in India are tighter than in many other countries.

7.3 Trend of NPAs in Indian Banks

• The magnitude of NPAs registered to the tune of Rs. 1,19,170 crores in the Indian financial system represents 10.2 per cent of the total advances outstanding at the end of 2003-04. The 27 public sector banks as a group rank number one with Rs. 51,538 crores of NPAs.

• Since the unearthing of NPAs, the NPAs have grown in rupee terms from Rs. 39,253 crores in 1992-93 to Rs. 56,473 crores in the year 2001-02 and thereafter registered a marginal decline in the last couple of years. Overall the stock of NPAs has grown at a compound rate of 2.3 per cent per annum.

• NPAs in relation to advances have declined consistently over the period of study. The State Bank Group has an edge over the Nationalized Banks as a group in this aspect. Majority of the 27 PSBs have registered a decline in the ratio of gross NPAs to advances during the period of study barring Dena Bank, Punjab and Sindh Bank wherein an inverse trend is noticed.
• Performance of Indian Bank, United Bank, UCO Bank, Vijaya Bank has been remarkable in drastically reducing their NPA ratios during the period 1996-2004. With the help of massive capital injection from Government of India, these banks could write off their accumulated losses and shown a healthy progress on all fronts.

• The stock of NPAs in Indian PSBs owes its origin to 'public sector syndrome' that affected all the public sector units in the country. Indiscipline, unsound practices, weak policy framework, lack of supervision/accountability and political interference have resulted in accumulation of NPAs in the era of closed economy.

• The effect of overhang is more in burgeoning stock of NPAs; never the less new additions are also there indicating the on-going nature of the problem. The current value of gross NPA ratio of PSBs, 7.8 per cent is quite high in comparison to the developed countries.

• Increased profitability of banks, mainly due to spectacular returns from treasury operations, has enabled them to build provisions for NPAs and bring the net NPAs to net advances ratio down to 3 per cent. For some banks viz. Oriental Bank of Commerce, State Bank of Indore, State Bank of Patiala, State Bank of Saurashtra the ratio is zero as they have provisions equal to NPAs.

7.4 Asset Quality in PSBs

• Advances of the PSBs have grown six times over the period from 1996-97 to 2003-04. Owing to significance given to the issue of NPAs by the regulators, media and academia, growth in NPAs is not in same proportion. The share of standard assets has indeed increased from 76.8 per cent to
92.2 per cent during the same period making the loan portfolios relatively healthy.

- The composition of NPAs shows that over 67 per cent are chronic (belong to doubtful and loss categories) signifying that the banks will have to incur a substantial loss in the coming years on account of write offs. Notwithstanding the reforms in legislations governing recovery of dues to banks, the overhang component is growing year after year as more and more accounts are slipping into chronic category.

- The loss assets alone account to nearly 1 per cent of the advances of PSBs at the end of 2003-04 whereas the total NPAs constitute little over 1 per cent of advances in the USA. This indicates the severity of problem in Indian PSBs.

**7.5 Sectoral Composition of NPAs**

- The sectoral composition of NPAs was skewed towards priority sector at the beginning of the study period but by the end non-priority had a major chunk in the NPAs of PSBs. The priority sector NPAs are not growing in the same pace as the non-priority sector NPAs. The banks had more success in arresting accretion of new NPAs in priority sector than in non-priority.

- There is statistically significant relationship between priority sector lending and NPAs of PSBs. The occurrence of NPAs is more in priority sector loans than in other loans. But the trend shows a drastic decline contradicting the argument of many that priority sector lending is the major culprit. Enhancement of list of items under priority sector and rationalization of interest rate subsidy have made lending to the priority sector not all that risky as it was in the pre-reform era. This has encouraged
banks to increase their lending to priority sector even beyond the warranted 40 percent of net bank credit.

- Sectoral differences in creation of NPAs are blurring with priority sector loan portfolios showing healthy improvement. Government's stake in ownership of PSBs is declining besides deregulation of interest rates. PSBs are given functional autonomy. Moreover, Government guaranteed accounts are also being classified as NPAs on par with other loans. Hence moral hazard resulting out of state ownership can no longer be quoted as a major contributing factor for the inefficiency of the banks.

- It may be concluded that the PSBs can effectively play the twin roles of Commercial and Social Banking if adherence to best practices in the aspects of loan disbursement and recovery are ensured without blaming the directed lending to priority sector as the perpetrator for the problem of NPAs.

7.6 Impact of NPAs on performance of PSBs

- It is found that there is a significant negative relationship between profitability and NPAs. The banks had to incur a staggering Rs 3,607 crores of carrying costs annually and further had to carve out provisions to the tune of Rs. 29, 649 crores from the profits for NPAs. The windfall gains that PSBs reaped out of their investments in Government bonds came in handy for making provisions. The banks otherwise would have found it difficult to fulfill the provision requirements and still emerge profitable. This was tolerable as long as Government was the sole shareholder. But many PSBs have raised equity capital from the market and the investors are losing out on their returns due to loan losses and provisions.
- NPAs have jeopardized the liquidity position and recyclability of funds for the PSBs and have also adversely affected the capital adequacy of the banks. The banks with higher level of NPAs had lower profits which inhibited them from accessing capital markets. They had to resort to high cost borrowings to meet the capital adequacy norms or got recapitalized from Government of India.

- The predilection of banks to arrest NPAs has started showing negative effects on the economy. Banks' risk tolerance has come down considerably affecting seriously the small and medium enterprises that depend heavily on the banks for working capital. PSBs have resorted to investments in Government securities depriving the real sector for funds. As lending to Government is risk free and does not require equity backing. So the NPAs are not just the lenders' problem.

- At a time when the economy is all set to expand at record levels of growth, the problem of NPAs is constraining the banks' ability and willingness to finance the growth. The NPAs at a level of around 4 per cent of the GDP have assumed national priority. They are noticeably affecting the growth prospects of the country and became a challenge not just to the banks and regulators but also to the society.

7.7 Bankers' perspective of reasons for NPAs

- Bankers strongly believe that banks role is limited in creation of NPAs. But agree that political interference, priority sector targets, lax recovery practices and serious lapses in the policy and its implementation are the major internal factors that have contributed to non-performance of loans. It is observed that PSBs are not as aggressive as NBFCs in monitoring and
following-up the erring borrowers. In recent times the volume of business per employee has grown manifold constraining the time available for loan monitoring.

- Natural calamities, political pressures for postponement of recovery, withholding of repayment due to the hope of loan waiver are the important reasons in agriculture and allied loan segment. Wilful default is perceived as not a significant factor in this segment. The uncertainty crept into the agriculture sector as a result of liberalization (reduced subsidies), globalization (fewer barriers on imports) policies and climatic fluctuations are affecting the returns. Ingenuity is observed to be absent in this category as it is seen in other category of loans.

- In case of loans to small and medium industries lower rates of return due to inherent inefficiencies, ill prepared project reports and wilful default are the major reasons for non-performance of loan accounts. Bankers opine that inability of the promoters to estimate and handle risk properly in the fast changing socio-economic scenario as the major drawback in this segment.

- Insufficient training provided in the areas of recovery techniques and asset valuation is limiting the abilities of the managers in effectively confronting the NPAs. Training in the mere accounting practices and norms for asset classification without proper inputs for managing NPAs will make managers apprehensive about the NPAs.

- Banks are found lacking in the Management Information Systems and also in the area of discretionary powers given to the managers in credit related matters. Reduction of overdue period to 90 days will have serious
implications on asset quality if the bankers are not given enough powers to rehabilitate the clients who suffer from temporary liquidity crunch.

- Though underplayed by the bankers, corruption and frauds are found to be considerably responsible for NPAs. There are quite a few instances of reported nexus between bankers and defaulting borrowers. The frauds identified amount to hundreds of cores of rupees every year.

7.8 Effectiveness of RBI/GoI initiatives

- In the initial years importance was given to recovery of non-performing assets through various measures and legal action. This has increased the recovery rate but the stock of NPAs has increased instead of decreasing as the fresh additions outpaced reductions. Later identifying the significance of improving the quality of banking institutions, restructuring of banks was taken up which has improved the asset quality of the loan portfolios in the recent years.

- New legal machinery – the Debt Recovery Tribunals, Lok Adalats, Securitization Act are all found to be less effective in helping the banks. The number of cases filed with them is abnormally high causing delays in adjudication process. Interestingly, recovery was effected only in 30 per cent of the adjudicated cases showing that there are problems even after a decree is obtained from the tribunal. Value of mortgaged agricultural land and properties located in rural/semi-urban areas is difficult to realize and no bidder comes forward when the property is put to auction. This is precisely the reason why many decrees obtained by the banks have merely remained on paper for want of effective execution thereof. Cooperation is found lacking in the departments that are involved in executing the court decree in favour of banks.
• Compromise settlements have become the most effective means of resolving the non-performance as they succeeded in evincing interest in the defaulter. Bankers are apprehensive of this mechanism as this may encourage the default. Early warning system is found to be of great use to bankers as this helps them to concentrate on the follow-up of selected potentially problematic loans at the early stage.

• Accountability of bankers is found to have a negative impact on the bankers' ability to take risk which may affect the business opportunities, interest spread and profitability as banker turns down risky projects in favour of low risk – low return projects. This is reflected in the reduced credit deposit ratios of the PSBs.

• Restructuring of banks through up-gradation of technology and information systems, better internal controls and performance targets have greatly contributed to the less than proportionate increase in NPAs of banks. Awareness of ill effects of NPAs among all the employees of banks has also contributed to concerted efforts.

7.9 Bankers' Attitude

• Majority of the bankers view management of NPAs as their responsibility and are trying hard to reduce the NPAs effectively. They have a positive attitude towards the problem and are confident of taming the NPAs with increased follow-up and prompt recovery practices.

• There is a significant influence of level of NPAs in the branch and attitude of the banker indicating a cause and effect relationship. It is observed that
the negative attitude of the banker contributes significantly to formation of NPAs.

- No significant relationship is found between bankers' attitude and the location of branch as well as their experience. It is noteworthy that the managers who have worked through the pre-reform period are showing keen interest in accepting the responsibility to address the problem of NPAs. The younger ones who have inherited the NPAs are also eager to manage them.

- There is an interesting revelation that the bankers are dissatisfied with the level of discretionary powers vested in them for nurturing problem loans, but do not want more as they are skeptical of accountability for consequences thereof.

- The atmosphere in the PSBs is conducive for the management of NPAs as involvement of top management is found to be high in this aspect. Branch managers' opinions are sought in formulating policies and they get prompt response in matters related to NPAs from top.

7.10 Reasons for default from Defaulters' angle

- In case of agriculture loans defaulters' claim natural calamities, low price realization for the produce and problems in augmenting financial resources are severely affecting the repayment of loans. Hope of loan waivers are also making them avoid repayment.

- Lower rate of returns from investment, other external problems and ill prepared project report are sighted as the reasons for inability to pay back the loans taken by the small industrial units. Lower than expected returns
seriously constrain the liquidity and hamper the operations of the unit. Problem gets aggravated with reluctance of banks to sanction further credit lines culminating into sickness that is beyond the absorbing capacity of the promoters.

- Diversion and siphoning of funds to start new businesses have also resulted in the default in few cases. The ambitious promoters take-up too many businesses at a time and find it difficult to manage all of them. In some cases funds are embezzled into another venture making the borrowal unit sick and default the bank liability.

- Financial distress of the borrower and negligence are found to be the major causes of default in the other loan segments. Negligence is creeping up among the defaulters due to the absence of proper monitoring and persuasion by the bankers.

7.11 Bankers Vs Defaulters

- There is no significant correlation between the reasons ascertained for non-performance of loans in agriculture and small industry sectors by bankers and defaulters. Bankers find fault with the inability to generate incomes and political influence of borrowers whereas defaulters blame externalities for their inability.

- The differences may be due to the ignorance of the banker of the real problems of defaulter or due to biased responses from the defaulters. It is difficult to judge but bankers' opinion may be more appropriate as it pertains to aggregate of cases. This shows that bankers are not in touch with their borrowers regularly.
7.12 Defaulters’ attitude

- It is found that there is a negligent and negative attitude towards PSBs among the defaulters. They are taking advantage of the lenient approach of the banks in recovery of loans and default.

- Defaulters have taken the advantage of state ownership of the PSBs and used their political influence to get the loans and also to default. The negative attitude is widespread among all the classes of borrowers as significant relationships are found between education as well as political influence of borrowers on the attitude.

- Any defaulter will make a cost-benefit analysis before defaulting. The costs of defaults are loss of reputation, creditworthiness and goodwill in the market place. Benefits are monetary to the extent of loan liability. It may be concluded that the PSBs have failed to damage the reputation or creditworthiness of defaulter to the extent that they become costlier than the benefits. The slow and ineffective recovery processes are to be blamed for the negative attitude among the defaulters.

7.13 Future outlook

- The heavy provisioning of NPAs resorted to by many PSBs has put them in a position to write-off the loan losses or dispose the NPAs to asset reconstruction companies and clean their balance sheets off the legacy of closed economy. But some weak banks may not be able to afford this costly remedy. Moreover, writing-off is not the permanent solution for the NPAs.
• The absence of stringent legal course for resolving the NPAs is still haunting the banks. The PSBs are viewed as havens for wilful defaulters as they lack legal teeth to bite into the defaulters' wealth.

• The thrust on retail segment given by the banks in the recent past may pose new challenges in the coming years as banks will have to deal with more number of small and individual accounts. The laws relating to individual insolvency, strategies to be adopted in retail loan recovery must be given adequate importance.

• The competition that is going to come once the banking sector is open for foreign players may noticeably affect the quality of borrowers the PSBs get. The banks should stop being "lazy" and identify the opportunities to build long-term relations with good quality borrowers.

• As Government of India is off-loading its stake in PSBs, the banks are now responsible to their shareholders. This should change their attitude towards profit making goal and must learn to be more commercial. Investors may not tolerate/support the lenient approach of banks towards recovery of loans.
7.14 Suggestions

As the NPAs have two components - overhang and incremental - the solutions are different for each component. Overhang component requires stringent legal and other means of recovery. Incremental component can be taken care through toning-up the internal processes of the bank. The following are the specific suggestions to better manage the NPAs in PSBs based on the findings of the study.

- The legal system must be restructured so that quick disposal of claims is ensured. Some of the enactments that relate to banks are several decades old. Most of them are quite out-of-context with the present day complex economic and business environment. Amendments are necessary in the legislations that apply to recovery of loans by banks.

- The bankruptcy and foreclosure legislations in India are biased towards borrowers, may be rightly as borrower is the weaker of the two, but this needs to be changed at least in the case of apparent wilful default. The courts must favour banks in case of wilful defaults by not allowing the defaulter to prolong the legal proceedings. The delay will only deteriorate the recovery chances by giving the defaulter an opportunity to transfer the assets to someone else.

- The Debt Recovery Tribunals must be strengthened to function effectively and adjudicate within the aspired time frame of six months. To handle the loads of cases, the number of DRTs needs to be increased to cover more geographical areas also.

- Banks are failing to execute the decrees obtained from the courts and tribunals due lack of cooperation from Government departments like
Police and Revenue department. Necessary steps should be initiated to properly coordinate the departments involved in it and help the banks in effecting recovery quickly without any further delay as it would cost the banks heavily on the account of assets becoming obsolete.

- Companies Act may be amended such that banks / creditors are given powers to change the managements of the units in which wilful default is identified. This will enable the banks to establish a source of recovery without killing the unit.

- In case of foreclosure, unlike the existing procedure of dividing the proportions among the creditors first then disposing the assets, it is better if assets are disposed off first then the claims of creditors are settled. As settlement of creditors' claims involves a prolonged legal process, in the mean time value of assets gets affected due to obsolescence. So it makes sense to dispose the assets first before they deteriorate.

- The legislations relating to individual insolvency need to be reformed before hand as retail credit is picking up. The NPAs arising out of retail credit can be effectively resolved then.

- The interest rate structure needs to be changed in the PSBs. Interest rates should be charged based on the risk involved in the individual case rather than on the category to which a borrower belongs. The small and medium enterprises are charged exorbitant interest rates as a block but not all of them are that risky.

- The character of the borrower must be taken into account while charging interest on loans. Incentives must be given in the form of low interest rates for prompt paying borrowers, to distinguish them from the delinquent ones.
This will improve the bank-borrower relationship and lead to healthy credit culture.

- Latest developments in technology must be made use to better manage the credit information. Banks can create a database on borrowers' creditworthiness and share it among themselves. This will reduce the cost of making independent credit assessment of every customer by every bank.

- Monitoring of loans assumes priority in ensuring performance. Hence, banks should step-up their monitoring activities. The accounts that are showing potential signs of non-performance must be monitored immediately to prevent slippage. Prompt legal action must be initiated against the wilful default at the first signs of diversion or siphoning of funds without waiting for them to default.

- Exclusive task forces / recovery cells, specialized in recovery of hardcore NPAs must be developed at regional offices to cover the entire region. Any asset that turns sticky and needs some stringent action may be referred to these task forces. This will reduce the burden on the branch managers to handle the legal matters and help them concentrate on business development. This will also increase the recovery rate as the task force is well trained in recovery and legal procedures. But accountability of the managers must also be given due importance to check indiscriminate lending as somebody else is involved in recovery.

- There is a need to crack down heavily on wilful defaulters as social/financial cost of defaulting is less. The banks may consider publishing the names of all the wilful defaulters in the media to exert
pressure on them. This can be done after a notice is issued to the defaulter regarding the publicizing intention of the bank.

- The PSBs should change their tolerance of default and must be prompt in initiating action against the defaulters. This is very essential to change the way the PSBs are looked at. The attitude of borrowers towards the PSBs will change only when they carry out proper credit assessment and step-up monitoring of loans. The banks should coordinate and share information on credit assessment to stop the defaulters of one bank obtaining loan from others.

- Training in credit appraisal and monitoring is to be imparted to bankers to enable them to take credit decisions more effectively. Bankers must be exposed to modern methods of capital budgeting and risk management techniques through financial/credit derivative products.

- As the banks have built-up reserves for absorbing loan losses, they can clean their balance sheets by selling the NPAs to asset reconstruction companies. Quick disposal may fetch higher price and also reduce the holding cost of NPAs. Disposal should be seen as a one-time settlement. Banks should abstain from such means to cope with NPAs.

- Banks need to restructure their operations to offer more non-interest services to establish alternate source of income and reduce dependence on interest spread as the only source of income. When non-interest income increases, the banks afford to lend at lower interest rates and still stay profitable. Lower interest rates lead to higher quality of assets thereby reducing non-performance. Banks can offer Brokerage Services, Insurance Services, Trust Services, Mortgage Services, Financial Planning Services,
and data processing for other banks to augment income from service charges on deposit accounts and overdraft fees.

- The share of PSBs in banking assets is declining considerably showing the effect of competition in the banking industry. The new private sector banks are aggressively eating into the business of PSBs. If PSBs continue "lazy banking" will soon loose the quality corporate customers, both large and small, to private banks. This can radically affect the asset quality of the PSBs. Hence they need to reorient their marketing strategies to attract good quality customers.

- None-the-less bank frauds are seriously damaging the institutions. They not only affect the asset quality but also the image of banks. PSBs are viewed as vulnerable to manipulation. This image needs to be changed through better internal monitoring and stringent action against the straying officials.

- The concept of accountability is wrongly perceived by the bankers and has affected the risk tolerance. Bankers shall be educated about the right spirit of accountability and its importance. It should be seen as an opportunity to prove one's diligence and not as a restraining factor.

- Bankers should be given discretion in handling NPAs. In the new 90 day regime a defaulting borrower need not be seen as an offender in all the cases. The default may be due to temporary hold-up in flow of funds and not intentional. Banker can judge it in the light of past track record of the customer and must exercise discretion in dealing with the customer rather than terminating the relationship with rigid/harsh terms.
7.15 Summary

Non-performing assets in Indian financial system are high in comparison to developed nations across the globe. The PSBs have accumulated huge stock of NPAs which constitute 7.8 per cent of the total advances. The measures initiated by RBI have helped banks to arrest the further accretion of NPAs. Lenient legal provisions available to banks for recovery of loans is a major factor for NPAs along with weaknesses in credit appraisal, monitoring and follow-up. The bankers have a positive attitude towards the problem of NPAs. Management Information Systems, training in risk management and asset valuation techniques are found wanting. Defaulters have a negative attitude towards PSBs and this is resulting in negligence to repay the loans take. Stat ownership and political interference are also contributing to the creation of NPAs.

Setting-up of task forces is suggested at regional level to handle hardcore NPAs separately out of the branch to bring-in specialization in recovery activities. Amendments to individual and corporate bankruptcy laws are to be made empowering the banks. Credit culture of PSBs needs to be improved such that risks are correctly priced. Banks need to offer more non-interest services and grant discretionary powers to managers to nurse NPAs to performance. The Management Information Systems are to be modified and modernized to effectively manage the problem of non-performing assets in PSBs.