Chapter 7

Summary of Results and Suggestions
Summary of Results

The Indian banking system, with one of the largest banking networks in the world, has witnessed a series of reforms over the past few years like the deregulation of interest rates, dilution of the government stake in public sector banks (PSBs), and the increased participation of private sector banks. As a result, Indian banking sector banks has registered a very rapid growth in India. But, still there are many challenges before the banking industry in India. One of the most important is, rising level of NPAs among the public sector banks. The NPAs are considered as an important parameter to judge the performance and financial health of banks. The level of NPAs is one of the drivers of financial stability and growth of the banking sector. Through the NPAs of the Indian financial system are not as alarming as those of pre-crisis South Asia or China, they are still quite high. The problem of NPAs is really very alarming in the Indian public sector banks. NPAs affect the accounts of a financial institution in several ways. Firstly, interest income can not be booked on any assets that have become a NPA. In addition, provisioning needs to be done against NPAs, further affecting profits. Indian government has already taken number of initiatives to control the problem of NPAs in the Indian public sector banks. Two important initiatives have now come about which seek to bring about structural reforms to the Indian credit market by empowering financial institutions to recover NPAs. Among these two, Securitization Act 2002 (The SARFAESI Act) is most significant to solve the problem of NPAs. The Act empowered the banks to sidestep the courts and dispose of the defaulters' properties given as securities to recover the dues after giving due notice. Though the Act sent the defaulters scurrying in panic, its progress has been plagued by one hurdle or the other. Expectedly, in the initial stages there was a lot of confusion over who were, by definition, defaulters under the Act, the modus operandi of issuing notice, taking possession and disposing of such securities, and so on. Since the enactment Securitisation Act 2002, Indian banks and financial institutions have been scrutinizing some of their distressed assets. The mechanism thus far has been selling banks to trade in their assets for Security Receipts (SRs) issued by SPVs set up for holding these assets. The recovery and workout process is managed by Assets Reconstruction Company (ARC) set up under the SARFAESI Act 2002 that vests them with the special recovery power. As a result,
the last 6 years of its existence, SARFAESI has had a salutary effect on NPA management in banks. Besides, the Act has paved the way for several out-of-court settlements. It has also generally helped inculcate a repayment discipline among borrowers. The next step for the market is to move towards trading in such assets where entities other than the selling banks invest in SRs. Providing imputes to such a move is the recent RBI stipulated that Recovery Ratings (RRs) assigned by the rating agencies will be the basis for valuing the SRs in the book of investors. The experience with the SARFAESI Act 2002 has been very positive and has helped the Indian banking sectors reduce, to an extent, the problem of impaired assets. Further, Securitization is expected to become more popular in the near future in the banking sector. To study the various aspects of NPAs management in the selected public sector banks, a comprehensive questionnaire was prepared; responses were gathered, coded, tabulated and analyzed. Some of the important findings of the study are given as under:

The study reveals that Indian public sector banks are the highest loan providers to the priority sector. This result is supported by both primary as well as secondary data. Most of the Indian public sector banks are facing the problem of NPAs. The study also reveals that most of the public sector banks have their own credit recovery department. The study suggests that both the factors external as well as internal are equally responsible for the causing NPAs in the selected Indian public sector banks. The most important internal factors which are responsible for growing NPAs in the selected public sector banks are: poor competencies in appraising the project value, target completion, and managers have poor skills in credit scoring. A bank with an efficient credit appraisal and loan recovery system will grow stronger over the years. Such banks have good management control and also inherent strengths in terms of a highly motivated staff, good checks and balances, which are further enhanced by a regulatory and supervisory system. The study also reveals that under monitoring and controlling factors lack of manpower and poor focus of top management are responsible for causing bad loans in the selected public sector banks. No administrative penalties were found least important internal factors causing NPAs in the selected Indian public sector banks. The study also makes an attempt to find out the external factors causing NPAs in the selected public sector banks. The study reveals that economic down turns, Influence from the central government and the willful defaults by borrowers are highly responsible external factors causing NPAs in the selected public sector banks. It has been observed that in current economic scenario, the policy of government is one of the major factors
contributing to NPAs in the public sector banks e.g. expansionary fiscal policy measures administered to stimulate the economy supported industrial sectors like construction and real estate. Business failure is also found one of the important external factor causing NPAs in the selected banks. 90 days of non payment for account turning NPAs and natural calamites are found least important external factors. During the survey, it has been observed that lack of due diligence, systemic failure and corruption are the three root causes of the NPAs in the Indian public sector banks. There was a lack of due diligence in many cases on the part of the staff, and loan proposals were approved by the boards as a matter of routine. Further, the study also tries to establish the relationship between internal and external factors causing NPAs in the selected public sector banks. The study reveals that internal and external factors causing NPAs are not related with each others and both factors are not equally responsible for causing NPAs in Indian public sector banks. The study also reveals that banks face some difficulties in their inspection of accounts. Main difficulties faced by banks in inspection of accounts are: heavy routine work & inadequate staff and non submission of stocks by parties. Distance borrowers units from branches is not an important difficulty faced by banks in inspection of accounts. Early warning signals of an account turning NPAs have also been studied. Irregular payment and no operation in account were found highly responsible early warning signals of an account turning NPAs. It is interesting to note that frequent return of cheques and frequent over-drawings were least important early warning signals. The study also makes an attempt to find out the suggestions to improve the performance of bad loans. Recovery machinery to be improved in PSU banks like new generation banks, sufficient staff to be given and support from controlling office were found the most important suggestions for improving the problem of NPAs in public sector banks. Stern action to be taken after analysis in the case of willful defaults and compromise is better than recovery through the legal suits. The study also investigates the various factors controlling the problem of NPAs in the selected public sector banks. The study identified that public sector banks should adopt good pre-sanction scrutiny and need based financing. Added to these two, banks should go for post sanction scrutiny and interaction level should be increased between borrowers and banks. Restructuring is another suggestion to reduce the problem of NPAs. Restructuring addresses long-term financial problems of a borrower company by changing the leverage structure. It has been experienced that in most cases, bank-based restructuring merely addresses the financial structure of the company. The restructuring in the hands of the banks
Section 2

Suggestions to Manage the Problem of NPAs in the Indian Public Sector Banks

In India continuing the process of financial reforms for induction of best practices and technological changes, the RBI emphasized transparency; diversification of ownership and strong corporate governance practices to mitigate the prospects of systematic risks in the banking sector. The overall improvement in the efficiency parameters of the scheduled commercial banks (SCBs) reflects the positive response to the policy initiatives and changing business environment. To restructure mounting NPAs the RBI issued the detailed draft guidelines on the sale/purchase of nonperforming assets where securitization companies and reconstruction companies are not involved. The draft guidelines cover: (a) Procedure for purchase/sale of nonperforming financial assets by banks, including valuation and pricing aspects; (b) Prudential norms relating to asset classification, provisioning, accounting of recoveries, capital adequacy and exposure norms and disclosure requirements. The guidelines, among other things, provide that a NPA in the books of a bank shall be eligible for sale to other banks, only if it has remained as NPA for at least two years in the books of the selling bank and such selling should be only on cash basis; a NPA should be held by purchasing bank in its books at least for a period of 15 months before it is sold to other banks, banks should ensure that subsequent to the sale of a NPA to other banks should ensure that subsequent any involvement with reference to the assets sold and do not assume operational, legal or any other type of risks relating to the financial assets sold. Its ongoing process and there is expectation of gradual change in banking asset structure with hiving off NPAs. Added to RBI’s rule and regulations, there are some other strategies to manage the problems of NPAs in the Indian public sector banks. Studies have shown that management of NPAs rather than elimination is prudent. These NPA management strategies are given as under:

- Special Mention Accounts: In a recent circular, RBI has suggested to the banks to have a new asset category - ‘special mention accounts’ - for early identification of bad debts. This would be strictly for internal monitoring. Loans and advances overdue for less than one quarter and two quarters would come under this category. Data regarding such
accounts will have to be submitted by banks to RBI. However, special mention assets would not require provisioning, as they are not classified as NPAs. Nor are these proposed to be brought under regulatory oversight and prudential reporting immediately. The step is mainly with a view to alerting management to the prospects of such an account turning bad, and thus taking preventive action well in time. An asset may be transferred to this category once the earliest signs of sickness/irregularities are identified. This will help banks look at accounts with potential problems in a focused manner right from the onset of the problem, so that monitoring and remedial actions can be more effective. Once these accounts are categorized and reported as such, proper top management attention would also be ensured. Borrowers having genuine problems due to temporary mismatch in funds flow or sudden requirements of additional funds may be entertained at the branch level, and for this purpose a special limit to tide over such contingencies may be built into the sanction process itself. This will prevent the need to route the additional funding request through the controlling offices in deserving cases, and help avert many accounts slipping into NPA category.

- Establishment of an AMC may be useful when the size of problem reaches systematic proportions so that special management skills are needed. An important purpose of have asset management companies is the managerial factor. The handling of bad loans and assets requires other skills than are normally available in a bank. Real estate specialists, liquidation experts, and people with insights into various industrial sectors may be needed. In addition, managing large amount of bad assets would interfere with the daily running of the bank. If a separate AMC is established to handle bad assets, both the good bank and the AMC could be given independent and transient profit goals. This would provide clearer incentives for managers and staff. Moreover, to the extent that the workout of non performing assets is hampered by a lack of coordination among the different creditors, a AMC could facilitate the resolution of such loans with multiple creditors.

- The study reveals that poor pre and post sanction scrutiny is one of the reasons behind the growing non-performing assets in the Indian public sector banks. Thus, the study identifies the need of effective of pre and post sanction scrutiny. Effective and regular follow-up of the end use of the funds sanctioned is required to ascertain any
embezzlement or diversion of funds. This process can be undertaken every quarter so that any account converting to NPA can be properly accounted for.

- Combining traditional wisdom with modern statistical tools like Value-at-risk analysis and Markov Chain Analysis should be employed to assess the borrowers. This is to be supplemented by information sharing among the bankers about the credit history of the borrower. In case of new borrowers, especially corporate borrowers, proper analysis of the cash flow statement of last five years is to be done carefully.

- The study identifies the need of improving the relationship between the banker and borrowers. A healthy Banker-Borrower relationship should be developed. Many instances have been reported about forceful recovery by the banks, which is against corporate ethics. Debt recovery will be much easier in a congenial environment. Assisting the borrowers in developing his entrepreneurial skills will not only establish a good relation between the borrowers but also help the bankers to keep a track of their funds.

- The study proved that securitization is very effective tools to fight with the problem of NPAs. This has been used extensively in China, Japan and Korea and has attracted international participants due to lower liquidity risks. The Resolution Trust Corporation has helped develop the securitization market in Asia and has taken over around $460 billion as bad assets from over 750 failed banks. Its highly standardized product appeals to a broad investor base. Securitization in India is still in a nascent stage but has potential in areas like mortgage backed securitization. ICRA estimates the current market size to be around Rs 3000 Crores. There is need to make the securitization system more effective in India.

- Countries such as Korea, China, Japan, Taiwan have a well functioning Asset Reconstruction/Recovery mechanism wherein the bad assets are sold to an Asset Reconstruction Company (ARC) at an agreed upon price. In India, there is an absence of such mechanism and whatever exists, it is still in nascent stage. One problem that can be accorded is the pricing of such loans. Therefore, there is a need to develop a common prescription for pricing of distressed assets so that they can be easily and quickly disposed. The ARCs should have clear ‘financial acquisition policy’ and guidelines relating to proper diligence and valuation of NPA portfolio.
• Some tax incentives like capital gain tax exemption, carry forward the losses to set off the same with other income of the Qualified Institutional Borrowers (QIBs) should be granted so as to ensure their active participation by way of investing sizeable amount in distressed assets of banks and financial institutions.

• The study reveals that highest lending has been made to the priority sector by the Indian public sector bank. So far the Public Sector Banks have done well as far as lending to the priority sector is concerned. However, it is not enough to make lending to this sector mandatory; it must be made profitable by sharply reducing the transaction costs. This entails faster embracing of technology and minimizing documentation. The study suggest whatever be the sector, the financing should be made on the basis of need.

• Public sector banks should be allowed to come up with their own measures to address the problem of NPAs. This may include waiving and reducing the principal and interest on such loans, or extending the loans, or settling the loan accounts. They should be fully authorized and they should be able to apply all the preferential policies granted to the asset management companies.

• The study also identifies the need of improvement in the existing NPAs recovery machinery. An effective strategy of NPA resolution has to involve the financial and operational restructuring of unviable industrial borrowers. Because the representative NPAs of larger size are industrial loans collateralized by the fixed assets of the borrowers, they typically do not have much value if the viability of the borrower is in doubt. However, corporate restructuring has been a difficult process worldwide. Its success depends not only on an efficient and effective corporate insolvency regime, but also on labour laws, competition policies, trade policies, and other structural factors. From this perspective, the resolution of the NPAs in the banking system is only a part of the larger effort of industrial restructuring and structural reforms. It is inherently difficult and requires strong political leadership. While setting up the ARC provides a potentially useful instrument to facilitate bank and corporate restructuring, it would be naïve to expect that it alone will be the panacea for the resolution of the NPA problem of the Indian banking system.

• Numerous studies have stressed the creditability of a well developed capital market in the restricting process. A capital market brings liquidity and a mechanism for write off loans.
Without this a bank may seek to postpone the NPA problems for the fear of capital adequacy problems and resort to tactics like ever greening. Monitoring by bond holders is better as they have no motive to sustain uneconomic activity. Further, the banks can manage credit risk better as it is easier to sell or securitize loans and negotiate credit derivatives. Indian debt market is relatively under developed and attention should be focused on building liquidity and volumes.

- There is a fear that disposal through the provision of excessive reserves may result in a deflationary spiral. A thorough provision of reserves will have no negative impact on the long term dividends paid to shareholders. Firstly, it helps restore credibility in the financial system. Further, an adjustment mechanism can be created by which the capital gains and future profits that will result from the disposal of NPAs will pass back to the creditors and taxpayers who incurred the losses today. The swift disposal of NPAs during the Great Depression in the middle of a severe deflationary current helped restore the credibility of the financial system.

- There is argument that the current organizational competencies, regulatory framework, quality of disclosure and incentive structure produce an inconsistent framework, which leads to an unsustainable performance level for a Bank. Micro level issues will have to be addressed in order to root out the problem. Processes at every stage of an assets life impact the overall quality of the intermediation process and so a consistent set of procedures are necessary to handle the problem.

Last but not the least, another way to manage the NPAs by the Indian public sector banks is Compromise Settlement Schemes or One Time Settlement Schemes. However, under such schemes the banks keep the actual amount recovered secret. Under these circumstances, it is necessary to bring more transparency in such deals so that any flaw could be removed.
Respected Sir/Madam,

I am a Research Scholar (Reg No: 91-IGR-359) at the Department of Commerce, M.D. University, Rohtak; and doing my research on the topic entitled ‘Securitisation Act and NPA Management in Selected Public Sector Banks’. With a view to achieve various objectives and to test the hypothesis, this study plans to undertake a survey of 60 public sector bank branches from Haryana, Punjab, and Delhi. The data for the survey are being collected only from the branch managers of public sector banks. I am in need of certain information, which can be supplied by you only. I shall be very grateful if you could kindly fill the questionnaire with accurate and complete information.

The information supplied by you will be kept strictly confidential. It will be used in the study for estimating aggregates, proportions, averages and other statistical measurement. The information of respondents will be used only for academic purpose only.

Looking forward for your kind cooperation.

Thanking you in anticipation

With Regards

Seema Kadian
Research Scholar
Department of Commerce
M. D. University, Rohtak-124001

Personal Address:
House No. 666
Sector-1
Rohtak-124001 (Haryana)