CHAPTER - 11

RECOMMENDATIONS FOR IMPROVEMENT IN CREDIT RISK MANAGEMENT IN PSU BANKS IN INDIA

11.1 Need for PSU banks to strengthen their due diligence, credit appraisal and post sanction loan monitoring system

Growing Non-performing Assets (NPA) with PSU banks is a matter of concern. While the rise in NPAs could partially be attributed to the adverse impact of the global financial crisis, the aggressive lending stance of PSU banks during the preceding boom period as also inadequate due diligence and laxity in monitoring of the loan accounts are also responsible for deterioration in the asset quality. This has been so, especially in case of retail loans. While the gross NPA ratio declined from end March 2006 to end March 2011, mainly due to a commensurate increase in gross advances; the absolute amount of gross NPAs increased by Rs.46,669 crore (an increase of 91%) during FY 2005–06 to FY 2010–11. As such, the NPA stock has risen consistently.
Slippage ratio of the banking system, defined as fresh accretion to gross NPAs to opening balance of gross standard advances, which had shown a declining trend from FY 2005–06 (1.9%) to FY 2007–08 (1.8%), abruptly increased to 2.18% in FY 2008–09 and 2.21% in FY 2009–10. At system level, new accretion to NPAs has been much faster than the reduction in existing NPAs due to lower levels of upgradation and recoveries. Also, despite write-offs, gross NPAs have continued to rise significantly.

It may be comforting for some PSU banks to take refuge under net NPA figures but the comfort is misplaced. PSU banks need to, not only utilize effectively, the various measures such as CDR mechanism, One Time Settlement Schemes, Debt Recovery Tribunals, provisions of the SARFAESI ACT etc. put in place by RBI and the Government of India for resolution and recovery of bad loans but also strengthen their due diligence, credit appraisal and post sanction loan monitoring systems to minimize and mitigate the problem of increasing NPAs. Prevention is always better than cure. Overall economic growth in the last decade or so, coupled with higher disposable incomes have led to an exponential growth in retail spending. As the efforts directed towards financial inclusion take off, the bankable population will see further rise. This would require that delinquency risks and quality of portfolio are
carefully managed by PSU banks. PSU banks thus need to strengthen their due diligence, credit appraisal and post sanction loan monitoring systems on an on-going basis which is bound to result in improvement in credit risk management by PSU banks.

11.2 Corporate governance deficit

Several studies have highlighted the direct relationship between good governance standards and the performance and efficiency of an entity. This is all the more true in respect of banks, which, in their fiduciary capacity deal with public money on one hand and on the other, enjoy government/central bank support due to their centrality in the overall financial system. The recent crisis has also amply demonstrated how weak governance framework contributed to the build up to the crisis through excessive risk taking. Transactions in risky and complex products which were barely understood, neither by the financial entities nor the customers, was another contributing factor. While over the last one decade, the governance requirements have been considerably enhanced in India, good governance has to be a continuous and ongoing process. In India we had the “derivatives” episode recently which was a case of inadequate application of “suitability and appropriateness” requirements and, consequently, was a case of governance deficit. As
such the Board of Directors and the senior management have a great oversight responsibility in ensuring that the respective banks lay down robust compliance culture and corporate governance framework which is reviewed periodically for its efficacy and efficiency.

11.3 Overcoming Information asymmetry

Information asymmetry in a multiple banking scenario is a serious issue. A framework for pooling and sharing of credit information amongst banks had been put in place so as to enable banks to streamline their credit appraisal framework and also to instill discipline among the defaulting borrowers. The utility of such data, however, hinges inexorably, on its integrity and timeliness. Lapses in sharing of information defeats the very purpose of such arrangements. Unfortunately this arrangement has not worked. PSU Banks should strive to make this work. Hopefully with licenses granted for additional Credit Information Companies, it is expected that the system will evolve a robust information sharing arrangement and further the development of the banking system.
11.4 Technology and HR development

In view of the current dynamic business scenario of increasing financial sophistication and innovative financial tools, PSU banks are faced with complex risks. Thus, robust enterprise wide risk managements systems are the fundamental requirement for PSU banks to be able to survive in the long run. PSU banks with proper risk management systems would not only gain competitive advantage but would also add value to the shareholders and other stakeholders. PSU banks, therefore, have to endeavor for integrated risk management systems, both within the bank and also across the group. Such an integrated risk management architecture would be currently difficult due to the disconnect between businesses, risk managers and IT systems across the PSU banks’ organizations in their existing set-up.

Indian PSU banks have achieved most of the computerization under the Core Banking Solution (CBS). This may not, however, prepare them adequately for the necessary MIS and analytical tools for credit risk management. In order to upgrade the risk management systems, banks need to upgrade their technology proportionately so that the MIS and the analytical tools for risk management are available. This will entail
large investments in technology particularly for those PSU banks which have to migrate to the advanced approaches under Basel II.

Further, with the explosive growth of the internet, mobile and wireless tools, the way both the economy and business are conducted today has been revolutionized and as such, the technological needs of PSU banks are not confined to only credit risk management requirements. The need for technological innovation in the context of financial inclusion is of high priority.

Technology has evolved as the integrator and holds the key to the future success of any corporate entity and more so for the PSU banks. Speed, accuracy and quality in operations and delivery mechanism as also cost efficiency are some of the known benefits that would accrue to both PSU: banks and their customers. However, enhanced usage of technology also poses severe challenges for PSU banks both, in terms of keeping pace with the fast growing /changing technological demands so as to maintain an edge on the profitability, delivery and quality fronts as also with regard to the recognition, understanding, management and mitigation of risks inherent in the use of technology.
The Reserve Bank of India, on its part, has taken several initiatives in this direction which include formulation of the IT Vision document 2011–17 which sets the priorities for PSU banks for moving forward from the core banking solutions to enhanced use of IT in areas like MIS, regulatory reporting, overall risk management, financial inclusion, customer relationship management and enhancing automated data flow within banks and to RBI without any manual intervention, etc. Measures are afoot to setup Next Generation RTGS (NG-RTGS) system taking into account the latest developments in the areas of technology, messaging and networking, etc.

On the part of PSU banks, there is an imperative need for a three-pronged action agenda, viz., first, technology upgradation coupled with its integration with the overall credit risk management strategy to achieve an edge, better housekeeping, optimizing the use of funds and building up of MIS for decision making, better management of assets and liabilities and the risks assumed which in turn have a direct impact on the balance sheets. Second, a more dynamic and challenging work culture to meet the demands of credit risk management, customer relationships, product differentiation, corporate governance and regulatory prescriptions. Third, focus on internal controls, credit risk measurement, credit risk mitigation systems and business continuity
plans to effectively mitigate possible risks arising out of adoption of technology which could have a potential bearing on the overall financial stability of PSU banks.

11.5 Establishment of corporate debt restructuring (CDR) cell for small loans

If a large company defaults its case goes to a corporate debt restructuring (CDR) cell, a lenders forum which recasts the loans, often waiving interest, providing a moratorium and rescheduling repayment. For small borrowers the PSU banks do not have a similar CDR cell with the result that the NPAs take a very long time for resolution and often the bank officers are averse to allowing concessions to small borrowers which otherwise are readily available to large borrowers under the CDR mechanism. If a corporate debt restructuring (CDR) cell is also established for small loans the credit risk management in PSU banks in India will improve considerably.

11.6 Implementation of advanced approaches under Basel II

The implementation of the advanced approaches under Basel II poses several challenges for PSU banks and the Reserve Bank of India alike.
The standardized approaches have already been implemented in India and all the PSU banks have migrated to the standardized approach under Basel II framework as of March 2009. Migration to the Advanced Approaches is important for larger banks because it involves adoption of more sophisticated risk management systems. Moreover, there are reputational issues too if large banks continue with standardized approaches. However, the implementation of the advanced approaches raises several issues relating to development of human resource skills, technology upgradation, branch interconnectivity, availability and management of historical data, robustness of risk management systems, etc. Though RBI has set an indicative time schedule for implementation of the Advanced Approaches, PSU banks’ response has not been encouraging so far. It is high time for larger banks to seriously upgrade their systems and skill sets and migrate to the Advanced Approaches.

11.7 Appropriate risk pricing of loans

There is a considered view that loan defaults could be managed by appropriate risk pricing of loans encompassing the terms of credit variables such as interest rate, maturity, collateral, and credit culture. Costing of banking products is an issue which has largely been escaping serious debate within PSU banks in India. Proper and fair pricing of
risks and of banking products is essential from credit risk management and customer service perspectives. It can also enhance competition resulting in passing of the benefits of such increased competition in terms of lower costs to the ultimate customer. The challenge before PSU banks is to make the best use of technology and innovation to bring down the intermediation costs while protecting their bottom lines. The issue of fairness to all classes of customers is also a very important issue. Today, there are a lot of complaints from customers about lack of fairness in floating rate products. PSU banks need to be sensitive to that.

11.8 Need for improvement in lending policy of PSU banks – Need for re-engineering

In the Indian context, there is a considered view that banks lending policy could have crucial influence on non-performing loans (Reddy 2004). Improvement in lending policy, therefore, can play a significant role in improvement in credit risk management in PSU banks in India. A default is not entirely an irrational decision. Rather a defaulter takes into account probabilistic assessment of various costs and benefits of his decision. Reddy (2004) raised various critical issues pertaining to credit delivery mechanism of the Indian banking sector. The study
focused on the terms of credit such as interest rate charged to various productive activities and borrowers, the approach to risk management, and portfolio management in general. There are three pillars on which Indian PSU banks' credit system was based in the past;

i) fixing of prices of credit or interest rate as well as quantum of credit linked with purpose;

ii) insisting on collateral; and

iii) prescribing the end-use of credit.

Interest rate prescription and fixing quantum has, however, been significantly reduced in the recent period. The issues in security-based or collateralised lending, need careful examination in the context of growing services sector. Given the fungibility of resources, multiple sources of flow of resources, as well as application of funds, the relevance and feasibility of end-use restrictions on credit need a critical review. The link between formal and informal sectors shows that significant divergence in lending terms between the two sectors still persists, despite the fact that the interest rate in informal markets is far higher than that of the formal sector - the banking sector. The convergence between formal and informal sectors could be achieved by pushing the supply of credit in the formal sector following a supply
leading approach to reduce the price or interest rate. There is now only a marginal difference in the NPAs of banks lending to priority sector and the banks lending to private corporate sector. Given the deficiencies in these areas, it is imperative that banks need to be guided by fairness based on economic and financial decisions rather than system of conventions, if reform has to serve any meaningful purpose. Experience shows that policies of liberalisation, deregulation and enabling environment of comfortable liquidity at a reasonable price do not automatically translate themselves into enhanced credit flow and improvement in credit risk management. Although PSU banks have recorded improvements in profitability, efficiency (in terms of intermediation costs) and asset quality in the 1990s, they continue to have higher interest rate spreads but at the same time earn lower rates of return, reflecting higher operating costs. Consequently, asset quality is weaker so that loan loss provisions continue to be higher. This suggests that, whereas, there is greater scope for enhancing the asset quality of PSU banks, in general, PSU banks need to reduce the operating costs further. The tenure of funds provided by PSU banks as loans depends critically on the overall asset-liability position. An inherent difficulty in this regard is that since deposit liabilities of banks often tend to be of relatively shorter maturity, long-term lending could induce the problem of asset-liability mismatches. The maturity
profile of PSU bank deposits shows that less than one fifth is of a tenor of more than three years. On the asset side, nearly 40 per cent has already been invested in assets of over three year maturity. PSU Banks also have some capacity to invest in longer term assets, but this capacity will remain highly limited until the fiscal deficit remains as high as it is and the Government demand for investment in long dated bonds remains high. Some enhancement of their capacity to invest in infrastructure, industry and agriculture in longer gestation projects can be achieved by allowing a limited recourse to longer term bond issues.

Lending rates of PSU banks have not come down as much as deposit rates and interest rates on Government bonds. While PSU banks have reduced their prime lending rates (PLRs) to some extent and are also extending sub-PLR loans, effective lending rates continue to remain high. This development has adverse systemic implications, especially in a country like India where interest cost as a proportion of sales of corporates are much higher as compared to many emerging economies. The problem of NPAs is related to several internal and external factors confronting the borrowers (Muniappan, 2002). The internal factors are diversion of funds for expansion, diversification and modernisation, taking up new projects, helping/promoting associate concerns, time/cost overruns during the project implementation stage,
business (product, marketing, etc.) failure, inefficient management, strained labour relations, inappropriate technology/technical problems, product obsolescence, etc., while external factors are recession, non-payment in other countries, inputs/power shortage, price escalation, accidents and natural calamities. In the Indian context, Rajaraman and Vasishtha (2002) in an empirical study provided an evidence of significant bivariate relationship between an operating inefficiency indicator and the problem loans of PSU banks. In a similar manner, largely from lenders perspective, Das and Ghosh (2003) empirically examined non-performing loans of India’s PSU banks in terms of various indicators such as asset size, credit growth and macroeconomic condition, and operating efficiency indicators. The Indian viewpoint alluding to the concepts of credit culture owing to Reddy (2004) and risk pricing owing to Mohan (2003) confirm with several studies mentioned above that apart from the business cycle, banks lending policy play an important role in the management of loan defaults and credit risk.

PSU banks, therefore, need to re-engineer their lending policy for improvement in their credit risk management.
11.9 Observance of self discipline and prudence in credit risk management

As India’s growth rate fades, its banking system is developing bad habits. Debt restructurings are on the rise. Indian PSU banks have low bad debt reserves in the Asia-Pacific region. Without an improvement, the pressure to fudge the numbers will only increase.

The Reserve Bank of India’s Financial Stability report, released on June 29, 2012 said that banks remain comfortably capitalized, but the central bank is concerned about the deteriorating quality of the bank’s loan books.

Debt restructurings are also on the rise. In 2011-12 banks sought to restructure a record $12 billion in corporate loans – an increase of 156 per cent. Rating agency CRISIL expects the total to double in the coming year. India’s Debt Restructuring Mechanism allows banks to ease terms on loans without setting aside provisions. Although, of late, RBI has taken some corrective steps but these are by far inadequate. What’s more, banks are being flexible with many loans - including $4 billion to Air India and $5.5 billion to loss-making state electricity boards – without either formally classifying them as NPAs or ushering them through the formal mechanism.
Meanwhile, evergreening, where banks lend additional money to keep stressed borrowers from defaulting, is common practice. Property experts Knight Frank estimate that at least a tenth of real estate loans are stressed, more than twice the 3-4 per cent cited by banks. The level of NPAs on infrastructure lending, around half a per cent of total loans, looks suspiciously low, since these loans have increased from 7 to 15 per cent of the banks' overall loan books since 2007.

The low level of reserves at India banks may be encouraging them to fudge the numbers. Most banks reported allowances of less than the RBI's minimum of 70 per cent of probable losses on total NPA's. At 69 per cent, Indian banks average level of reserves of bad loans is far below China's 252 per cent and Indonesia's 212 per cent. Setting aside greater provisions will hurt the banks' bottom lines. But without a bigger buffer, the bank's bad habits will only worsen.

PSU banks, therefore, need to avoid large scale restructuring and infuse greater discipline in credit risk management. PSU banks also need to be more prudent in building up reserves for bad loans.
11.10 *Need for PSU banks to adopt modern methods of credit risk mitigation and transfer*

PSU banks in India mostly resort to the traditional methods for controlling credit risk like credit rationing, credit limits, collaterals, loan pricing etc. Amongst the newer methods PSU banks have adopted some of such methods like asset securitization and loan sales but these methods are adopted very selectively and with reluctance. PSU banks are, however, yet to adopt the modern methods of credit risk mitigation and transfer like credit derivatives, credit default swaps, credit options and credit linked notes. Banks abroad have been using such modern methods with encouraging results and PSU banks in India should also adopt such modern methods to improve the credit risk management.

11.11 *Lessons to learn from NBFCs: Some good practices in credit risk management relevant to PSU banks*

Non banking financial companies (NBFCs) have seen a significant improvement in handling of bad assets, even in the high interest-rate regime (Business Standard November 10, 2011). NBFCs which directly complement their financial counterparts, the banks,
outperformed them in terms of bringing down gross non-performing assets (NPA). Reasons for the same are as under:

1. NBFCs have much larger ability of physical recovery; (Ramesh Iyer, Managing Director, Mahindra Finance)
2. NBFCs do not reschedule loan repayments like banks; (Ramesh Iyer, Managing Director, Mahindra Finance)
3. Short term and smaller loans do not leave space for excessive leverage and asset liability mismatch. NBFCs borrow for the same tenor and lend for nearly the same duration; (Ramesh Iyer, Managing Director, Mahindra Finance)
4. NBFCs have invested very deep in technology to ensure timely action as part of their risk management framework. Constant technological upgradation for better debt recovery is one reason NBFCs have been able to move against the downward trend and NBFCs have been able to leverage technology much ahead of the public sector banks in India. The recovery mechanism of NBFCs is very efficient and the operate on a very different model from banks; (Ramraj Pai, Director, Crisil Ratings)
PSU banks would do well to take a clue from the credit risk management practices adopted by NBFCs to improve their own credit risk management.

11.12 Writing off of bad loans

Several PSU banks in India have resorted to premature writing off of loans because writing off of loans helps the banks show lower NPAs. However, with such write offs the recovery efforts tend to slacken and this practice is not in consonance with sound credit risk management. Some PSU banks like the State Bank of India (SBI) have of late realized this and have almost stopped writing off loans and have ensured that recovery efforts do not slacken in such cases. SBI wrote off only Rs. 66 crore of loans during quarter ended September 30, 2011 as against Rs. 662 crores written off during the corresponding quarter in the previous financial year. To improve credit risk management PSU banks should stop the practice of premature and large scale write off of loan accounts.

11.13 PSU Banks approach towards loans and deposits

While inputs and outputs are easily identified in most businesses, that is hardly the case in banking. For PSU banks the question is - Whether
deposits are input or output? A typical financial intermediation role for PSU banks involves the use of deposits together with physical inputs of land, labor and capital to make loans and earn interest income. This approach suggests that PSU banks should treat the number of bank branches, total operating expenses and deposits as inputs and loans (advances) and non-interest income as outputs. PSU banks ideally should follow this formulation where deposits are not coveted as an independent output; instead they are treated only as a conduit to generating loans. PSU banks in India, however, covet deposits as an independent output and being risk averse tend to focus more on deposit mobilization than on improvements in credit risk management and credit expansion. This approach needs to be changed and credit risk management and credit expansion should be given more weightage than deposit mobilization. Such a change in approach and attitude, particularly in performance evaluation of bank officials of PSU banks, will bring credit risk management in PSU banks in the right perspective and focus.

11.14 "Lazy" Banking

The management of many PSU banks have become risk averse, particularly after the Harshad Mehta scam, and have started
investing heavily in government securities, which is a clear reflection of "lazy" banking. Such PSU banks abstain from credit expansion to play safe and consequently due emphasis is also not laid in such PSU banks on improvement in credit risk management policies and procedures. There is a need to curb such tendency to resort to "lazy banking" and bring the desired focus on credit risk management and credit expansion.

11.15 Counter cyclical prudential measures

From policy perspective, many studies have suggested that regulators should adopt counter-cyclical prudential measures for maintaining financial stability and ensuring sustained economic progress. According to White (2006), such a policy framework could entail a new macroeconomic stabilization framework and symmetric policy response to the expansionary and contractionary phases of the financial cycle. Adoption of counter cyclical prudential measures by PSU banks in India and building counter cyclical provisions and holding counter cyclical capital buffers in good times will lead to a consistently efficient and better credit risk management in PSU banks in India. Thus even in an expansionary phase, when the going is good for the PSU banks, PSU banks should run their capital through a stress test to assess what impact
worsening economic conditions will have on their loan portfolios and bank supervisors should evaluate those models independently. This will help the PSU banks to be less pro-cyclical because they will have taken into account the whole business cycle.

The business cycle impact on non-performing loan could be managed with appropriate terms of lending in terms of maturity, interest rate and capital requirement (Misra B.M. and Dhal).

11.16 Avoiding Credit Risk Concentration

Basel (1999a) has pointed out that concentration is probably the single most important cause of major credit problems. PSU banks in India have the tendency to specialize in certain industries or geographical areas or business houses due to the convenience in collecting information and the benefit of familiarity. Banks reported a deployment of 32.29% of their total advances to the infrastructure sector and 13.56% of total advances to basic metal and metal products sector as on 21st September, 2012 (Business Standard: November 19, 2012). Thus almost half of the total advances are given to just to two sectors. PSU banks need to avoid such credit risk concentration for better credit risk management. For minimizing credit risk PSU banks
should resort to diversification which can be used to offset the additional volatility created from an increase in risky loan due to concentration. Seeking out assets whose yield returns are negatively correlated, PSU banks can combine different types of loans into their portfolio and diversify away the non-systematic risk.

11.17 Guarding against adverse selection

In India presently there is a high interest rate regime. With high rates of interest responsible borrowers with less probability of default tend to keep away from the loan market but such high interest rates do not prevent riskier borrowers from borrowing from the PSU banks. The resultant adverse selection can prove to be very costly for the PSU banks unless they are on their guard against such a phenomenon usually seen in the banking business. PSU banks need to upgrade their loan appraisal capabilities to avoid such an adverse selection. Quantitative credit exposure limits can also be used for credit risk management in high interest rate regime. However, this measure needs to be used with caution by PSU banks. As Duffie and Singleton (2003) have cautioned, smaller credit limits may reduce exposure but they can also reduce the operations of the borrower to a sub-break-even level. Under such circumstances PSU banks need to choose an optimal limit which can
greatly improve credit risk management and at the same time avoid adverse selection.

11.18 **Focus on economically efficient projects rather than politically attractive ones**

Government ownership of PSU banks has at times encouraged PSU banks’ management to promote financing of politically attractive projects rather than the economically efficient ones. From the credit risk management perspective PSU banks’ management needs to be very cautious and should act responsibly. While socially desirable projects may be pursued which are in the long term interest of the PSU banks, PSU banks should be very cautious in resource allocation and credit risk management and should support economically efficient projects and avoid projects which are prompted merely by the political interests of the party in power and not by economic considerations.