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Address:-Ashok Yakkaldevi 258/34, Raviwar Peth, Solapur - 413 005 Maharashtra, India
Cell : 9595 359 435, Ph No: 02172372010 Email: ayisrj@yahoo.in Website: www.oldror.lbp.world

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THE GROWING CRISIS OF THE TWIN BALANCE SHEET PROBLEM IN INDIA

Parul Maurya[1] and Sumit Khanna[2]
[1]Research Scholar, Dr. Shakuntala Mishra Rehabilitation University, Lucknow, India.
[2]Research Scholar, Sri Ramswaroop Memorial University, Lucknow, India.

ABSTRACT:

India has been battling with many problems concerned with the economy. Banking sector's health is one of the dark spots of the economy as instead of showing growth it faces a constant threat of being trapped under the burden of debt. This is primarily due to the inability of big corporate houses to repay the loans taken.The problem of NPAs has become a chronic one for public sector banks. Similarly corporates also face a huge strain on their financial soundness due to various reasons including market sluggishness. The problem faced by public sector banks is directly linked to that of the corporate sector.The way the overleveraged balance sheets of corporate houses impacts the health and profitability of public sector banks which is ultimately reflected in their balance sheets is what is referred to as the "Twin balance sheet problem".This problem is a legacy of boom of the mid 2000s where companies launched various new projects worth several lakhs of crores of rupees with the help of credit taken from banks. It relates to distressed and overleveraged companies and increasing NPAs in the public sector banks. Due to this issue, banks suffer from the sting of stressed assets which carry very less probability of revival. The emergence of problem can be traced to the time when banks were reluctant to recognize NPAs and followed the policy of ever-greening loans. The present study focuses on the problems faced by both banks and corporates in managing their balance sheets, the reasons for failure of previous measures and the suggestions offered by the economic survey.

KEYWORDS: *Twin balance sheet problem, NPAs, public sector banks, corporate houses, stressed assets, Asset Reconstruction Company.*

INTRODUCTION

The Economic Survey of 2016-17 has acknowledged one of the serious challenges Indian economy is facing that is the 'twin balance sheet' problem. The Economic Survey released before the Union Budget said that "a decisive resolution is urgently needed before the TBS problem becomes a serious drag on growth'. It is a problem faced by both Public Sector Banks and major Corporate houses. Their balance sheets are in a terrible state which is a hurdle to the thriving growth and investment opportunities. On one hand, the balance sheet of Public sector banks show soaring NPAs and on the other hand corporate houses are distressed and overleveraged. The problem faced by one institution is directly linked to the other. TBS is stress on balance sheets of both lender and borrower. Banks have to suffer the sting of stressed assets and non-performing assets as the chances of revival are very less whereas corporates have interest and financial obligations which are beyond their current paying capacity. This state of bad assets and unmanageable liabilities creates a misery for everyone.

At the time of boom, companies borrow huge sums from banks for investment in infrastructure and

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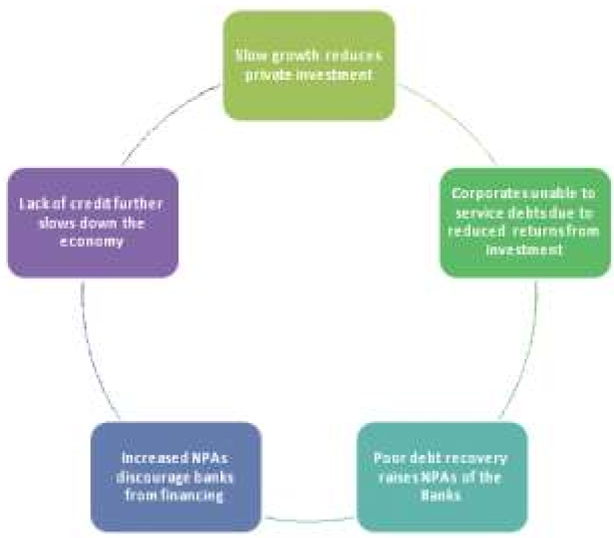
development and when the economy faces a slump, the companies earn lower profits and are unable to repay the loans taken from the banks and the debts keep on accumulating. This directly affects the balance sheets of the banks as there is a constant rise in NPAs and thus the problem of twin balance sheet. It is seen as a serious obstacle because it has led to decline in investments made by corporates. The growing problem of NPAs affects not only the profitability of banks but also limits the credit availability to the corporate sector.This problem has become a serious one as it has hindered the growth of all sectors and led to a decline in private investment.As India has followed conventional methods to resolve this problem not much improvement has been noticed in the recent past. The steel, cement and airline industries are a few examples of industries which are heavily indebted.

ORIGIN OF THE TWIN BALANCE SHEET PROBLEM

In the mid 2000s the economy was rising and facing an upward swing. During this period, economies all over the world were blooming. Thus the firms were ready to take risks and grab the upcoming investment opportunities. The investment-GDP ratio during 2007-08 soared from 11% to 38%, capital inflows increased, bank credit doubled, for the first time the amount of non-food bank credit doubled. Overall it was a period of credit boom and due to such aboom in the economy, firms expanded their horizons and took advantage of growing investment opportunities. Many firms borrowed huge amounts of money to invest in commodity and infrastructure business like power, infrastructure development etc.

But due to the Global Financial Crisis of 2007-08, the economy faced a set back and as result, growth rates and investment incomes dropped drastically, cost rose more than budgeted, revenues collapsed, projects delayed, clearances took more time, bad debts arose. Firms that had borrowed huge sums domestically had to suffer as the interest rates were increased by RBI to control inflation. International borrowers also suffered as the value of rupee depreciated drastically from Rs. 40 per dollar to Rs.60-70 per dollar. Thus all these factors led to decline in investment and profits of the firms and thus unable to repay their loans.

Before the recessionary pressure, the investments seemed hopeful and industry was optimistic. The twin balance sheet problem creates a vicious economic circle where the private investment is dampened by slow growth. Debt ridden corporates are unable to service debts thus increasing the NPAs of the banks. This increased NPA in turn discourages banks to provide finance for private investment. This economic cycle can be explained with the help of a chart:



Thus we can see that the problem of twin balance sheet creates a vicious circle which affects the whole economy and eventually leads to economic stagnation and unemployment.

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KEY TERMS

Non-Performing Assets- Any asset that ceases to generate income for the bank is referred to as NPA. In India, a loan is classified as NPA if the interest or installment remains overdue for a period of 90 days or more. When the loans are on the verge of default, they are classified as NPA.This high level of NPAs requires bank to make more strict provisioning norms.

Stressed Assets-Assets of the banking system consists of both loans given and investment. Stressed asset is a term broader than NPA as it includes NPA, restructured assets and assets written-off within its ambit. It indicates the financial health of a banking company. The increasing proportion of stressed asset shown in the balance sheet shows a more deteriorating position.

Restructured assets refer to the loansthe payment period of which gets an extension, reduced rate of interest, conversion into equity, gets additional financing. Any loan that is modified into a new loan due to its non-payment by making the terms of loan simpler is a part of restructured assets. Written-off assets are those which upon its non-payment have become bad and no amount could possibly be recovered from such assets.

Bad loan encumbered Bank-There is an urgent need in India to set up bad banks which could buy the NPAs of banks and restructure them. This would help the banks to remove the bad assets from its balance sheet and start its business afresh. The bad bank would be a centralized agency that would take over the stressed assets and relieve the banks from the stress it faces and thus enable it to concentrate on its core business.

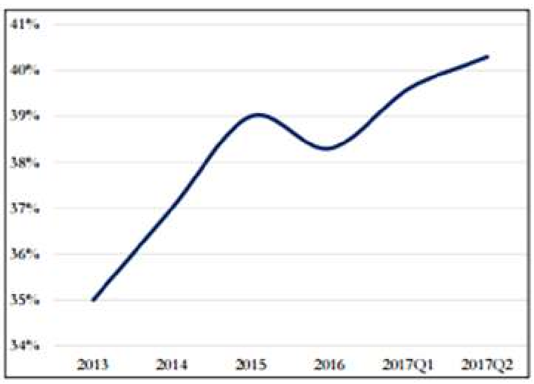
Asset Reconstruction Company(ARC)-The banks get into an agreement with the asset reconstruction companies that take over a part of their NPAs at an agreed commission and try to recover it from the debtors. Generally assets are taken over at an amount less than book value. Sometimes, ARCs offer low prices as they hardly recover any amount from the debtors, which the banks find difficult to accept. ARCs derive their powers from the SARFAESI Act.

Overleveraged companies-Companies in which debt accumulation is so much high that they are unable to pay the principal as well as interest are referred to as overleveraged companies. This means that companies are not earning enough or they do not have sufficient funds to enable them to pay back their debts. Technically it means that they have interest coverage ratio less than 1.

WHY IS TBS A SIGNIFICANT PROBLEM

Stressed loans owned by the banking sector crossed a mark of $133 billion during the last year. The report released by the Economic Survey in the Union Budget mentioned an urgent need to address this problem. Thus it has become imperative to tackle this serious issue as it significantly hinders the private investment. It is a cause for slump in growth in almost all the sectors of the country.The Indian corporate sector is under one of the highest degrees of stress in the world.

Share of debt owed by stressed companies-



Source- Credit Suisse

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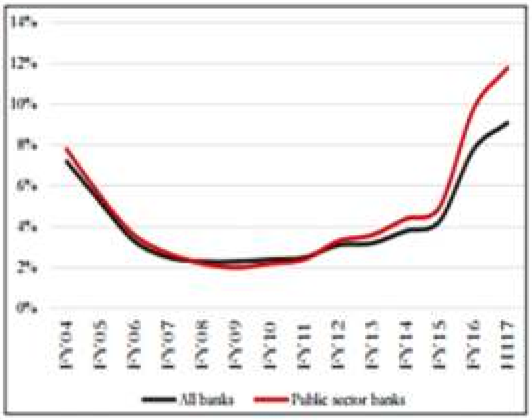
Gross NPA ratio (Percent of gross advances)



Source-RBI

The above data shows that NPAs continue to rise showing the accumulation of bad loans. More than four-fifths of the NPAs were in the public sector banks, where NPA ratio had reached almost 12%. On the corporate side, 40% of the corporate debt was owed by companies which had an interest coverage ratio less than 1 which means they did not earn enough to meet their interest obligations.

FEATURES OF INDIA's TBS

• In India, as in other countries an increase in borrowings led to overleveraging and debt servicing problems. This is the standard TBS problem which is similar in almost all countries. But the consequences of TBS differed in India as compared to other countries. Even if there was damage to the balance sheets but the economy did not stagnate as they generally do in other countries. The economy continued to grow at its normal pace.

• The default situation reached to such a point where it seriously triggered a banking crisis, threatened the stability of the entire banking sector yet the GDP was maintained at modest rate, interbank market did not stress, no outside liquidity support was required. This is because NPAs are majorly concentrated in public sector banks which are totally backed by the government.

• Despite the existence of high levels of inflation and weak exports, the economy managed to have high levels of aggregate demand and high levels of growth as opposed to other economies. One of the most significant differences between India and other countries was the way in which the financial system responded despite facing acute stress. In other economies bankruptcy, slow-down of growth, economic stagnation were the peculiar features of TBS.

• Perhaps India developed its own unique version of TBS what the Economic surveys called "Balance Sheet Syndrome with Indian characteristics".In many ways India's TBS is similar to that of China as both the countries provide generous amount of finance to allow highly levered corporations to survive. Even though India's corporate debt as a proportion of GDP is lower as compared to some of the major economies of the world, TBS is likely to remain an obstacle for growth and investment.

WHY DID THE PREVIOUS MEASURES FAIL

Despite there being many banking related laws and regulations, the steps taken to tackle the problem of TBS did not result into any fruitful results primarily because conventional methods were followed to solve this problem.The banks followed liberal policies to finance corporates in the period of boom which ultimately became a factor to cause distress of the balance sheets of the banks. India followed a decentralized approach under which individual banks were allowed to take decisions for restructuring which led to delay in resolutions and thus delaying the solution.

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For example, if a firm is unable to meet its debt obligations, bank may overtake it. But if the sector faces distress, the bank might find it difficult to find a good price for its asset from any buyer. The process of selling the physical assets largely depends upon economic conditions. As physical assets deteriorate very fast and its takes longer for banks to dispose them off, their value keeps on deteriorating. Even in service oriented sector say for example kingfisher airlines and many other non-operational airlines, banks were caught in a troubled net as these airlines generally operated taking aircrafts on lease and did not have sufficient tangible assets to be disposed off. Mostly the airlines operated on leased aircrafts and the lessor simply took the aircraft back which made it more difficult for banks to get back any of the loan portion financed by it.

SUSTAINABILITY OF THE INDIAN STRATEGY

As the banks resorted to the policy of ever-greening of loans i.e. following prudence in recognizing NPA and extended credit to borrowers who had not met their previous debt obligations, it led to serious concerns.The Indian sustainability strategy is based on two scenarios-

1. Phoenix Scenario- Under this situation, reliance is placed on double digit growth numbers, banks expect that downfall in profit making of corporates is seasonal and rising growth will surge the demand which will help loss making entities to earn profits again. This seems to be an unrealistic proposition as default in loan is just termed to be unfortunate turn of economic events. Advancing loans to somebody who already owes you and struggling to pay the earlier amount is not logical.

2. Containment Scenario-In this situation, bad loans would be limited in nominal terms which would slowly reduce the share of NPAs in the balance sheets. This method is expected to slowly fade away the NPA problem even if not completely wipes it out.

Earlier both the methods seemed viable but as per recent data, these are failing. New and innovative methods need to be adopted to solve this crisis.

MEASURES OFFERED BY THE ECONOMIC SURVEY

The Economic Survey suggested creation of Public Sector Asset Rehabilitation Agency (PARA) which would purchase loans from banks and then dispose them off. This could be done by either converting debt into equity, selling the stakes in auction or by granting a reduction in debt. After the debts are disposed off the balance sheets, the government would recapitalize them paving way for making new loans.Funding of PARA may be done by RBI or government by way of transfer of securities. Money can also be obtained from capital markets.Creation of PARA is aimed to minimize the existing bad debt liability and provide quick and efficient solutions to the bad loan problem. The concept of PARA is highly professional and steps should be taken to ensure that it works as intended. To make the PARA successful, its decisions should be based on commercial rather than political principles. Recoveries should be achieved within a short period. The loans could be transferred at market values to avoid the distress of transferring loss to PARA due to the element of inflation present.

As the stressed debt is heavily concentrated in large companies, it suggests restoration of the financial viability of enterprises to enable them focus on their operations rather than worrying about their finances.This would also help them to consider new investments for long term growth and survival.RBI has also played a vital role in framing strategies to avoid concentration of loans in the banking sector. It has empowered lender banks in dealing with non-performing loans. It has also advocated setting up of asset reconstruction agencies to take up the loans of banks. It has revised rules to tighten up the norms to discourage build-up of NPAs, limit credit exposure in an individual company, fixed a specified limit to advance credit etc. Thus RBI being the apex banking body has taken several stringent measures to bring the banking sector out from the loop of debt-trap and revive the sector.

CONCLUSION

The TBS problem is a serious impediment to the credit growth and economic development. Corruption and bribery amongst government officials and employees in checking the documents and financial soundness of the borrower is one of the reasons for sickness of the banking sector. On the corporate side delay in project clearances, poor project performance, red-tapism etc. are the reasons for failure of the project.Even if the approaches to resolve the TBS problem failed in the past or had limited success, India can learn from international experience to overcome the impeding difficulties.Cleaned up balance sheets would encourage both lender and investor to freely grab the opportunities and ignore the lessons of past. The time has come for India to acknowledge the seriousness of this problem and accordingly take measures to resolve it.

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