REVIEW OF RESEARCH

AN ANALYSIS OF NON PERFORMING ASSETS OF INDIAN BANKS

Dr. Jagdish Biradar

Asst. Professor , Veerappa Nisty Engineering College , Shorapur.

ISSN: 2249-894X
IMPACT FACTOR : 5.7631(UIF)
UGC APPROVED JOURNAL NO. 48514
VOLUME - 8 | ISSUE - 8 | MAY - 2019

ABSTRACT:

Growing non-performing assets is a recurrent problem in the Indian banking sector. Over the past two decades, there have been two such episodes when the banking sector was severely impaired by balance sheet problems. In this paper we do a comparative analysis of the two banking crisis episodes- the one in the late 1990s and one that started in the aftermath of the 2008 Global Financial Crisis and is yet to be resolved. We describe the macroeconomic and banking environment preceding the episodes, the degree and nature of the crises and also discuss the policy responses that have been undertaken. We conclude by drawing policy lessons from this discussion and suggest some measures that can be adopted to better deal with a future balance sheet related crisis in the banking sector such that the impact on the real economy is minimal.

KEYWORDS: *Non-performing assets, Public-sector banks, Capital adequacy, Bank recapitalization, Balance-sheet crisis.*

INTRODUCTION

Banks play a crucial role in the Indian financial system. More than two-thirds of household savings are channeled through the banking system, which also provides more than 90% of the commercial credit in the country. In a bank-dominated economy, sustained impairment of the banking sector due to balance sheet problems creates a drag on real economic activity and can take the shape of an economic crisis. It is imperative to expeditiously resolve a banking sector crisis so that banks as the primary source of credit can start functioning normally again. In India, banking crisis is a recurrent phenomenon. Since the liberalization reforms of 1991, there have been two major banking crisis episodes-the first one took place during the 1997-2002 period and the second one started in the aftermath of the 2008 Global Financial Crisis and is yet to be resolved.

In this paper, we compare and contrast the causes and magnitude of the banking crisis in both these periods, discuss how the previous crisis got resolved and draw policy lessons for the ongoing crisis.

Specifically, we compare the two crises on three dimensions: (i) the antecedents preceding the crisis-both macroeconomic and banking sector related, (ii) the degree and the nature of the crises, and (iii) the policy responses to the crises.

While some empirical work has been done to analyse the non-performing asset (NPA) problem of the Indian banking sector (Rajaraman et al., 1999; Rajaraman and Vasishtha, 2000; Mohan, 2003; Ranjan and Dhal, 2003; Reddy, 2004; Das and Ghosh, 2007 among others), to the best of our knowledge there is no comprehensive study that explores the two major NPA episodes in post liberalization India and analyses them in a comparative framework. Such a comparative analysis is important because it helps to understand common patterns leading to recurrent bank balance sheet problems as well

LBP PUBLICATION

as the differences across the two episodes. It is possible that the solution that may have worked last time may not be successful in reviving the health of the banking sector during the ongoing crisis.
The Indian economy has changed rapidly and significantly since the implementation of the liberalization, deregulation and privatization reforms of the early 1990s. The banking sector has also undergone remarkable changes over the last 25 years. When comparing crises across time, the main antecedents that need to be considered are the changes in the overall economy as well as in the banking sector at the time of the crises. The economic factors that are relevant here include the growth rate of GDP and the evolution over time of the bank credit to GDP ratio. Also important is the structure.

banking as captured through factors such as the depth of banking penetration, share of bank credit in the overall capital formation, ownership structure of banks, level of capitalization, and key aspects of banking regulation. These antecedents help to understand the causes of the crises and also facilitate a comparison of crises occurring at different points in time. There are several ways to describe a banking crisis. The most common manifestations of stress in the banking sector are in the form of insolvency and illiquidity. In India, crises have mostly manifested in the form of high levels of NPAs and their impact on the capital adequacy levels of banks. Hence, the levels of NPAs, in absolute and in relation to the capital in the banking system, constitute a convenient metric to compare the degree of banking crises.

Finally, for a comprehensive analysis of the two crisis episodes, it is important to compare the consequences of the crises, especially in terms of the policy responses undertaken. Given that banking is a regulated activity, it is important to assess how the regulator (in this case the Reserve Bank of India or RBI) responds to the crises. Resolution of a banking crisis is a collective effort where the regulator works closely with the stakeholders the shareholders, management, customers, and employees of the banks. Regulatory response at the onset and during the course of a banking crisis is a critical determinant of how effectively and efficiently the crisis is resolved. In India, given the dominance of government owned banks (public sector banks or PSU banks), the government as an owner and manager of these banks becomes a key stakeholder.

In the next section we give a brief description of the banking sector and highlight some of the problems associated with the way banking is organized in India. we discuss the macroeconomic and banking environment preceding the two crisis episodes with the objective of throwing light on possible causes of the crises as well as to provide a context to the subsequent policy responses.

BANKING ENVIRONMENT IN INDIA

Banking in India broadly consists of the commercial banks and the co-operative banks. Commercial banks in turn are classified into scheduled and non-scheduled commercial banks. The scheduled commercial banks (SCBs) are those banks that are included in the second schedule of the Reserve Bank of India Act, 1934 and satisfy certain conditions with regard to paid up capital, reserves etc. The SCBs include the public sector banks (nationalized banks, State Bank of India and its subsidiaries), domestic private sector banks (old and new), foreign private sector banks and regional rural banks. It may be worthwhile to note here that the amount of NPAs reported by the banks may not be indicative of the actual extent of stress on their balance sheets. This is because banks are adept at hiding NPAs through ever greening or creative accounting, which means that the official NPAs reported by them, may not be an accurate reflection of the stress in their portfolio (Banerjee et al, 2004). Hence it may not be a correct characterization to say that stress in one crisis episode was greater than the other because the amount of NPAs was higher. It is possible that the stress is greater during the ongoing banking crisis for example but banks have gotten better at hiding it.

The old private sector banks are those that were operational before the Bank Nationalization Act was passed in 1969. Owing to their small size and regional operations, they did not get nationalized. After the nationalisation of banks in 1969, the entry of private sector banks was not allowed until January 1993, when the barriers to entry for private sector banks were removed. The new private sector banks were set up when the Banking Regulation Act was amended in 1993 in the wake of the liberalization and privatization reforms. Entry of foreign banks was also liberalized in the post reform

period. The non-scheduled banks are those that are not included in the second schedule of the RBI Act, 1934 on account of the failure to comply with the minimum requirements for being scheduled. As of March 2015.

MACROECONOMIC AND BANKING CONDITIONS PRECEDING THE CRISES

To compare and contrast the two high bank-NPA episodes, we describe the macroeconomic and institutional differences and similarities across both the periods. The banking crisis that started around 1997 was preceded by a series of liberalization, deregulation, and privatization reforms initiated in 1991. When the economy was being opened up, the banking sector that had operated in a protected and regulated environment for decades, also needed to be reformed so that it could measure up to international standards. As mentioned in the preceding section, banking sector reforms in this era primarily consisted of deregulation of entry, strengthening bank supervision and implementation of prudential norms based on internationally accepted practices The liberalization, deregulation and privatization reforms of the early 1990s also triggered a big investment boom in the economy. It also paved the way for foreign firms to enter. This created competition for the existing domestic firms. Also when the licensing restrictions were removed, domestic firms rushed to expand capacity. But several of them were not able to adapt to the changing environment or withstand competition from other domestic firms and foreign entrants and became economically unviable. This resulted in stress in the advances portfolio of the commercial banks. Apart from private and PSU banks, there also existed financial intermediaries called Development Finance Institutions (DFIs). DFIs such as IDBI, ICICI, and IFCI were critical players in the financial sector in the 1990s. They were term-lending institutions that extended long term finance to the industrial sector. Although the DFIs were not deposit taking entities, they accounted for a substantial share of the overall commercial credit in the economy. Almost all the lending for new industrial projects (referred to as project finance) was done by the DFIs while commercial banks focused mostly on working capital finance.

The DFIs had access to low cost capital from RBI as well as from multilateral agencies. They also borrowed resources from banks through bonds that qualified for the latters statutory liquidity reserved (SLR) requirements. With the initiation of macroeconomic and financial sector reforms in the 1990s, the operating environment for the DFIs underwent a significant change. Their access to low-cost capital was withdrawn which meant that DFIs had to raise capital in the market. They also faced stiff competition from the banks that started doing project financing but at lower rates. This caused severe stress in the financial position of the DFIs and their NPAs accumulated to very high levels.

By the late 1990s they were no longer economically viable. In the late 1990s the Indian economy experienced a series of external shocks. The Asian financial crisis happened in 1997. This was followed by India conducting nuclear blasts in 1998. Then there was the collapse of the Internet bubble in the US in 2000-2001. In the immediate aftermath of the nuclear blasts of 1998, international sanctions were imposed on India. These events led to a general slowing down of the economy. The average real GDP growth rate between 1997 and 2002 slowed down to around 5% from an average of 7% during 1994-97.

In some sense, the banking crisis of 1997-2002 was an outcome of post-liberalisation structural changes in the economy and was accentuated by a few events both internal and external which resulted in a cyclical slowdown of the real economy. The macroeconomic and banking sector conditions preceding the ongoing banking crisis were very different from the earlier episode. The period from 2003 to 2008 witnessed unprecedented economic growth, remarkable growth in exports and favorable macroeconomic conditions in the form of low inflation and low interest rates. India became a major beneficiary of benign global conditions over a sustained period of time.

The banking sector also witnessed structural changes in the 2000s. There was a remarkable increase in the volume of bank credit. Bank credit grew at a staggering rate of 25% during 2003-2007.

The credit boom in general was larger during the mid 2000s than the one in the 1990s and the absolute magnitude of the subsequent NPA problem was also much bigger. The composition of bank lending underwent a transformation. With the death of the DFIs under the burden of ever growing

NPAs, project financing became a part of commercial bank lending. The absence of a deep and liquid corporate bond market meant that providing credit for infrastructure became a part of banking business. This was especially the case for the PSU banks that were more susceptible to political pressures. This change in the composition of bank lending was problematic for three reasons.

Policy changes led to large-scale private sector participation in infrastructure development. Over the period from 2003 to 2007, there were major private entrants into sectors such as aviation, telecom, mobile telephony etc. that were earlier under complete government ownership. There was a huge demand of credit from these industries but commercial banks had little expertise or experience in assessing these businesses. This resulted in potential mismatch of the skills required to do project lending and the capabilities at the PSU banks.

Secondly, this led to a fundamental asset-liability mismatch problem. Unlike DFIs which were funded by long-term bonds and hence could extend long-term credit to industrial projects, commercial banks main source of funding are deposits which tend to be more short-term in their maturity profile. Hence banks doing long-term project lending on the back of short-term assets is bound to result in maturity mismatches in the balance sheets.

Lending to infrastructure also exposed banks to risks they were not accustomed to. These risks emanated from delays and roadblocks due to policy issues, environmental approvals, and the ability of the promoters to bring in large amount of equity needed to complete the projects. It also complicated the governments role. On one hand the government was the owner and provider of capital to banks, and hence would be concerned about the credit risks that the PSU banks were undertaking. On the other hand as a key participant in the economys infrastructure development, the government bore crucial responsibility for the viability and creditworthiness of such projects

In general banks doing infrastructure lending is structurally problematic because of myriad reasons. Infrastructure financing contracts are susceptible to political problems. It is harder to predict long-term demand while doing these project assessments. Recovery of debt and resolution when the project fails is also much harder. For example recovering a cement factory is typically easier than recovering a bridge or a road.

During the 2000s the private sector banks grew rapidly both in number and size and gained market share. By the time the current banking crisis started, the structure of the banking sector had changed.

The share of the PSU banks measured as share of total credit went down to 70%. But overall the banking sector has become larger in size, which means that even if the share of PSU banks has declined, the fiscal burden on the government in the event of a banking crisis is now greater in absolute terms.

The roots of the present crisis can be traced to the excessive lending done by the banks during the credit and investment boom of 2003-2008. In 2008, the world witnessed the Global Financial Crisis. In the aftermath of the crisis India experienced a dramatic slowdown in growth, a massive depreciation of the exchange rate, high inflation and a sustained period of monetary contraction during which RBI raised interest rates to deal with rising inflation. All of these events wreaked havoc for the corporate sector and in turn for the banking sector.

In the immediate aftermath of the 2008 crisis, governments across countries undertook measures to support the financial sector and broadly to get out of a severe recession. Concerns about a potential economic slowdown prompted the Indian government to also take stimulus measures to support the economy. One such measure was to encourage banks, especially the PSU banks, to lend even more to the infrastructure sector, which by 2009 had already started showing stress due to a slowing economy, longer than anticipated delays to obtain clearances from the government, escalating costs etc.

RBI as the banking regulator also announced schemes of restructuring which allowed banks to suspend norms of income recognition and restructure loans that could have become non-performing. This made it easier for already over-leveraged companies to borrow more. Between 2010 and 2012, the leverage of Indian companies increased further while the underlying economic situation continued to worsen.

By 2011, the Indian economy entered into a business cycle recession and demand started slowing down (Pandey et al, 2016). The overall slowdown of the global economy and the weakening of external demand for Indian exports contributed to this. Partly the slowdown was also triggered by widespread corruption scandals specifically in the coal, and telecommunication sectors that shook the entire economy. The public exposure of the corruption scandals led to policy paralysis with the government backing away from any major structural reform.

From the dramatic growth years of the 2003-2008 period, real GDP growth rate during the 2011-2013 slowed down to 6%. New projects failed to take off due to the lack of government approvals and projects that had received credit during the credit boom period got stalled owing to the general slowing down of the economy. The problem was especially acute in the infrastructure sector. This led to a fresh wave of NPAs especially in sectors such as infrastructure, steel, metals, textiles etc.

DEGREE AND NATURE OF THE CRISES

By late 1990s, many of the PSU banks had begun showing signs of weakness. The CRAR of most of these banks was either at or had gone below the safe level of 8%. In other words, many PSU banks were undercapitalized. The growing NPAs of these banks became a major drag on the financial system (Hanson and Kathuria, 2002). By 1997, the ratio of gross NPAs to advances had reached 15%. Theloan quality was worse in the term-lending DFIs (Hanson and Kathuria, 2002) During the period from 1997 to 2002, gross NPAs amounted to 11% of gross advances and net NPAs accounted for 6% of net advances. The NPAs of the PSU banks were higher than that of the private sector banks. The share of gross NPAs in the advances made by PSU banks was close to 12% and the same for private sector banks was roughly 8%. Figure 7 shows the year on year growth rate of NPAs of commercial banks from 1997 to 2015 and figure 8 shows the share of NPAs in the advances of different bank-groups over time. While the NPA share was much larger in the first crisis episode the growth rate of NPAs is significantly higher in the ongoing crisis.

In case of the ongoing crisis, the NPA problem started assuming serious proportions roughly from 2013 onward but the NPAs had been growing from 2010. To some extent the restructuring schemes introduced by the RBI helped the banks to suppress the extent of their balance sheet stress in the aftermath of the 2008 Global Financial Crisis. In April 2015, RBI introduced the Asset Quality Review (AQR), which forced the banks to recognize the stressed assets on their books and provision for them. This was applicable to private and PSU banks alike. The AQR resulted in a sharp decline in the share prices of several banks. By September 2015, 9 out of 10 stressed banks were government owned. Profitability of the banking sector in general has been declining since 2012.

In 2015, the share of gross NPAs in advances of the overall banking sector stood at 7.5%. Although in percentage terms this was smaller than in the previous episode, the absolute size of the problem was bigger given that the banking system has grown significantly in size since the early 2000s.

The continuous erosion of bank capital to provision for NPAs has made it increasingly difficult for the banks to make new advances. As a result corporate credit has been stagnating over the past few years. Year on year growth rate of bank credit has declined sharply from 13.8% in 2014 to 5.8% in 2015.

It was required per se. India was a major beneficiary of the information technology and subsequent outsourcing boom. Exports of IT services registered phenomenal growth in the early 2000s and contributed to the overall economic recovery. The remarkable pick up in GDP growth from 2003 onward coupled with the low inflation and low interest rate environment proved to be a blessing for the banking sector. The credit boom that started during this period dramatically expanded the banks books. As the economy recovered the addition of fresh NPAs also slowed down. Moreover in the early 2000s there was a secular decline in interest rates when monetary policy got rejected. 10year government bond yields went down sharply from 2001 onwards. While between 1996 and 2000 the bond yields averaged at 12.14%, between 2001 and 2003 the average was down to 6.9%.

This gave the banks substantial capital gains on their SLR holdings. The capital gain almost acted as a natural bail out for the stressed banks. Significant investments were made in the

infrastructure and other sectors such as telecommunications, information technology, roads and highways etc. This unleashed massive productivity gains in the real economy. The firms as a result were in a strong position and the addition of fresh NPAs slowed down.

In other words, the banking sector got bailed out of the crisis through rapid and dramatic improvements in the macroeconomic environment which itself was an outcome of very specific domestic and global conditions.

In comparison the current banking crisis is a much more difficult one to resolve, given the magnitude of the problem as well as the macroeconomic environment in which it originated. The V-shaped growth recovery of the early 2000s including the export and investment boom is unlikely to happen this time around. The economic slowdown that began in 2011 continues to be a cause of concern and the growth momentum is much slower than what it was in early 2000s.

While real GDP growth rate over the period 2012 to 2016 has averaged at about 6 to 7%, several questions have been raised about the official estimates. Firm level data shows that economic activity has been sluggish since 2011 and has not yet recovered. Exports as well as private sector investment have been declining since 2013.

The global economic outlook since 2012 has also been very different from what it was during the 2003-2008 period. Developed economies such as the US, UK, the Eurozone countries, Japan and the like have been struggling to recover from a deep-seated recession that began with the 2008 global financial crisis. This is also one reason why the export outlook for the Indian economy continues to remain bleak unlike the mid 2000s.

In addition to these the Indian economy experienced a massive monetary contraction in November 2016 when the legal tender status of high denomination currency notes was canceled by the government and RBI resulting in 86% of the currency in circulation being withdrawn. In 2016-17 this is likely to act as a further drag on the economy and maybe even add to the NPA woes of an already struggling banking sector.

All these factors imply that unlike the last episode, the banking sector will not be able to grow out of the crisis this time and reform measures would be needed. Several policy actions have already been implemented. Balance sheet troubles for banks started as early as 2011-12. When the first signs of trouble surfaced, RBI as the banking regulator took recourse to regulatory forbearance. For example RBI initiated several restructuring programs (such as Corporate Debt Restructuring, Strategic Debt Restructuring, 5/25, Joint Lenders Forum etc.) to enable the banks to resolve the stressed asset problem. However these programs helped the banks to hide the actual extent of the stress on their balance sheets instead of solving the underlying problems. The continuation of the stressed asset problem has worsened the availability of credit for the real economy.

The government initiated the Indradhanush program in August 2015 to revamp the PSU banks. It is a seven-pronged plan, which also includes recapitalisation or infusion of capital into the banks. According to the estimates of the government, the total amount of extra capital required by the PSU banks till FY 2019 is around Rs.1,80,000 Crore.

Out of this the government plans to infuse Rs. 70,000 Crore over the next four years from budgetary allocations. 40% of this amount will be allocated to the six biggest PSU banks, 40% to banks that require support and 20% to banks based on their performance (Kumar et al, 2016). The planned budgetary allocations for PSU bank recapitalisation started with Rs 25,000 crore in each of 2015-16 and 2016-17 and were brought down to Rs. 10,000 crore in each of 2017-18 and 2018-19, amounting to a total allocation of Rs. 70,000 crore.

The remaining Rs.1,10,000 Crore will have to be raised by the PSU banks from the capital market in order to meet the capital adequacy norm as per the Basel III standards.

There has been considerable debate by now in the public policy domain about the pros and cons of using the resources of the government, which is essentially the taxpayers money to recapitalize banks.

Committees such as the Narasimham Committee II (1998) and the Nayak Committee (set up under the chairmanship of Mr. P. J. Nayak and report submitted in 2014) for example were against such

capital infusion operations. Recapitalisation imposes a significant fiscal cost on the government. Another action taken by the government under the Indradhanush programme has been to set up a Bank Board Bureau (BBB) to facilitate the appointment of top officials at the PSU banks. However the progress made by the BBB has been slow since it began functioning in April 2016. In general the Indradhanush program, so far the only step taken by the government to deal with the ongoing banking crisis, does not propose any far-reaching structural reform that would help to tackle the balance sheet problems faced by the banks.

While in 2015, the RBI started the AQR to force banks to recognize their NPAs and provision accordingly, it maybe argued that the AQR should have been done much earlier in order to prevent the accumulation of losses in the banking system over multiple years.

The steps adopted so far to address the ongoing bank balance sheet problem have arguably been small fixes and incremental changes. The need of the hour is a transformative reform initiative so that the next time around the NPA problem of banks does not become as big and also the cost to the taxpayer is minimized.

CONCLUSION

Comparing the two high bank-NPA episodes in post-liberalisation India throws interesting insights into the reasons behind the occurrence of these crises, their implications and approaches to resolve them. Growing out of the problem appears to be the most efficient and quickest approach to resolve a banking crisis. However, this approach is feasible only under three conditions (i) the crisis is not too deep i.e. the extent of impairment of the bank balance sheets and consequent capitalization is within reasonable limits, (2) the source of the impairment is cyclical macroeconomic factors and (3) the macroeconomic recovery in the aftermath of the crisis is a sharp one. The Indian economy witnessed these conditions in the 2003 to 2008 period that helped resolve the banking crisis of the late 1990s. It is important to note that the extraordinarily sharp economic recovery is an exception rather than a rule, especially after a banking crisis. Indeed, in a bank centric economy like India, it is more reasonable to expect slower than normal recovery after a banking crisis, similar to what is happening at present.

Another key insight is that time is of essence in resolution. Early recognition and action on resolution mitigates the damaging impact of a crisis. In order for banks to take such early action, strong governance and proactive banking regulation is critical. This will ensure that the subsequent NPA resolution has minimal effect on the banks capital.

A third factor that aids quicker and more efficient resolution is a strong legal framework for resolution. In this regard a big reform has been the enactment of the new Insolvency and Bankruptcy Code in India. However there are several weaknesses in its implementation. Only time can tell to what extent the new law will be able to better resolve stressed assets in the banking sector within a shorter period of time.

Finally, regulatory forbearance does not facilitate resolution and can actually worsen the banking crisis by providing incentives to the banks to defer NPA recognition and delay action. Restructuring of a loan should be the commercial decision of a bank and should not automatically qualify for regulatory concessions in terms of deferment of recognition of NPAs.

REFERENCES:

- Acharya, V. and Kulkarni, N. 2011.What Saved the Indian Banking System: State Ownership or State Guarantees?
- World Economy, Vol. 35(1), pp. 19-31.Banerjee, A., Cole, S. and Duflo, E. 2004.
- Banking Reform in India . Indian Policy Forum, Vol. 1(1), pp. 277-332.
- Das, A., and Ghosh, S. 2007 Determinants of Credit Risk in Indian State-owned Banks: An Empirical Investigation. Economic Issues Journal Articles, Vol. 12(2), pp. 27-46.
- Capital Requirements and Bank Behaviour: An Empirical Analysis of Indian Public Sector Banks . Journal of International Development, Vol. (15), pp. 145-156.

- Global Financial Development Report. 2013.Rethinking the Role of the State in Finance World Bank, Washington DC. Gopinath, S. 2007.
- Special Features of Financial Sector Reforms in India . Inaugural address delivered at the 18th Annual National Conference of Forex Association of India on April 6, 2007 at Bangkok.
- Hanson, J.A. and Kathuria, S. 2002.India's Financial System: The Challenges of Reform . World Bank Working Paper, Washington, DC: World Bank. Jayadev, M. 2013.
- Basel III Implementation: Issues and challenges for Indian banks . Indian Institute of Management, Bangalore Management Review, Vol. 25(2), pp. 115-130.

LBP PUBLICATION