Journal of Politics & Governance,
Vol. 5 No. 1, March 2016, Pp. 4-7
ISSN: 2278473X

Ticking Time Bomb: The Indian Banking System

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Abstract

This is a perspective paper on the long term impact of Non-Performing Assets of the public sector banks in India how the process of further deterioration in the scenario can be reversed. The author first tries to unfold the root causes of the burgeoning crisis arising out of Non-Performing Assets and then suggest appropriate measure, which if adopted, can help the nation protect itself from the looming catastrophe which can shake not only the erring banks but also the entire economy of the country. The crisis of non-perming assets can be ignored only at nation's peril. Hence it is imperative for the government as well as the Reserve Bank of India to take urgent measures in order to diffuse the proverbial time bomb which is almost ready to burst. Any further delay in managing Non-Performing Assets in an effective manner is bound to devastate the financial stability of the country, thus making it vulnerable the dictates of the global payers.

Keywords: Public Sector Banks, Non-Performing Assets, India

Introduction

Public sector banks have once again delivered financial results that will hardly cheer anybody. A deep-dive analysis of statistical data released by Reserve Bank of India on 23 December 2015 shows that India is currently staring at a crisis of unprecedented magnitude. Non-Performing Assets (NPAs) in the banking system stood at INR 2.6 Trillion or 5.4% of total advances as of 31 March 2015. In addition, loans totaling another INR 3 Trillion or approximately 6.2% of total advances belong to restructured category. It is a well-known fact in the Indian banking circles that a significant percentage of restructured assets will eventually become doubtful assets since the financial viability of restructuring was not rigorously validated. Banks wanted their year-end balance sheets to appear healthier than they really were, and unsound restructuring efforts were merely an attempt at pushing the can down the road. Stressed assets, i.e. a combination of NPAs and restructured assets, still do not tell the full story. There is another hidden pocket of Non –Preforming Assets on Bank balance sheets that go often unnoticed. When banks sell NPAs to Asset Reconstruction Companies (ARCs), they typically retain 85-95% of exposure to eventual loan recovery in the form of Security Receipts. Banks have sold assets with a book value of INR 1.9 Trillion till 2015 and considering the abysmal recovery ratio of ARCs till date, it is more than likely that a significant percentage of face value of security receipts will eventually be written off.

Current Governor of Reserve Bank of India, the Indian equivalent of Federal Reserve's Chairperson, is Mr. Raghuram Rajan, a well-meaning and an erudite economist who was the Chief Economist at the International Monetary Fund (IMF) from October 2003 to December 2006. He has been at the forefront trying to tackle this impending crisis that he inherited but, unfortunately, is dogged by the exceptional scale of the problem. Public Sector Banks, where Indian government holds majority shareholding, are worst hit by the crisis. Their share of non-performing and restructured loans as a percentage of total advances is more than double of private sector banks. Concentration risk for public

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sector banks is at an all-time high level. Top 10 borrowers account for 13 per cent of the entire bank loans and a whopping 98 percent of the net worth of the banking system. Stressed assets as a percentage of total net worth exceed 100 percent for many banks rendering them insolvent by fiduciary standards though not by accounting standards. Growing NPAs have effectively stymied the transmission of RBI's repo rate reductions to bank's lending rate. Banks need higher net interest margin to manage their capital ratios that are impacted by growing NPAs and subsequent provisioning requirements. This has led to a virtual stoppage of credit growth and has raised theoretical concerns regarding Lemons Problem. India needs to tackle NPA problem aggressively rather than pussyfooting as it has been doing over the last two years. The magnitude of the crisis is already significant and any delay will only lead to worsening of the situation to a deep crisis.

Imperatives

There are four initiatives available to the Indian government and RBI. It is unlikely that one of them in isolation will be enough to prevent the crisis but a determined multipronged approach may well work.

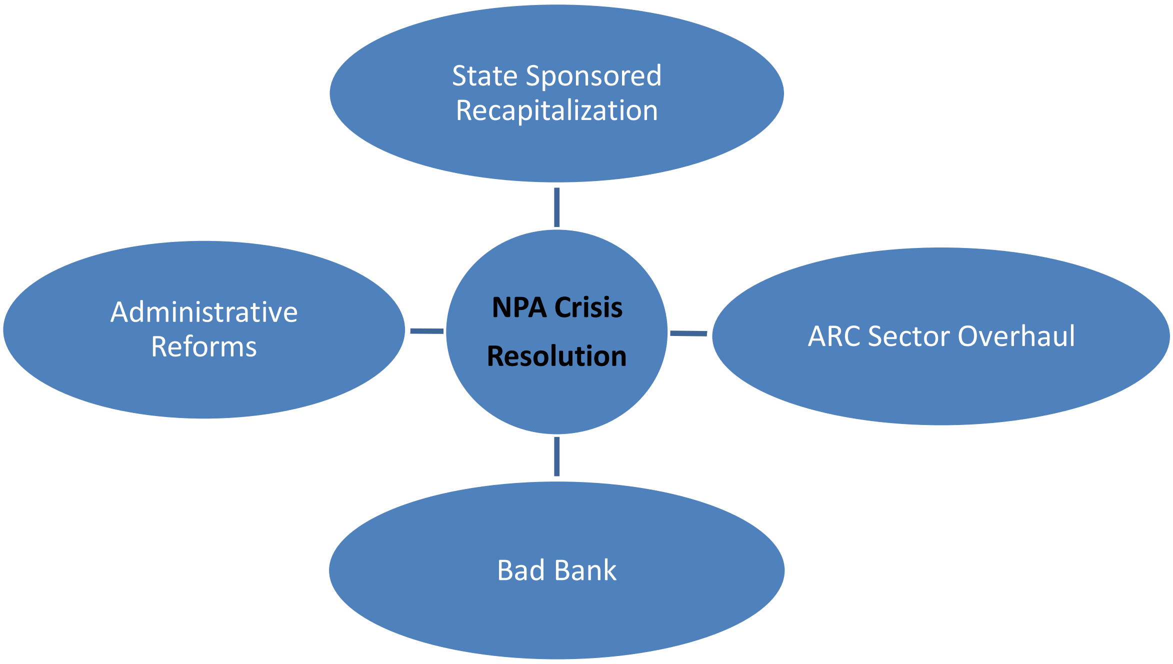

Figure 1: Multi-Pronged Approach to deal with NPAs in Indian Banking System

First initiative necessary to tackle NPA problem is a recapitalization of Public Sector Banks by Government so that they can start lending in a prudent fashion. New loans, when underwritten properly, will reduce the magnitude of the problem by sheer denominator effect. Most of the Public Sector Banks are trading below their theoretical book value and considering the opacity of their balance-sheets, there is a limited demand in secondary markets to participate in a follow-up subscription. The price discovery mechanism for a forced secondary offering of shares of public sector banks is likely to be vicious and subsequent dilution of Government's holding may not be palatable from financial and public perception perspective. Government's announced plan of INR 700 billion investment over next 4 years fall way short of required amount. Fitch estimates that banks need INR 9 Trillion of capital infusion over the next four years to comply with Basel III requirements. This is a huge amount for a cash constrained government and INR 700 billion earmarked by government are insignificant in this context.

While trying to arrive at the ratio of NPAs to total advances within 5%, I estimate that Government needs to infuse at least INR 2.5 Trillion of capital over the next two years. This figure may reduce further to INR 1.6 Trillion with the softening in future bond yields once RBI's monetary policy transmission effort achieves success. Reduction in bond yield will result in mark to market gain on bonds held in balance sheet towards statutory liquidity reserve requirement. This will bring credibility back into the banking system and remove the impediment in immediate growth of credit book. A larger, diversified and better quality credit book will improve the profitability of banks, increase equity valuation and position them to tap capital markets rather than relying on government support. An investment by government in Public Sector banks is actually the most logical initiative as in the absence of such initiative, the notional value of government's shareholding will only decline further whereas investment will lead to a higher valuation at a future date. Capital infusion by Government in Public Sector Banks will not be a desperate gambler's 'double-down' decision but a well thought strategic investment.

Second initiative necessary to tackle NPA problem is a complete overhaul of ARC sector in India. This will involve changing the sale mechanism adopted by banks currently, liberalizing the FDI regime for the sector and streamlining legal recovery process. Today, Banks sell their assets to the highest price bidder irrespective of their past recovery performance or operational wherewithal to effective manage the distressed assets. Prior to August 2014, ARCs were allowed to only invest 5% of sale price while they were paid close to 1.5% annually as a management fee. Since it takes a long time to resolve distressed assets (often more than five years), ARCs were able to recoup their entire investment even in a zero recovery scenario and had no 'skin in the game'. Since August 2014, the 5% requirement has been enhanced to 15% but the *pari-passu* nature of ARC investment still leads to a perverse incentive. Banks need to adopt a mechanism where ARCs recoup their investment only after Banks have received the face value of security receipt. ARCs can be incentivized by offering them a disproportionate share of recoveries in excess of face value. This mechanism will weed out non-efficient players and will incentivize players that make serious recovery efforts and are technically proficient in managing distressed assets.

In addition, the investment restrictions in ARCs need to be removed as contemplated in the current budget. The current capitalization of 15 ARCs is approximately INR 30 Billion. Given 15% capital requirement, they cannot buy new assets in excess of INR 200 Billion over a period of time. INR 200 Billion of investment capital is pittance considering INR 5.5 Trillion of distressed assets. Past guidelines imposed a restriction on maximum equity that a foreign player can own in an ARC. Large global buyers of distressed assets and special situations asset management firms have therefore shied away from the entry to the Indian market. The government needs to allow unfettered entry of foreign capital in ARC sector to bring required capital and the missing expertise required in managing distressed assets. Though enactment of Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (the "Sarfaesi Act") was a noble attempt to resolve legal bottlenecks and expedite recovery process, there are still some lacunas and procedural bottlenecks that impede recovery process. Amendments necessary to streamline the process will be a welcome step and should act as confidence building measure for infusion of fresh capital in ARCs.

The third initiative necessary to tackle the NPA problem is the creation of a Bad Bank that will act as super ARC by the government. The capital flow to ARC sector will happen over a period of time and existing ARCs have very limited financial ability to participate in the government's clean-up exercise. Further, there will always be certain assets where a difference in perception of value exists between buyer and seller. The existence of a state-owned entity tasked exclusively with tackling NPAs on a one-time basis will facilitate expedited clean-up process of banking system without sacrificing intrinsic recovery value of the transferred asset.

None of these initiatives will lead to a long term success until systemic and administrative reforms are implemented in the public sector banks. Fourth initiative necessary for dealing with this crisis is a complete overhaul of risk management system, performance appraisal system and board appointment process in the public sector banks. Otherwise, the problem will recur at a later date. To that avail, RBI needs to propose, implement and rigorously monitor guidelines that promote prudent lending and reduce concentration risk significantly from the current levels. RBI needs to advise banks on adopting sector specific caps, applying single name exposure limits, developing policies that ensure transparent and fair assessment of collateral value and implementing constant risk monitoring mechanisms that incorporate Value at Risk (“VAR”) as a primary metric.

Conclusion

Banks need to invest in human and technical resources necessary to comply with new RBI guidelines. Further, banks need to implement performance appraisal systems that incorporate long term asset performance as a critical metric in evaluating bank employees for their career advancement. Lastly, the government needs to appoint more professionals on bank’s board of directors rather than state appointees. Skills should be a determining factor and not political patronage as has been the case. Tighter accountability and adequate incentive mechanisms need to be put in place for bank employees that will stimulate profitable lending in the future.