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A Study On Non Performing Assets And Recapitalisation Of Public Sector Banks In India

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ABSTRACT

Banking industry in India is struggling hard to address the problem of Nonperforming Assets(NPA) . The problem is much more severe among Public Sector Banks and it has reached almost 9 percent of the total advances in 2015-16. Reduced interest income and provisioning requirements erode away profitability and lending capacity. The recent announcement by the Government of India to issue recapitalization bonds worth Rs 1.35 lakhs crore can give stimulus to the banking sector without incurring much fiscal burden. The capital base of the banks will be strengthened and the banks can earn dividends on shares. However banks and the government must be more responsible and take extra care while exploiting the new opportunities. The losses are needed to be recognized and reported properly.

Keywords: bail in, bail out, non performing assets, public sector banks, recapitalization.

1. INTRODUCTION

A well organized and smooth functioning banking system is inevitable for maintaining stable economic growth. During the last few decades, especially after the initiation of financial sector reforms banks have been playing a significant role in determining the speed and nature of economic progress. However the industry is now struggling hard to address the problem of large Non Performing Assets(NPA). Financial liberalization ushered in the era of competition between banks for maximum the market share which eventually resulted in the accumulation of huge stressed assets. Mounting NPAs is a matter of serious concern for most banks especially Public Sector Banks(PSB).

An asset is classified as non-performing when it ceases to generate income to the lender. Reserve Bank of India defines NPA as loan or an advance where

- Interest and/or installment of principal remain overdue for a period of more than 90 days in respect of a term loan.
- The account remains ‘out of order’ for a period of more than 90 days, in respect of an overdraft/cash credit.
- The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted.
- Interest or installment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the cases of an advance granted for agricultural purpose and
- Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

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Even though the problem of NPA is not a new issue for the banking sector, academic community started monitoring its changes closely since the mid 2000's. NPA ratio in India seems to be higher than many other emerging economies, a little more than Korea even at times of East Asian Crisis. This study examines 1. the extend and causes of NPAs in India and 2) the government's decision to recapitalise PSBs.

SECTION I

With a few exceptions Gross NPAs as a percentage of gross advances for Scheduled Commercial Banks has been increasing since 2005-06. NPAs and its provisioningerode away the profit of banks leaving its balance sheet impaired. Table 1 examines the trends of Gross Advances, Gross NPAs and NPA ratio since 2005-06.

TABLE 1
GROSS ADVANCES, GROSS NPAS AND NPA RATIO OF SCHEDULE COMMERCIAL BANKS

Year	Gross Advances (Rs billion)	Gross NPA(Rs billion)	Gross NPA as % of gross advances
2005-06	15513.78	510.97	3.3
2006-07	20125.10	504.86	2.5
2007-08	25078.85	563.09	2.3
2008-09	30382.54	683.28	2.3
2009-10	35449.65	846.98	2.4
2010-11	40120.79	979.00	2.5
2011-12	46488.08	1423.26	3.1
2012-13	59718.20	1935.09	3.2
2013-14	68757.48	2633.72	3.8
2014-15	75606.66	3233.35	4.3
2015-16	81673.45	6119.47	7.5

Source: Handbook of Statistics on Indian Economy 2016-17

During the period between 2005-06 and 2015-16 gross NPA has increased by almost 1098 percent. Gross NPA as percent of gross advances more than doubled to reach 7.5 percent in 2015-16. NPA ratio registered sharp increase in 2015-16. According to Financial Stability Report, June 2017 the ratio has increased to 9.6 in 2016-17. The problem is much more severe for PSBs which is shown in Table 2.

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TABLE 2
GROSS ADVANCES, GROSS NPAS AND NPA RATIO OF PUBLIC SECTOR BANKS

Year	Gross Advances (Rs billion)	Gross NPA(Rs billion)	Gross NPA as % of gross advances
2005-06	11347.24	413.58	3.6
2006-07	14644.93	389.68	2.7
2007-08	18190.74	404.52	2.2
2008-09	22834.73	449.57	2.0
2009-10	27334.58	599.26	2.2
2010-11	30798.04	746.00	2.4
2011-12	35503.89	1172.62	3.3
2012-13	45601.69	1644.61	3.6
2013-14	52159.20	2272.64	4.4
2014-15	56167.18	2784.68	5.0
2015-16	58183.48	5399.56	9.3

Source: Handbook of Statistics on Indian Economy 2016-17

In 2015-16 NPA ratio in PSBs has reached almost 9 percent of the total advances. Between 2005-06 and 2015-16 NPA ratios in PSBs increased by 158 percent. Total bad loan of India's 38 listed commercial banks have crossed Rs 8,00000crore at the end of June quarter of 2017. This accounts for nearly 11 percent of total loans in the banking sector. Around 90 percent of the stressed assets are in the books of PSBs. According to a study conducted by CARE Ratings the top 20 banks with highest NPA ratios are PSBs.

The roots of NPA problem in India can be traced back to the days of financial and banking sector reforms initiated in India since 1990s. Reforms were inevitable to maintain the speed and stability of economic growth. Competition between banks for exploring the unexploited avenues of market intensified. Economic conditions from mid 2000s were also favourable since it was growing at the rate of 9-10 percent per annum. Investment GDP ratio and corporate profitability reached new heights. This period also witnessed the increased flow of foreign capital into the country. Without considering the conservative debt equity ratio firms expanded its size and banks were competing each other to finance the big and influential firms, sometimes even by violating the existing norms and regulations.

The period followed was not as smooth as expected. Signs of recession became visible in the West. It gradually transmitted to emerging economies including India. Profitability of many firms started eroding. Economy was entering into a stagflationary phase of high inflation and slow growth. Central Bank, as usual was more concerned with keeping inflation at moderate level and with this end, rates were kept at high level. Higher interest in the midst of low business expectations further worsened the other side. Some firms borrowed from abroad but when the rupee depreciated their condition also worsened.

In addition to the economic slowdown there were a lot of other factors which can be considered as reasons for rising NPAs. Procedural formalities and delay in land acquisition for firms,non transparent way of giving loans etc were some among them. In some cases relaxations were given. Large number of loans were restructured and thereby more time was given for

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repayment. However such measures could only postponed the peril followed. Under Asset Quality Review (AQR) initiated by the Central Bank, large number of hidden NPAs in the balance sheet was reported. Even though inevitable, this was another reason for rising NPAs. NPA has reached the level of Rs 6119.47 billion for Scheduled Commercial Banks in general and Rs 5399.56 billion for PSBs in particular as of 2015-16.

India as mentioned in the 'Economic Survey 2017' is facing the Twin Balance Sheet Syndrome now. The balance sheets of both PSBs and many firms are in a dreadful situation and this hinders investment and growth. Large number of firms are not in a position to run the business and they prevent others from investing, by defaulting the repayment to the bank. Besides, banks have to maintain a minimum Capital Adequacy Ratio(CAR). When NPA goes up, banks are required to set apart further capital to maintain the ratio. This will affect the lending capacity of banks. Reduced interest income and provisioning requirements for NPA also affect the functioning and profitability of banks.

SECTION II

For maintaining the stability of the financial system, it is high time that we need to deal the situation more seriously and honestly. The proposed Financial Resolution and Deposit Insurance Bill 2017 deserves special mention in the present context. It is actually the bye product of G-20 meeting at Brisbane, Australia in November 2014 which embarrassed the directives of Financial Stability Board. Financial Stability Board is an international body that monitors and makes recommendations about the global financial system. Following the 2008 crisis and large bail outs many Western countries including Greece, Spain and Portugal were in deep economic crisis. Actually the context, manner and way by which bail out was executed had some flaws. The concept of 'bail out 'gave way for 'bail in' and that was incorporated as an integral part of the proposed bill. Accordingly, loss of banks must be borne by its unsecured creditors(depositors). In case of bank failure the depositors, whose money is given as loans is likely to lose his share of deposit and in lieu of that the he will be forced to satisfy with bank shares. Depositors who are saving money in full trust of bank are actually getting cheated. 'Bail in' was experimented in Cyprus and depositors lost crores of Euros from their accounts. There are a lot of other clauses including haircuts, bridge service provider etc which are seemed to be highly unacceptable in an economy like India. Policy makers are needed to be more vigilant and pragmatic while copying and pasting policies from the west.

Recapitalisation, especially in the form of 'bail out' seems to be more sensible in Indian context. Bail out' is a situation in which a business, an individual or a government offers money to a falling business to prevent the consequences that arise from the business downfall. It can take the form of loans, bonds, stocks or cash. Irresponsible lending by banks, mismanagement among some corporate firms and general economic conditions paralyzed credit flow and brought the whole banking and thereby economic activities into an uncomfortably low level. Economic slowdown was further aggravated by demonetization and introduction of Goods and Service Tax(GST). Considering these state of affairs, satisfying Basel III norms regarding CAR by 2019 is a challenging task. As per the norms banks have to maintain its CAR at 11.5 percent. Banks are running short of capital and there is a need to infuse capital into the system.

In a developing economy like india, there is a need to allocate large amount of resources for developmental and welfare activities. So government have limitations in directly pumping funds to sinking banks and hence it issue bonds. Recently on October 24th 2017, the

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government announced issuance of recapitalisation of bonds worth Rs 1.35Lakh crore. After demonetization plenty of deposits (almost Rs 4.3 Lakh crore) accrued into the banking system. The Government has not yet announced the modus operandi of recapitalisation. However, usually government issue bonds which bank can subscribe at a fixed coupon or interest which is linked to market rates. The government is likely to use this money to buy the shares in public sector banks. This will give the banks more capital and it is interesting to note that banks are giving the government, money to buy it own shares.

In the early 90s there was recapitalisation in a similar manner. Even though bonds were non tradable in nature at first, they were later made marketable. Marketable bonds can be sold and raise fund when liquidity is demanded. Apprehensions in the fiscal front do not seem to be vital. Recapitalisation has only a very trivial impact on fiscal deficit. As per International Monetary Fund accounting practices recapitalisation bonds are 'below the line' financing and impact of recapitalization bonds are offset by buying shares in banks. For Rs 1.35 lakh worth recapitalisation bonds, the annual interest payment may be between Rs 8000 and Rs 9000 core. However the dividends earned on shares may offset the cost of interest to some extent. After providing for bad loans, the banks can use the extra fund for further lending. At a new and high capital base, banks can easily do so. But this is not possible under the existing situation. Even with high liquidity, lending is restricted to the extent of capital paucity. Increased lending and private spending stimulate the economy and the multiplier impact can lift the economy to a better level of income and employment. Banks can also use interest accrued on the bonds which it holds. According to Goldman Sach's research report every incremental Rs 100 billion of bank capital infusion by the government has the potential to increase the GDP growth by 0.5 percentage.

When debt/ GDP ratio rises it may affect the rating of the government. But on the other side rating of PSBs may shows some positive signals. However if the capital infusion brings financial stability, the government's rating will surely go up in the long run.

Recapitalisation involves a moral hazard. Moral hazard is a situation in which one party undertakes a risky venture knowing that it is protected against the risk and other party incurs the cost. While taking any decision relating to recapitalisation, the probability of occurring such practices must be foreseen and discouraged.

Recapitalisation may be a choice but it is an inevitable choice. Otherwise the prospects of the economy in both short and long run seems to be bleak. Capital must be infused and provide for loan losses at the earliest. Banks are needed to recognize and report losses properly. If not, bank books will be filled with capital and there are chances of inflation. Last but not the least; even though recapitalisation is the need of the hour it should not be a practice to use it frequently. Otherwise, banks and borrowers may behave recklessly and awaits for some favours from the government. Authorities much refrain from such practices so as to maintain the strength of our banking system.

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