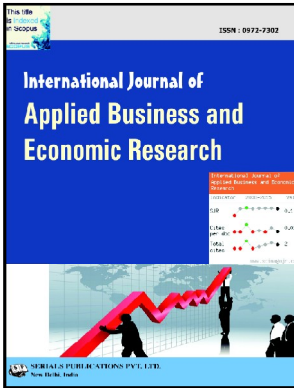

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Stressed Assets of Commercial Banks- Implications for Financial Stability and some suggested Policy Changes

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Abstract: *Background/Objectives:* Non-performing Assets are the biggest problem faced by the state-owned banks in India in the current economic scenario accentuated by global uncertainties like the Brexit factor. *Statistical analysis:* As Commercial banks are the engines of economic growth and given that the 6 largest PSU banks in India own in excess of 73% of Banking Assets, the drag of the NPA's has a significant impact on most of the economic parameters such as GDP, funding capabilities and so on. In the December'15 quarter, of the 40 listed banks, 10 banks had gross bad loans of more than 8%, while 22 banks had in excess of 5%. As a consequence, in a matter of 40 days, they lost more than Rs1.8 lakh crore in market capitalization. This is just one example of the importance of strengthening the balance sheets of banks, as indicated by RBI measure of the Asset Quality Review. *Findings:* Therefore to improve recovery and reduce the impact of NPA, banks have no choice but to undertake various measures. *Conclusion/Improvements:* This paper aims to discuss the impact of soaring NPA on the balance sheets of banks and offers suggestions on some probable ways to overcome and mitigate the negative impact on the Economy. We also analyze the correlation between economic indicators such as GDP, IIP and the lead-lag of bank NPAs apart from the Social Justice aspect of resolving this issue.

Keywords: Financial Stability, Indian Banking System, Social Justice

1. OBJECTIVE OF THE PAPER

Non-performing assets or stressed assets has impacted the profitability of banking institutions in a big way.

- It reduces the leverage of the bank as more provision need to be kept aside for loan losses.
- It not affects current stream of profit, but it also blocks the future scope of the income.

- It reduces the return on assets (ROA) of the bank and hence reducing the return on equity (ROE) for the shareholders.

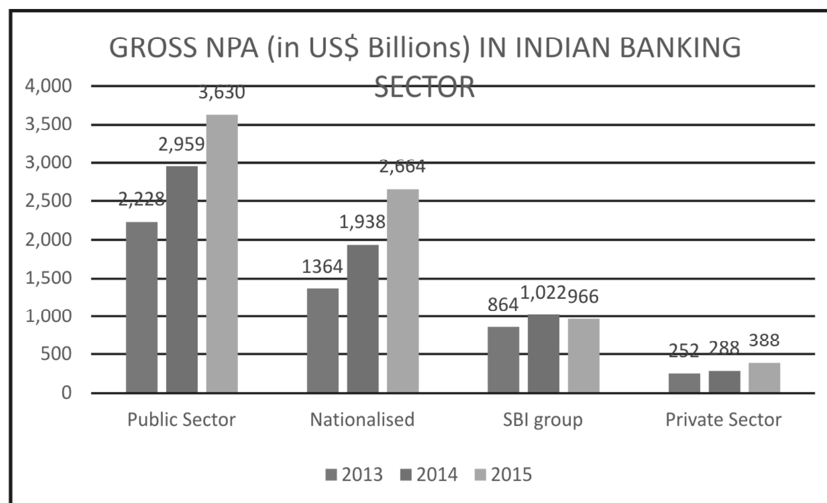
We study the impact of this problem and offer suggestions for overcoming this obstacle to Economic Development in India

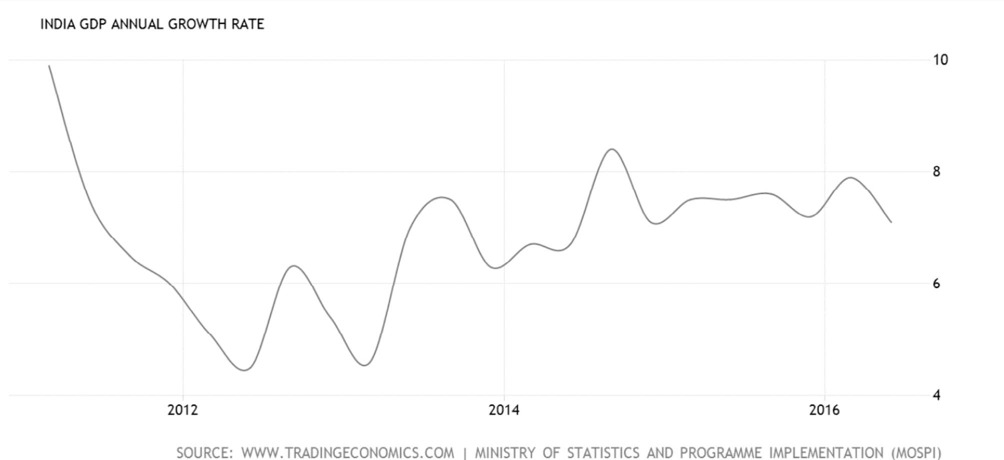
Background to the Issue of rising NPA's in the Indian Banking System

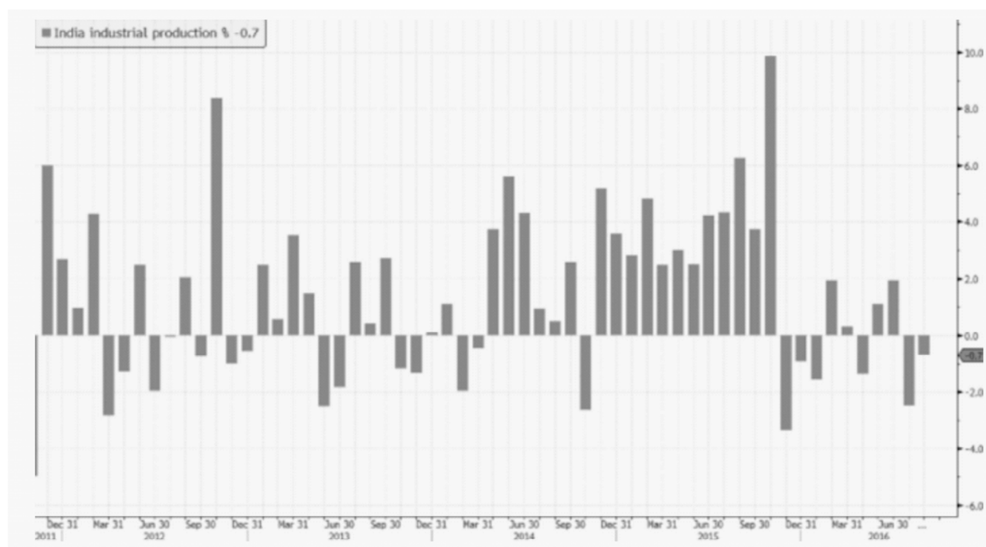
India has a social banking motto such that a fixed amount of loans need to be provided to priority sector as mentioned by RBI. This increases the risk of default as the priority sector includes sectors such as agriculture, textile SMEs (Small & Medium Enterprise), and these sectors are dependent on natural factors such as monsoons which are beyond human control. But, most of these are covered by provisions for loan losses. As per Financial Stability Report of RBI, the gross bad loans of commercial banks stand at 7.6% in March 2016, which is further expected to rise to 8.5% of total advances by March 2017. The Indian bank's NPA i.e. $195 billion, has become greater than the GDP (Gross Domestic Product) of many countries such as New Zealand, Sudan, Oman etc. and this explains the size of Indian NPA and the need to clean it.

- The bleeding banks with soaring NPAs not only hinders with the interest rate cut but it also increase capital requirement and thus pull down various Government policies. The reason for non-transmission of rate cuts by commercial banks to common people is also attributed to poor state of banks. This is eating up the capital base of banks. The capital base is shrinking at such an alarming rate that it needs government support soon. Due to absence of any concrete measures by government to clean bank's balance sheet, the Reserve Bank of India has initiated a mission to clean the balance sheets of banks by March 2017. The increasing NPL in the Indian banking sector can be significantly divided into two sectors – Public Sector Banks and Private Sector Banks. India is a unique mix of state run and private sector banking and hence it complicates the situation even further as the structure and governance of both the segments of banks are entirely different.
- Less equity and lower funding costs result in a return on equity (the key measure for bank profitability) for big banks that is almost double that of banks with less than $100 million in assets.

As per RBI, the following issued data signifies the alarming rate at which our stressed assets are increasing.







Source: Department of Statistics, Government of India

Thus as we see that the stressed assets are increasing further we need to understand its root cause and solve the problem. As per our understanding two major challenges before Indian Banking industry are- Governance issues and Structure of banking policies.

2. REVIEW OF LITERATURE

Kamini Rai (2012) stated that the main reasons of increasing NPAs are the target-oriented approach, which deteriorates the qualitative aspect of lending by banks and wilful defaults, ineffective supervision of loan accounts, lack of technical and managerial expertise on the part of borrowers.

Kavitha N. (2012), emphasized on the assessment of nonperforming assets on profitability its magnitude and impact. Credit of total advances was in the form of doubtful assets in the past and has an adverse impact on profitability of all Public Sector Banks affected at very large extent when non-performing assets work with other banking functions and also affect productivity and efficiency of the banking groups. The study observed that there is increase in advances over the period of the study.

In an attempt to understand the indicators of NPAs and its related impact, Rajput, Gupta, and Sharma (2012) used an empirical approach to analyze the profitability indicators as a focal point on non-performing assets (NPAs) of all private and public sector banks in the Indian context.

From a cross-country perspective, many studies have done on the problem of non-performing loans (NPLs) to let us know that major problems had incurred on overall performance of the banking system of all these country due to the impact of NPL, for instance, in context of Italy (Sergio M., 1996), US banks (McGoven J., 1993 and Bloem & Gorter, 2001), Argentina (Bercoff et al., 2002), East Asia (Lee et al., 2001), Taiwan (Hsihui et al., 2007), Australasia (Kurt Hess, 2007).

3. NEED OF STUDY AND DESIGN OF PAPER

PSU banks are struggling more because of the following governance issues embedded in state run organizations:

1. **Lack of consistent policies and coordination**- They do not have a standard credit rating framework, in spite of being controlled by government. They have different rating and loss calculation metrics. Loan rejected by one bank is sometimes processed by another bank. There is a serious lack of coordination and credit information exchange on risky counterparts, defaulters, credit track record and so on.
2. **Lack of technical expertise to evaluate a project-** PSU banks do not have people who can critically evaluate all projects and their costs. Project cost is inflated by promoters so as to reduce their equity contribution. In a 70:30 debt: equity funding structure, if the project cost is inflated by 30-40 per cent, equity contribution required from the promoter is reduced drastically to 0-10 per cent.
3. **Corruption among PSU banks' rank and file-** Syndicate relationship between promoter and influential executives of public sector bank is a big risk and impacts decisions on credit right from disbursing loans to classifying them as NPA or restructuring and lengthening the repayment period. Ex- The Bhushan Steel-Syndicate Bank case is fresh in the public mind.
4. **Cleansing the system is good but equal importance should be given for fixing responsibility and taking ownership-** Cleansing the system of bad loans is good, but it also needs to be ascertained how and why this huge pile of bad debts accrued in the system. Naming and shaming scrupulous and wilful defaulters should be done. Banks should be advised to review the retail loans, personal loans and credit cards of these defaulting promoters. Banks take risks to make money. The money in the case of PSU banks is of the taxpayers and depositors. Casual and irresponsible behavior should not be tolerated. Accountability and ownership should be fixed, which is unfortunately missing in public sector banks.

As the data suggests that the overall stressed assets are increasing in the Indian Banking industry, the solution to this problem cannot be entirely the governance issues and hence we need to make structural reforms in Indian banking industry as a whole. Various structural reforms such as recapitalization and loan waivers have already been carried by the government in the past which have not been able to produce the expected results.

- Twenty-nine state-owned banks wrote off a total of Rs 1.14 lakh crore of bad debts between FY 2013-2015, much more than they had done in the preceding nine years.
- Bad loans of public-sector banks grew at a rate of 4 per cent between 2004 and 2012, in FY 2013-2015, they rose at almost 60 per cent. Since 2013, bad debts written off until March 2015 constitutes 85% of such loans.
- India's largest bank, State Bank of India, is way ahead of others in declaring loans as unrecoverable, with its bad debts shooting up almost four times since 2013 — from Rs 5,594 crore in 2013 to Rs 21,313 crore in 2015.
- In fact, SBI's bad debts made up 40 per cent of the total amount of bad debts of all other banks in 2015 and were more than what 20 other banks wrote off. Also, in 2014, it alone constituted 38% of the total bad debts written by all the banks. The figure of bad loans for 2014 and '15 combined, Rs 34,490 crore, was Rs 10,000 crore more than that for between 2004 and 2013, Rs 23,992 crore.
- Punjab National Bank, India's second largest bank has also witnessed a consistent rise in bad debts since 2013. These grew by 95 per cent between 2013 and 2014 but climbed by 238 per cent between 2014 and 2015 — from Rs 1,947 crore in 2014 to Rs 6,587 crore in 2015.

The government has initiated banks recapitalization scheme known as Indradhanush scheme which aims to capitalize public sector banks with Rs 70,000 crore up to financial year 2018-19. The important features of this scheme are

- Adequately capitalize all the banks to keep a safe buffer over and above the minimum norms of Basel III.
- Extra capital for the next four years up to FY 2019 is likely to be about Rs.1,80,000 crore.
- Rs.70000 crores to be make available by bank for four years till 2019. About 40% of this allocated to the top six big banks. The remaining 20% to banks based on performance. Eight banks which did not get any money in first two tranche will get preference.

The expected capitalization in this fiscal is as follows:

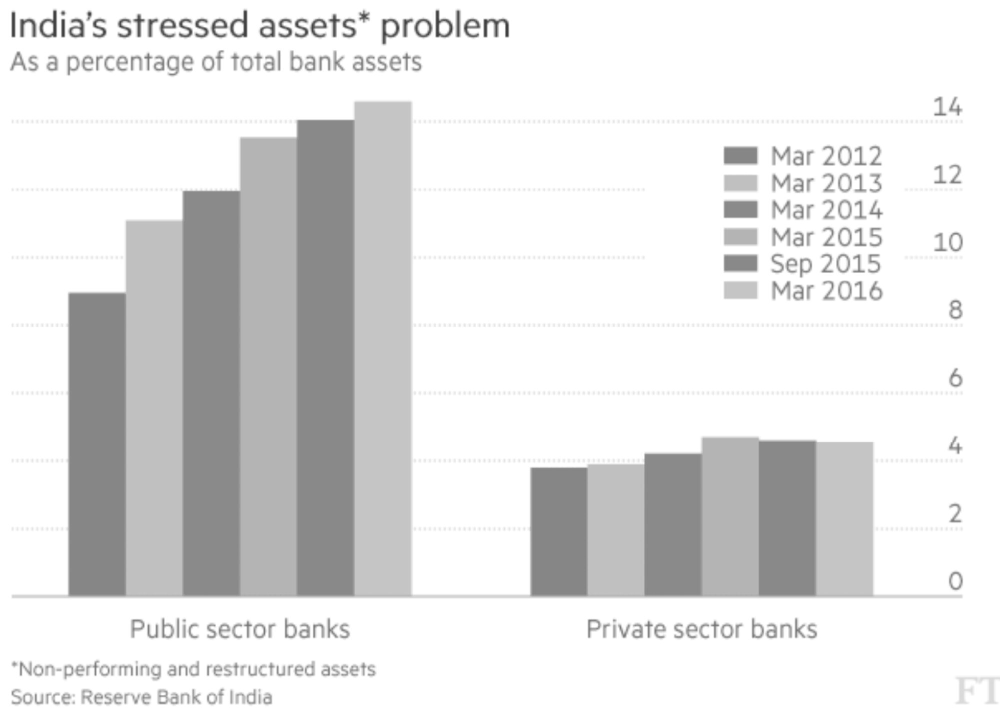
Table: Capitalisation of PSBs in FY 2015-16

Sl No.	Bank	Capital Allocation (Rs Crore)
1	State Bank of India	5,531
2	Bank of India	2,455
3	I.D.B.I.	2,229
4	Bank of Baroda	1,786
5	Punjab National Bank	1,732
6	Canara Bank	947
7	Indian Overseas Bank	2,009
8	Union Bank of India	1,080
9	Corporation Bank	857
10	Andhra Bank	378
11	Bank of Maharashtra	394
12	Allahabad Bank	283
13	Dena Bank	407
	Total	20,088

Source: Government press release, CPR research

But in the light of recent developments in the stressed assets the viable structural reforms can be brought in the following ways in the Indian scenario:

- Corporate governance issues particularly in PSU banks as suggested before.
- Development of Credit Default Swap (CDS) markets in India.
- Bankruptcy Courts to settle pending litigation on loans gone sour.
- Lowering Government Stake in PSU's to below 50%.



The Insolvency and Bankruptcy code, 2015 will replace the existing laws of bankruptcy and help in faster recovery of sick industries, which can be initiated by either debtors or creditors. It will also help India to improve its world's ranking in "Ease of Doing Business" as resolving insolvency is one of their key parameters. Bankruptcy bill in its original and expected structure, can overcome few shortcomings of ARC.

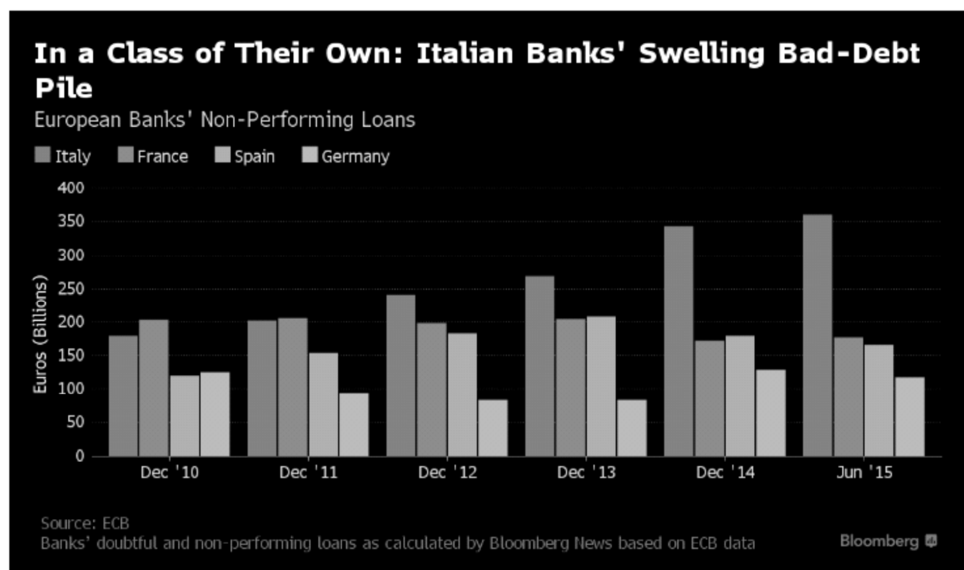
- It allows private lenders to enforce security interests on satisfying assets without satisfying banks and other financial institutions, forcing to change management, share allotment in troubled companies, which are against the laws prescribed by RBI and in no way helping in recovery of loans, rather became a business model.
- It seems completely counter-intuitive for an agency with special powers conferred by the law to rescue a loan that goes bad due to bad lending, as initially the structure of AMC was designed in such a way so as to deal with NPA due to systemic risk, which is not the case with India.

Although downturn of this bill might be closing down of genuine MSME entrepreneurs, who are not wilful defaulter, rather require some time and guidance to overcome their NPAs. Thus it is important to consult and gain confidence of these small entrepreneurs.

Italian Bad Bank Schemes

Italian banks has planned to combine their bad loans and divide it into tranches accompanied by purchasing of government securities to make it more attractive for potential investors. The price of the guarantee, which is the most striking point of discussion in Brussels, will be based on the price of the credit default swaps of the comparable loans or the market price. The price will be low initially and are supposed to rise subsequently in order to stimulate initial interest.

While removing stressed assets and help banks clean-up their balance sheets and spur lending, it may first require them to recognize billions of Euro losses if the disposable price becomes less than the book value on bank's account. Italian banks have provisions to cover less than half of the nominal value of their stressed assets, so asset disposals at even lower levels imply losses. In Italy the bad loans to small businesses are varied, whereas in Spain they were mostly bad mortgages, which implies that the banks will get rid of the loans for big discounts, as compared to Ireland that paid an average of 43 cents for each dollar of assets its bad bank took over and Spain's bad bank paid 47 cents. By securitizing the bad loans, the guarantee involved in Italian package will reduce the difference between what investors are willing to pay and the amount required by the banks to avoid large losses. However, the success of this plan might depend on the ability of guarantee in eliminating the shortfall.



There are few positive developments in Italy that can contribute to the success of the bad bank policy.

- In November, the rating service Fitch raised its outlook for Italian banks to stable from negative that might allow Italian banks to borrow at more attractive rates.
- Loan creation growth has continued. Increasing loans potentially means more diversification away from the nonperforming loans.
- A wave of consolidation in the Italian banking sector may mean that some of the weaker and smaller banks would be absorbed by safer counterparties.

- Last, but not least, the Italian economy is forecast to grow at a slow but steady rate this year.

The policy of Bad Banks might not be as successful in India, as there are structural differences between the Indian and Italian banking structure and hence this policy cannot be implemented in its original format.

Italian banking industry is entirely privatized and is highly diversified in terms of banking structure and legal format whereas India's banking sector is a peculiar mix of state owned banks (public sector banks or "PSBs") and private sector banks, wherein the state owned banks include 72.1% of the total banking assets, but in terms of profit, the private banks have surpassed the state owned banks. In 2015, PSU contributed about 42.1% of the entire profit. As the shareholder in public sector banks, the government (and therefore the tax payer in substance) is already underwriting the risk for public sector banks. Also, the government has already initiated the process of recapitalizing the PSBs over a three year period through the "Indradhanush" scheme. Thus already existing capital subsidy, a publicly funded asset reconstruction company will further aggravate the moral hazard already incorporated in PSB management. Knowing that they can offload debt to this sovereign bad bank , will further create market indiscipline and hamper prudent investments along with disincentive to be diligent, which is contrary to one of the principal lessons of the financial crisis of 2008; the prevention or avoidance of moral hazard in banking. India already has established a regulated asset reconstruction industry. Unlike the proposed sovereign-backed asset reconstruction company, these asset reconstruction companies are privately funded and therefore will only buy assets from the state owned banks at their true cost, inflicting losses and preventing moral hazard. The Union Budget-2016 should focus on policies aimed at enabling emergence of a thriving distressed debt trading and resolution market. The government should focus on privatizing control over PSBs consistent with Nayak Committee recommendations as a step towards complete privatization and restructuring of Indian banks.

Accounting Moratorium

RBI has given clear guidelines to all the banks to clean up their bad loans from their balance sheet by March 2017, and claimed it as a fair span to do the process of cleaning up. The major issue in cleaning of the assets is that are the Indian banks ready to take a hit on their balance sheet in such a short span of time. State Bank of India, the largest bank reported a massive 67% fall in consolidated net profit at Rs 1,259.49 crore in December quarter 2015, after it classified loans worth Rs 20,692 crore as bad loans, in their balance sheet.

SBI has warned of the further stressed results in the upcoming results as they have identified only half of the expected bad loans which is going to increase further.

Bank of Baroda posted a loss of Rs 3,342 crore, the highest quarterly loss by any bank, as it undertook the cleaning up exercise. IDBI Bank recorded the next biggest loss at Rs 2,184 crore, followed by Bank of India at Rs 1,505 crore, UCO Bank at Rs 1,497 crore, Indian Overseas Bank at Rs 1,425 crore, Central Bank of India at Rs 837 crore, Dena Bank at 663 crore.

Such huge losses posted by the biggest banks of India clearly indicate that such vigorous cleaning exercise is going to hit hard on the bank's profitability and would take a toll on huge opportunities. Although stating the above fact, it is clear that the issue of NPA cannot be left as it is and hence it needs to be tackled

in a way that it does not harm the lending ability of our banks. One such option can be the use of Accounting Moratorium till the period of March 2017. The accounting moratorium is the process in which all the accounting policies ceases for a defined period of time. It is the term used by the national governments and done under a scenario of political or commercial stress as done by countries such as Brazil, Russia. Some of the positive aspects of declaring moratorium are:

- The Moratorium is an official law.
- The Moratorium does not distinguish between domestic and commercial settlements.
- The Moratorium does not distinguish between Public and Private Initiatives.

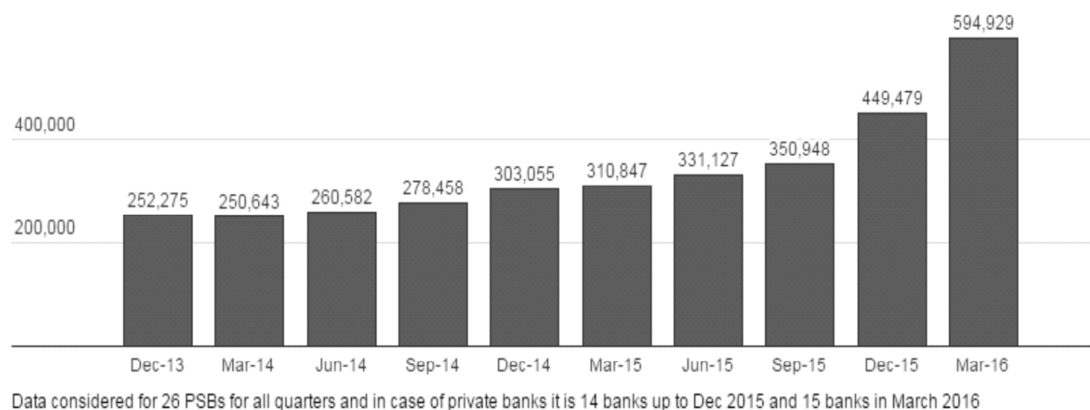
In this way, it will help banks to identify their previous stressed assets without taking a hit on current profit and still be able to lend to the public in the more reformed and diligent way such that the economy of India can still continue to grow. This will further help banks to pass on the rate cuts done by the central bank to the common public, which will further initiate rate cuts by the banks. As it will eliminate the major concern of RBI of not transferring the rate cuts to the common man.

One Time Loan Waiver

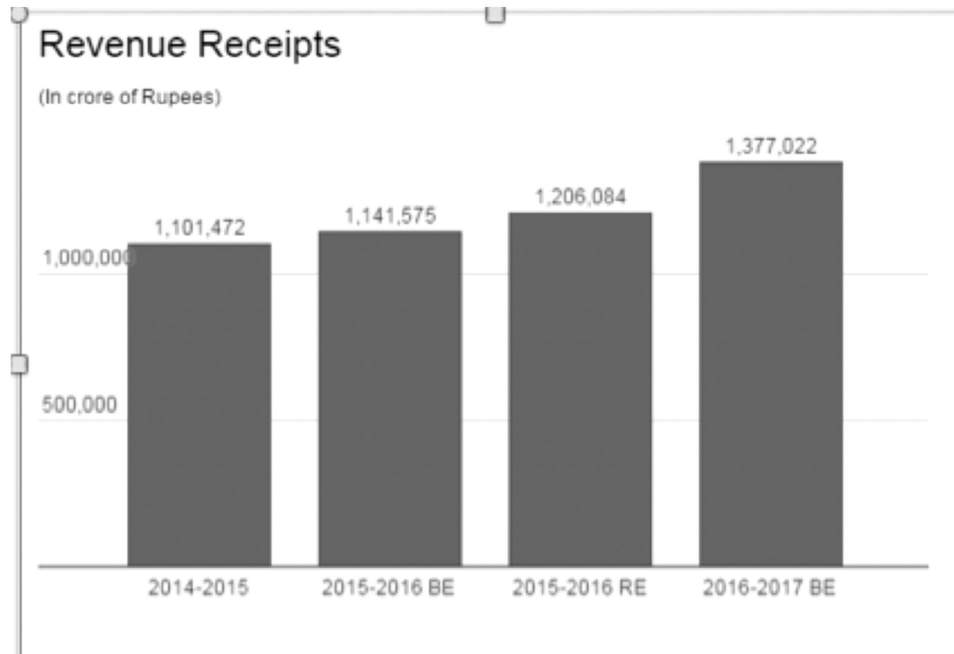
The total Gross Non-Performing Assets (GNPAs) of all the commercial banks stood at Rs 5,94,929 crores as at end March 2016,adding to the substantial high value of about Rs 200,000 crore in just one quarter (reported value at the end of December 2015 quarter, the total GNP.As stood at about Rs 4,00,000 crore.) Over 90% of its value is constituted by the public sector banks. This is about 8.20% of the total loans lent and this explains the enormity of the problem. A considerable chunk of restructured loans have turned bad in the recent months. More is likely to increase if economic reforms are not practiced immediately. The following graph is drawn using the data collected through the annual reports of various banks.

Privatisation of Banks

The loss of Rs. 18, 000 crore incurred by PSBs has implications for the RBI. On the one hand, the government foregoes revenues through dividends and profits, while on the other it would need to provide resources through enhanced expenditure to bail out loss-making banks from small subset of population called Taxpayers, which tend to share most of the burden of the governmental biases. The government could consider setting standards for the banking industry — privatising some of the inefficient PSBs while



Data considered for 26 PSBs for all quarters and in case of private banks it is 14 banks up to Dec 2015 and 15 banks in March 2016



rewarding profit-making ones. This implies we need to change our age old policies of state run banks. One of the objectives of social banking under which private sector banks were nationalised in 1969 and 1980 was to ensure financial inclusion of all the sectors of the population. The Central government has been successful in ensuring a bank account in every household under the Prime Minister's Jan-Dhan Yojana, in the past two years. The advancement in technology is already making possible safe banking transaction through mobile phones. Through Digital India initiative, and with widespread availability of UID Adhaar information, various credit ratings and mobile phones, technology can help in eliminating human intervention in day to day functioning of the bank. Small banks and payment banks are expected to penetrate deep into rural India, and therefore the need for actual commercial bank branch is reducing in current scenario.

Privatising loss-making PSBs will have a positive effect on the management and the staff of such banks. Also, privatising a few loss-making PSBs will ensure that market discipline and force them to rectify their current strategies and compete freely in the market. As the Planning Commission was a vestige of the socialist era, so is social banking. We need to reconsider if actually all the public sector banks, are really required to serve the purpose of social banking in our country and at what cost.

The following table shows us the prospective amount that will be earned through privatisation of just 5 top PSU which can be used for capitalisation requirement as per Basel 3 norms and also help in cleaning of bad loans.

Considering the biggest example of Singapore, where the entire banking industry is privatised, after the formal announcement in March 1985. Raising cash through sale of state enterprises, getting rid of poorly managed state enterprises, and freeing state enterprises from political interference so that they can function as commercial entities could be seen as the probable reason for the privatisation and it has proved to be a success story since then. The major factors that could be the reasons for the privatisation then, which still hold good in current Indian scenario are-

Table 1
Income from Privatization of Public Sector Banks

Name of the Bank	*No.of Outstanding shares (in Mn)*	*Current Government's Share*	*Value of Government's Share*	*Current Market Price of Share (in Rs)*	*No. of Shares when Government stake reduces to 33%*	*Amount Received after Privatization of Banks (in Mn)*
SBI	7762.68	58.60%	4548.93	264	2561.684	1373063
PNB	1854.56	58.57%	1086.216	144.9	612.0048	180046.2
Canara Bank	475.19	64.50%	306.4976	311.2	156.8127	99079.02
Bank of Baroda	2211.5	57.50%	1271.613	171.9	729.795	254705.1
Allahabad Bank	723.03	60.00%	433.818	85.4	238.5999	41370.33

Authors Data. (Figures from Government of India Reports)

- Corporates were usually cash backed up or lightly geared after suffering the Global Financial Crisis scare; everybody wanted to be prepared for the next crisis. In the western world, corporates delayed expansion investments as the macro outlook was uncertain; their cash was piling up; likewise, in Asia. In Singapore, the average corporate net gearing was <25%, with most corporates systematically deleveraging in the last decade after the Asian Financial Crisis, partly aided by property divestments with the birth of REITs.
- Asian consumer businesses attracted sustainable growth by most of the businesses. The Asian consumer was highly valued as income is growing in the coming decade and household balance sheets were not stretched yet. Conversely, consumers in the developed world were likely to tighten their belts.
- Low valuations for cyclical business. As global demand turned down and industrial activity slowed, commodity stocks have been suffering from overcapacity and worries of insufficient demand. Such scenario tends to change with time. Privatisation offer taught us that poor prospects are by no means a sure-bet on underperformance.

4. CONCLUSION

The capital requirement to clean up the bank's balance sheet is far beyond the total expected revenue of the government for the fiscal year 2016-2017, and thus waiving off entire bad loans is beyond the scope of the government. Banking sector analysts are still working out the capital implications for Public sector banks on account of this additional chunk of bad loans. It will account to trillions of rupees if we include the money needed to provide for stressed assets, meet the Basel-III capital norms and fund their credit expansion plans. Thus capital requirement is the biggest challenge. Since the government owns 70 percent of the industry, the government owes huge responsibility. The current situation of state-run banks has convincingly proved that nationalization of state-run banks have failed to create a healthy banking system, though it had helped to create financial inclusion of masses, but no banks can run for without the efficiency and this is the high time when government should start focusing on the strategy of privatization of the state-run banks such that all can compete freely in the market.

Key learnings that need to be understood before implementing the privatisation strategy in Indian banking industry.

- Privatization works best when it's part of a larger promoting efficiency. New Zealand, the U.K., Mexico, and Chile are all successful privatizers. The privatisation in Indian Banking sector need to be accompanied by reforms of monetary and fiscal policies. The government will still be the shareholder in the state run banks. Privatisation should not be done with the soul motive of profit maximisation. It will further reduce monopoly of private banks in Indian industry and give equal opportunities to all the players in the market.
- Countries can benefit from privatizing management without privatizing the ownership of assets. Management contracts, leases, and concessions have been successfully used the world over, particularly in sectors where it is difficult to attract private investors. In Côte d'Ivoire, the leased water company improved technical efficiency, increased new connections, became more efficient in billing and collection of receivables —and reduced the number of expatriate employees by 70%. But because a change in ownership is usually needed to lock in performance gains, private management arrangements are likely to work best when they are a step toward full privatization.
- Privatisation of large financial institutions requires considerable preparation. Successful privatizations of large enterprises have bring about them into the competitive and marketable units (in East Germany, Argentina, and Mexico), bringing in dynamic private sector enterprises (in many telecom and airline sales around the world), settling past liabilities, and labour (in steel and railways in Argentina).
- Transparency is most important parameter for economic and political success. A lack of transparency can result in political backlash, as in the case of Poland, or even bring the process to a halt, as in the case of Guinea.

Privatization is not a blanket solution for the problems of poorly performing state run institutions. It cannot entirely overcome the problem of lack of competition, for weak capital markets, or for the absence of structural regulations. But when the market is essentially competitive, private ownership yields substantial benefits.

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Appendix 1

Abbreviation	*Description*
ARC	Asset Restructuring Company
GDP	Gross Domestic Product
GNP	Gross National Product
IIP	India Industrial Production
PSB	Public Sector Banks
PSU	Public Sector Unit
MSME	Medium Small Micro Enterprise
NPA	Non-Performing Asset
RBI	Reserve Bank of India
ROA	Return on Asset
ROE	Return on Equity