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DYNAMICS OF NON PERFORMING ASSETS IN INDIAN COMMERCIAL BANKS UNDER THE NEW PARADIGM SHIFT

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ABSTRACT

In the growing dynamism of the interconnected international financial architect from EMEs perspective, it has increasingly been realized today that failure of one bank in the developed world can complicate macroeconomic management and jeopardize financial stability in the overall world. Now the credit or market risk not only have negative effect the balance sheet of one bank but also call for overall banking sector to further refine their risk management skills. Banking business and risks are inseparable. Banks have to provide a balanced view of risk and return to develop competitive advantages and to comply with regulatory requirements

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The outlook for the global economy remains uncertain against a background of heightened uncertainty and rising stresses in the financial markets, global business and consumer sentiment has further deteriorated. India has been more fortunate in that it has emerged virtually unscathed from the global crisis. A combination of strong regulation and supervision and a will to evolve policies that lean against the wind helped insulate the Indian financial system from the crisis. The global nature of the challenges to the world economy and the increasing level of interconnectedness between different sectors within economies as well as among the different economies call for banks to further refine their risk management skills for enterprise wide risk management.

Banks, or more generally the credit institutions, in their role as intermediaries take upon themselves significant credit risks, while interposing between lenders (depositors) and borrowers. At its most basic level, risk management sets up the “rules of the game” to deal with issues arising from inter-connection between banks and management/ protection of interests of all stakeholders. Empirical evidence shows that banks with superior governance practices generate bigger profits, higher returns on equity and larger dividend yields. In this sphere, the proper management of Non-Performing Assets (NPA)[1] defines the earning capacity and profitability of the bank.

All the Indian banks have adopted the standardized approaches under the Basel II framework in 2009; however, the pace of migration to the advanced approaches has naturally been very slow. Though the Reserve Bank of India (RBI) has set an indicative time schedule for implementation of the Advanced Approaches (including management of NPAs), banks' response has been less than encouraging so far. Migration to the Advanced Approaches is important for larger banks because it involves adoption of more sophisticated risk management systems.

In the context of growing volume of bank credit, the task of assessing the quality of individual advances for the purpose of effective monitoring, follow up and also for the purpose of making adequate Provision for bad and doubtful assets had been becoming increasingly difficult .Its difficulty was felt in 1980's. Reserve Bank recognized the problem and evolved a system known as Health Code system for indicating the quality or health of individual advance. There are eight categories under the system. There is huge importance of this system and Institute of Chartered Accountants of India has been advised to check the veracity of the classification at the time of annual audit of the concerned bank branches.

RBI guidelines on health code system (Source: RBI)

Code 1: Satisfactory

This category covers all borrowers where

a) Conduct of the account is satisfactory.

b) All items and conditions like punctual submission of stock statement, monthly statement of select operational data, quarterly operating statements, wherever applicable, if half yearly operating and funds flow statements wherever applicable.

Code 2: Irregular

This category of borrowers covers those accounts where the safety of advances is not suspected, though there may be occasion of irregularities which may be considered as a short term phenomena. Example: The accounts are overdrawn beyond the drawing power or the sanctioned limit for a temporary period. Due to short term irregularities, in the account such as debit of interest etc. the account is not to be classified in category no: 2

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[1] NPA is defined as an advance for which interest or repayment of principal or both remain outstanding for a period of more than two quarters. Various studies have been conducted to analyze the reasons for NPA. Whatever may the case the elimination of NPA is impossible.

The reasons may be widely classified in two: (1) Over hang component (2) Incremental component.

Over hang component is due to the environment reasons, business cycle etc. Incremental component may be due to internal bank management, credit policy, terms of credit etc

Installments in respect of term loans overdue for less than 6 months or import bills under the letter of credit installments under deferred payment guarantee, if overdue for less than three months.

Some of the bills (not exceeding 10-15% of the total outstanding in the bills purchased/discounted account of the borrower) are overdue for payment by less than 3 months and/or repayment in respect of unpaid bills is not forthcoming immediately.

Code: 3

Stock viable/under nursing units in respect of which nursing/revival programmes are taken up should included under this category. These should also include units which are working and where operations were being allowed by the bank in the account with or without irregularity where there is reasonable hope for the unit being received ever though no study has been undertaken and viability is yet to be established.

Code: 4 Non viable/sticky

Accounts of borrowers under this category are those where the irregularities mentioned above persist say for a period of 6 months and over and there are no immediate prospects of regularization. Alternatively or in addition the accounts could throw up same of the usual signs of incipient sickness such as:

a) Apparent strangulation in business as reflected by slow/negligible turn over in the account.

b) Frequent request for over drawings or issue of cheques without ensuring availability of funds in the account.

c) Bills purchased/discounted drawn by the borrowers remaining overdue for 3 months or more recovery of such bills from the borrower poses difficulties.

d) In case of term loans 6 or more monthly installments or 2 or more quarterly installments or 4 or more half yearly installments are overdue.

e) Unexplained delays in submission of stock statement: quarterly or half yearly operation statements or balance sheets and other information required by the bank.

Banking business and risks are inseparable. Banks can’t avoid risk if they have to develop economy. There should be balance in taking risk and developing the underdeveloped parts of economy. Among the various types of risks associated with the banks, credit risk is the most important one. The default of small number of important borrowers could generate huge losses. This risk relates to non-payment of loans or deterioration of investments. The various types of risk associated with banks are as being highlighted in the following table1:

Table 1:

TYPES OF RISKS	DEFINITION
1. Credit Risk:	Refers to negative defaulting of other party
a. Counter party default Risk:	Depreciation of banks investments in stock market due to company specific cause.
b. Securitization Risk	In securitization risk is distributed by aggregating debt instruments in a pool an issuing new securities backed by pool
c. Concentration Risk	It is single exposure or a group of exposures with huge risk associated.
2. Market Risks:	It refers to changes in money, capital markets and foreign exchange markets.
a. Interest rate Risk:	It is defined as change in banks portfolio value due to interest rate fluctuations.
b. Equity Price risks	This is due to fluctuation in market prices of equality.
c Foreign exchange Risk	This is risk associated with fluctuation in exchange rates.
3. Operational Risk:	Risk is loss due to internal failures.
a. Legal Risk:	It arises from institutions failures to enact appropriate policy procedures or laws.
b. Documentation Risk:	Improper documentation gives ambiguity

	to financial contracts.
4. Liquidity Risk:	
a. Term Liquidity Risk:	Unexpected delays in payments
b. Withdrawal / Call Risk:	Risk of more credit lines drawn and more deposits withdrawn.
c. Structural Liquidity Risk:	When necessary funding transactions cannot be carried out
d. Contingent Liquidity Risk:	This is associated with additional fundings or replacing maturing liabilities.
5. Market liquidity Risk:	This risk arises when positions cannot be sold within a desired time period.
6. Other risk:	
a. Strategic Risk :	Negative effective on capital due to business policy decision.
b. Reputation Risk:	This is deviation of banks reputation from expected level.
c. Capital Risk:	Capital risk results from an imbalanced internal capital structure.
d. Earning Risk:	Earnings risk arises due to inadequate diversification of banks earning structure.
e. Outsourcing Risk:	Few of these risks are disruption risk, quality risk and reputation risk.

When the risk is /are identified then the next step becomes of management. Banks are risk engines. Banks have to provide a balanced view of risk and return to develop competitive advantages and to comply with regulatory requirements. Efficient credit information systems play a vital role in enhancing the quality of credit decision and improving the asset quality of banks. A scheme for disclosure of information regarding defaulting borrowers of banks an financial institutions was introduced Credit Information Bureau (India) Limited was set up in 2000 to facilitate sharing of information. Credit Information Act was passed in 2005 which set the process of setting up of few more Credit Information Companies in India. After the introduction of financial sector reforms in 1992, risk management practices have gained momentum. Indian banks have been able to maintain their profitability by managing risk. Most of the Banks have adopted a structured approach to risk management only after regulatory pressure to comply with Basel II standards. At present when RBI had announced the draft guidelines for Indian banks under Basel III on December 30, 2011, it calls for a coordinated and comprehensive policy response, including concrete and far-reaching actions in the management of NPAs.

Box1: Status of Implementation of Basel Norms in India (Source BIS, 2012)

- The Reserve Bank of India announced the draft guidelines for Indian banks under Basel III on December 30, 2011. The guidelines will be finalized taking into account the suggestions and comments received till February 2012. The timelines for implementation will be guided by the need to ensure a non-disruptive transition. The RBI would adhere to the internationally agreed phase-in period of Basel III implementation starting from January 1, 2013.
- The Indian banks' current capital base and liquidity position are broadly comfortable, as a starting point, vis-a-vis the Basel III guidelines. Both the capital to risk weighted assets ratio (CRAR) and the core CRAR of Indian banks at 13.5 per cent and 9.6 per cent as at end September 2011, respectively remained well above the regulatory requirement at 9 per cent and 6 per cent, respectively. Leverage ratios continued to hover around 6 per cent as against the Basel III requirement of a minimum of 3 per cent. Thus Indian banks start from a position of strength in the process of transition to Basel III regime, but many challenges lie ahead.
- Commercial banks in India migrated to Basel II with effect from March 31, 2009 and the preparations for migration to the advanced approaches are underway. The timeline for implementation of advanced approaches for the three pillars (viz., credit risk, market risk and operational risk) under the Basel II framework was announced in July 2009. The guidelines for the standardised approach (TSA)/alternate standardised approach (ASA) for operational risk were issued in March 2010 and those for internal models approach (IMA) for market risk in April 2010. Draft guidelines for advanced measurement approach (AMA) for operational risk were issued in January 2011, and final guidelines were issued in April 2011. Guidelines for internal rating based (IRB) approach for credit risk are under preparation

In order to develop a comprehensive policy response a framework for macro financial surveillance is to be placed which identifies, measures and manages all the possible risks, as and when they occur, with a view to effective crisis prevention. There are multiplicities of factor which are responsible forever increasing size of NPAs in Indian banks. Analyzing the number banking crisis occurred some common elements behind emergence of Non Performing Assets can be identified and clubbed into three headings.

1. Those attributable to borrowers:-

a) Failure to bring in required capital.

b) Too ambitious project: sometimes the project is too ambitious.

c) Sometimes the project is too long in its gestation period.

d) Sometimes due to unavoidable reasons expenses become unwarranted.

e) It is seen that over trading and over stocking is done by borrower.

f) Inventories are imbalanced many a times.

g) Lack of proper planning often leads to failure of project.

h) Dependence on single customer often results in accounts becoming non performing.

i) Sometimes borrowers lack expertise of holding a firm.

j) The quality of the product is ignored by the borrowers.

k) Mismanagement of the product also makes it a failure.

l) Improper working capital management is also one of the reasons for an account becoming NPA.

m) Sometimes funds are diverted in unproductive use.

n) Heavy borrowings also put huge pressure on borrower.

o) Poor credit collection also results in failure of banks.

2. Causes attributable to banks:

a) Wrong selection of borrower

b) Improper supervision

c) Poor credit appraisal

d) Rigid stand on issues

e) Overloaded system
f) Inflexible attitude
g) Units left uninspected
h) Lack of motivation of banks employees
i) Delay in sanction of loans.
j) Untrained staff in bank.
k) Lack of delegation of work.
l) Credit squeeze by banks.
m) Lack of technical knowledge.
n) Lack of motivation of employees
o) Lack of commitment to recovery

3. Other Causes

a) Lack of infrastructure
b) Fast changing technology
c) Taxation policies
d) Credit policies
e) Unhelpful attitude of govt.
f) Changes in consumer preference
g) Increase in material costs
h) Civil disturbance
i) Political hostility
j) Government policies
k) Changes related to banking
l) Slow legal system.

The globalised and liberalised nature of the challenges to the world economy and the increasing level of interconnectedness across sectors within economies as well as among the different nations has augmented the impact of the non performing loans/ assets across the world. Now the credit or market risk not only have negative effect the balance sheet of one bank but also call for overall banking sector to further refine their risk management skills.

The regulation of banking sector during the past two decades largely revolved around Basel I and Basel II capital regulations. The financial crisis has highlighted the importance of robust liquidity risk management by banks over their profitability. The crisis demonstrated that liquidity and solvency are quite deeply interrelated. Illiquid banks can become insolvent in no time and similarly an insolvent bank can become illiquid rapidly It was observed during the crisis that even those banks which had sufficient capital base had experienced difficulties due to imprudent liquidity management practices by excessive dependence on wholesale funding markets.

Kasuya, M (1999) Considered the what effects the non-performing assets of the Japanese banks had on the financial intermediation in the inter-war period and inferred from several evidences that there were the deterioration of financial intermediation in the inter-war period, which requires prompt action in required collection and required redemption of non-performing assets. R.Kannan (2010) in the context of severe competition in the banking industry, the weak banks are at disadvantage for leveraging the rate of interest in the deregulated market and securing remunerative business growth. Researcher in the monetary economies analysed the effect of NPAs on credit markets found a positive effect on the volume of bank credit as a percentage of GDP and a decrease in credit risk. Either one of these or more than one cause together makes an account NPA. The effects of NPAs may be summarized into the following points, which can be easily referred further.

i. Banks trust in peoples eyes goes down.
ii. Investments go down
iii. Dependency on institutional lending increase.
iv. Infrastructure and development of country goes down.
v. Unemployment increases.
vi. Govt. has to raise expenditure to cope up with unemployment.
vii. Number of probable entrepreneurs goes down.
viii. Window dressing is done in balance sheets. Short term loans are shown as long term. As a result funds get blocked.
ix. Growth of economy is constrained.
x. Funds go waste.
xi. Saving goes into dissavings.
xii. Opportunity costs of funds remain high.

xiii. Investment is hampered.

xiv. Incremental capital output ratio is used.

xv. Profit of banks comes down

xvi. Value of its share comes down.

xvii. Liquidity is squeezed.

xviii. Credit goes down.

xix. Risk weights are attached to certain sectors so diversity of funds decreases.

xx. Loans to international sector decreases. This reduces mergers.

xxi. There are closures of banks as in case of Global Trust Bank.

xxii. Loss to creditors due to bank`s low income.

xxiii. Salaries of bank employees come down.

xxiv. Domestic banks become unable to face competition from foreign banks.

xxv. Due to provisioning requirement funds go waste.

Banking systems are fragile not only within one country but also within and across regions. We had studied the various aspects of NPAs their causes and impact to one bank further to whole international financial architect. In the growing dynamism of the interconnected international financial architect from EMEs perspective, it has increasingly been realized today that failure of one bank in the developed world can complicate macroeconomic management and jeopardize financial stability in the overall world. For cross-regional contagion, we find that the contagion effects of Europe and the US on Asia and Latin America are significantly higher compared to the effect of Asia and Latin America among themselves. The impact of cross-regional contagion is attenuated when the host region has a more liquid and more capitalized banking sector.

Macro-prudential tools are a primary tool available in the armory of central banks to serve the objective of financial stability. In view of the various steps already taken by the government and RBI, has been taking measures for protection of depositors, enhancing the quality of customer services, dismantling controls and strengthening grievance redressal mechanism in the banks and within RBI. They have devised many methods to deal with non performing assets and to strict the credit risk from becoming the systemic risk:

I. Dismantling Control

Nationalization of banks was done to achieve the regulated development of Indian economy. Instead of development it leads to mismanagement, laxity in clientele focus and low innovative actions

With the advent of Chakarvorty and Narsimhan committee, the drive of dismantling of controls got started. Dual control of Finance Ministry and RBI ended. In 1994, RBI constituted separate Board of Financial Supervision (BFS) with the prime objective of separation of supervisory functions from regulating ones of RBI. Single controlling authority made hierarchy clearer, effective span of control and delegation of authority with due cooperation was achieved.

II. Liberalization In Banking Sector

Single controlling of RBI was followed by deregulation of commercial banks. Permitting the entry of new open economy, where competition became the driving force for adapting innovative approach in banking sector. Now in order to maintain themselves, the public sector banks have to adopt the new norms of changed environment and turn into dynamic self reliant units.

III. New Norms Of Banking

The management of fair competition was done with the adoption of BASEL ACCORD 1988. RBI here after laid down standards of capital adequacy, asset classification and provisions for non-performing assets. The definition of non- productive assets was made clearer. Transparency and instant corrective measures were to be executed. CAMELS norms to grade the banking sector so that mismanagement of banks working in protective shield in the past should end.

IV. Stress On Governance

RBI followed steps in order to achieve Good Governance in the banks. Banks and stock market are closely correlated to each other. SEBI introduced a general set of norms applicable to all companies including banking companies. RBI over this brought out an appropriate set of standards so to cover special needs of banking companies.

V. Change Of Capital Structure Norms

RBI's focus was to achieve proper set standard in over all working of banks. This cannot be achieved until and unless capital structure change so to reduce cost of capital and proper budgeting can be done.Government retained 51% of equity share of banks and rest was allowed for the public issue. This made banks to become one of the players in the secondary market and stressed their efforts to increment their goodwill. New investors or share holders put further pressure on banks to improve their working. Reduction of bureaucratic controls on board of directors synergizes them.

Adoption of BASEL norms further improvised capital budgeting and capital adequacy. Tier I, II & III has the main objective of achieving fresh capital, proper management and good governance.

VI. Risk Assessment And Management

This was one of the most important steps taken by RBI towards evolving a comprehensive model for risk management by the banks. This involved identification of risk prone areas in assets and liability; credit management; cross-country comparisons; analysis of market trends for managing risk in credit, solvency, profit, market etc. Proper accounting standards were established so that effective auditing of can be done.

VII. Fair Practice Code

RBI issued guidelines to the banks and financial institutions to frame their respective practice codes. This was the method to imbibe self- discipline. It also indirectly prevented accounts from turning into non-performing assets. Here each financial institution has separate performance code. It can also be said that it was a Citizen Charter which was self imposed.

VIII. Credit Rating

Credit rating came into scene to help the investors for taking timely and rational decisions in the light of investment instruments. In 2000 CIBIL (Credit Information Bureau of India Limited) by State Bank of India and HDFC to curb accretion of fresh NPAs. This body was technologically sound and ensured timely updating, speedy processing and availability of error free data to the banks. Thus it was a medium to expedite credit and investment decisions.

For investors the main purpose is to communicate the relative ranking of loss probability of a given investment in comparison with other rated instruments. This method provides low cost supplements to the investor and helps them to alter their portfolio mix.

For issuer or lender credit rating provides a basis for determining returns over the cost incurred or it suggest the marginal efficiency of investment which investor must get for bearing additional risk of capital invested.

Thus, credit rating holds an important position in the cycle of capital mobilization. For financial intermediaries CAMEL model (Capital Adequacy, Asset Quality, Management, Earning and Liquidity) is adopted so that all aspects of financial economics can be considered. In today's era the rising NPAs had made the credit rating business more important. RBI had constituted a group of representatives from CIBIL, Indian Banks Association, select banks and financial institutions to examine the functioning of CIBIL. This group is interpreting the importance of CIBIL in dissemination of information and suits filed on defaulters and lender. This group is also looking for the feasibility of supplying information online, its extent and periodicity.

IX. Circulation Of Information On Defaulters

RBI has circulated detailed list of willful defaulters and financial institutions. This serve as a cautionary measure for these willful defaulters to go for new credit. There have been a regular list circulated for the borrowers who has taken loan of one crore and above. This serves as an authentic source of information and has the financial institutions and borrowers to reduce these financial risks.

X. Compromise Settlement Schemes

RBI has issued the specific guidelines in 1999 to public sector banks for one time non-discretionary and non discriminatory settlement of Non Performing Assets of small-scale enterprise sector.

This scheme continued in 2000 and then after new guidelines was issued. In this one time settlement scheme covering 25,000 rupees and below still continued to be in operation. Now it has been raised for 50,000 rupees for small and marginal farmers.

This policy comes in the light when the Vidrabha suicide cases came in the news. The new flexible guidelines have been issued and banks are free to design and implement their own policies for recovery and to write-off debts.

XI. Other Guidelines

Reserve bank of India has suggested to the bank to have a special mention account, so that they can identify bad and doubtful debts guidelines were given for internal monitoring specially for the loans and advances over due for less than one or two quarters. These accounts do not classified as nonperforming assets and neither there is need for provisions. This helps in identification of signs of sickness and monitoring is possible to achieve some remedial measures.

We had addressed the various aspects of the banking related to NPAs it causes, impact and efforts. In the growing dynamism of the inter connected international financial architect following questions concerning bank capital; its high leverage, robust capital regulation; prevalence of shadow banking system; balance-sheet opacity and ease of asset substitution are need to be answered All the sectors of economy can go in slump due to NPAs. Economy can collapse. The problem of NPAs and its magnitude can be seen from the subprime crises of Uncle Sam. The financial turmoil which the whole world is witnessing is all because of NPAs. So many bail out plans have been launched but to make economy revive seems a stupendous task. So, to make economy flourish controlling NPAs is imperative.

Macro-prudential tools are a primary tool available in the armory of central banks to serve the objective of financial stability. The experience of India could become handy in this regard. At the same time, multilateral initiatives (IMF, FSB and BIS etc.) should not become prescriptive and the national policy makers must have flexibility and discretion to adopt policies that are adequate to their economic context. The initiative should be to examine the various instruments and the range of policy actions by sharing successful experiences and best practices.

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