NPA MANAGEMENT IN BANKS

Introduction

One cannot comprehend an economic and industrial growth without a healthy banking industry. The banking sector acts as the catalyst for the country's economy playing an instrumental role in providing financial resources especially to capital-intensive sectors such as infrastructure, automobiles, iron and steel, pharmaceuticals, healthcare etc. From the Indian perspective, the economy was on the upside during the period 2002 to 2008, which saw a credit growth of around 22% pursuant to by all the banks/FIs across various verticals. The scenario continued to be healthy until the economic slowdown across the globe from 2009 and onwards, which adversely impacted Business across the globe and the Indian economy was no exception. The continued slow down resulted in a speedy deterioration of financial health of companies leading to failures in meeting their debt obligations to the Banks/FIs, and the resultant growth in the NPAs of Banks/FIs. Apart from global slowdown, the increase in NPAs is also attributable to reckless lending by some banks in the past, improper monitoring of borrowers' accounts, higher interest rates etc. The menace of NPAs is ever growing as companies across various verticals which have amassed huge debts are not in a position to service the same.

Since March 2011, NPAs of the banks have been increasing; at the end of March 2015, the gross NPAs of the domestic banking system were 4.62 per cent of gross advances as compared to 2.36 percent of gross advances as at March 2011. The total stressed assets in the banking system (which includes GNPAs and restructured standard assets) as at March 2015 made up 11.06 per cent of the total advances of the banks up from 10.7 per cent in September 2014. In absolute terms, 40 listed Indian banks were having GNPAs of more than Rs. 3 trillion at the end of March 2015[1]. NPAs for the Indian banking system are likely to deteriorate further as a large number of restructured advances are likely to slip into the NPA net, specially the Infrastructure (mainly power, telecom & roads) sector loans. The infrastructure sector constitutes 31% of the total NPAs of Public Sector Banks whereas it constitutes 18 percent of the total NPAs of Private Sector Banks.

Continued domestic economic weakness and the liquidity crunch has had a twofold impact on the banking industry, viz. reduced growth in the advances and a surge in the growth rate of NPAs, which has accelerated the stress in the Indian banking system and in the event the economic situation does not improve, the health of the Indian banking sector may further get adversely affected.

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[1] Source – Compiled from the data at Indian Banks' Association's website

The need of the hour is to have robust mechanisms in place which are capacitated in improving the system's ability to deal with menace of NPAs and which encompass both preventive and remedial measures, to be able to contain the surging NPAs and to plug its inherent evils of drain on the Banks' profitability and loss of value to all stake holders.

The impetus of the Banks/FIs should be firstly to adopt proactive preventive mechanisms which at the first instance curb any fresh generation of NPAs and if thereafter there are slippages, for external reasons or reasons beyond the control of the Banks, necessary remedial measures should be adopted by the lenders for managing its NPAs.

Preventive Measures:

Improving the credit appraisal standards is the key to a healthy credit portfolio and consequent prevention of NPAs. In the past, reckless lending by banks without appropriate credit appraisal of the project and its financial needs has been one of the significant reasons for the present state of NPAs. The viability assessment parameters need to be strengthened and stress should be laid on carrying out an independent techno economic viability study of a project before the banks proceed to carry out any kind of lending. The banks should strive to enhance their in-house capabilities for the same and if required should engage independent experts and professionals in the field for establishing the techno economic viability of the project. The Banks should also keep a more realistic approach while stipulating repayment schedule which should be solely based on the expected cash flows of the project rather than on the basis of a thumb rule which may be applicable to all and sundry. The banks need to come out of their thought process of `one size fits all' and accordingly stipulate realistic repayment schedules. In many cases it has been observed that due to delays in completion and commencement of projects the repayment commences even before the facility has actually commenced commercial productions which itself marks the beginning of stress in the accounts right from inception. In line with the above perception the Reserve Bank of India in July 2014, introduced a flexible financing scheme allowing banks to extend long term loans of 20-25 years to match the cash flows of projects while refinancing them every five or seven years (commonly known as 5-25 scheme). Further during the course of appraisal it is imperative to factor in any contingency credit facility to enable the company to finance the cost over runs / project delays which may arise in future. In the absence of such a mechanism it is seen that in many cases, either there are delays in sanctioning of additional loans to meet the cost over runs or such loans are not sanctioned and the borrower utilizes the working capital funds for meeting its long term fund requirements which marks the commencement of vicious circle of working capital depletions, under utilizations of capacities, non generation of sufficient EBIDTA and non servicing of Banks' interest etc.

Another important measure is to strengthen the monitoring of the credit extended by the Banks which may include meaningful site inspections, quarterly audits, in depth analysis of the financial results of the borrower on a quarterly basis stricter norms for stock audit and audit of receivables etc. which may help the lender in detecting warning signals at an early date lest the issues assume monstrous proportions.

Strategic Debt Restructuring:

To further address the issue of growing NPAs and with the underlying objective that `equity stake holders should bear the first loss than the debt holders' the RBI came up with fresh guidelines, in June 2015 enabling a change in the management of the borrower companies, when the operational/ managerial inefficiencies are observed to be one of the reasons behind the continuation or aggravation in the stress being felt at the borrower company. The guidelines stipulate provisions for transferring equity of the company by promoters to the lenders as compensation for their sacrifices, further infusion of promoter-equity and transfer of the promoters' equity holdings to a security trustee/held in an escrow till 'turnaround' of company.

Under the strategic debt restructuring (SDR) mechanism in order to achieve the change of ownership/management at the borrower company, the consortium of banks and financial institutions / lenders under the JLF may collectively become the majority shareholder by converting their dues into equity, subject to the statutory limit set under the Banking Regulation Act, 1949. Supporting the efforts and through prompt inter-regulatory coordination, the Securities and Exchange Board of India (SEBI) has issued notification regarding fixing of conversion price and lock-in period and providing for necessary exemptions for banks from the takeover rules thus allowing them to convert debt to equity of companies, under SDR, without having to make mandatory tender offers to minority shareholders. The shares so acquired to be divested by the lenders in favor of a `new promoter' at the earliest.

The SDR gives an incentive to the lenders to maintain a `status quo' to asset classification for a period of 18 months from the date of invocation of SDR by the JLF and also a breather from making further provisions for the sated period of 18 months. Upon divestment of the shares in favour of the new promoter the lenders may also consider re-financing the debt which shall be considered as a `Standard Asset'. SDR addresses both the issues of safeguarding value of assets of viable entities by ensuring continuity of operations, albeit under a new management, while at the same time it also addresses the lenders concern w.r.t. the NPA status of an advance account as any change under the SDR will not be considered as a restructuring. To further strengthen the Banks, the RBI issued fresh guidelines, in September 2015 permitting the lenders, to effect a Change of Management outside of SDR, by invocation of pledge of shares of the borrower entity.

Remedial Measures

1. **Restructuring of Debt:**

Despite the best possible preventive measures being in place, a slippage in the account cannot be ruled out which may be attributed to several reasons beyond anybody's control. Once the account starts showing signs of slippage or mortality the Banks, in genuine delinquent cases affected by external factors and keeping the wilful defaulters at bay, should actively consider restructuring of the same in order to arrest the slippage and keep alive the hopes of revival of the account. Till March 2015 the Banks were keen to restructure the potential NPAs as the RBI guidelines provided regulatory forbearance and such restructured accounts were not to be classified as NPAs, subject to fulfilment of certain conditions. However, post March 2015 there has been a marked reluctance on part of the Banks to undertake restructuring as the incentive of asset classification as `Standard' is no more available, which is evident from the fact that since March 2015, no accounts were referred to CDR Cell by Banks. There is an urgent need to bring a change in such a thought process as preserving economic value of assets in case of viable units and minimizing the loss to the stake holders is of larger importance for the overall economic growth as compared to `Asset Classification' and `Provisioning' to be made in the banks' financial statements.

2. **Corporate Debt Restructuring Mechanism:**

Presently the restructuring of debts is undertaken either on bilateral basis or through the CDR forum (in case of multiple banking and aggregate debt being in excess of Rs.10.00 crore). However the success rate of structuring undertaken by the CDR is not very encouraging. The CDR restructurings have only been reduced to `mere ever greening' of accounts rather than addressing the real problem. Most of the CDR schemes are vanilla schemes encompassing deferment of repayments, reduction in interest, part conversion of debt into Equity/Preference Capital or any other debt instruments etc. as such the same has also not been able to fully accomplish the end for which it was envisaged.

3. **Joint Lenders' Forum and the Corrective Action Plan:**

The RBI came up with a fresh set of guidelines in February 2015 `Framework for Revitalizing Distressed Assets in the Economy' which recommended setting up of Joint Lenders' Forum (JLFs) for early identification of stressed assets and formulation of corrective action plan (CAP) to bail out viable units which are presently under stress and to initiate recovery action against the un-viable ones in order to arrest any further depletion in value.

Exit Route

The Banks should have a clear cut exit policy and should lay down definitive parameters which may be applied to the various bad loan accounts, which are incapable of being revived, depending upon the merit of each case. The banks may resort to either court driven or out of court measures to ensure the recovery of amounts from NPAs.

1. Compromises and Settlements:

The banks may resort to compromises and settlements with the defaulting borrowers and stipulate he repayment terms in accordance with the RBI guidelines and the respective bank's internal settlement policy. The same ensures a legal and dispute free resolution of NPA both for the borrower.

2. **Sale of NPAs to Asset Reconstruction Companies**:

For an effective resolution of distressed assets, debt aggregation capability and necessary skill sets for resolution are decisive. ARCs with ability to aggregate debt of different classes are in a better position to tackle complexities of recovering from a bad loan. ARCs have access to SARFAESI Act to take necessary steps for recovery and resolution of bad loans acquired from banks. Thus, ARCs with focus and domain expertise in resolution and the statutory/ regulatory empowerments for resolution are in a better position to implement timely resolution strategy thereby enhancing the value of stakeholders. Of late the RBI has issued several guidelines relating to the functioning and operations of the ARCs with an overall intent to equip the system to handle the enlarged stress assets base. The various guidelines issued by the RBI w.r.t. ARCs include an increase in the minimum threshold investment of ARC in the SRs from the initial level of 5% to 15%. The increased stake would encourage better due diligence on part of the ARCs and more realistic pricing of the debt which in the opinion of the ARC is actually doable. Further, the limit of FDI investment in an ARC has been raised from 49% to 74% (under Automatic route) to give further leverage to ARCs to strengthen their capital base to be able to effect more meaningful acquisition of large asset accounts. The ARCs have also been permitted to convert a portion of their debt into equity and also acquire a debt from another ARC. The RBI has permitted an extension of resolution period from 5 years to 8 years to enable the ARCs to give an extended re-structuring period to the borrowers who have entered into a restructuring arrangement with the ARCs post acquisition of their debts. To improve the financial ability of the ARCs, those ARCs which have acquired assets worth Rs.500.00 crore and above have been permitted to float a fund (to be subscribed by QIBs) and utilize up to 25% of the same for restructuring of the debts acquired.

3. **Recovery Action**

If the banks are of the view that the restructuring is not a viable option with respect to a particular stressed account then they may initiate recovery proceedings against the defaulting borrower by filing a suit for recovery before the Debt Recovery Tribunal or the Banks may proceed to take Possession of the secured assets under the provisions of SARFAESI Act 2002 and thereafter proceed to sell the same in a transparent manner, to be able to realize the best possible returns. In order to give a further impetus to recoveries, the percentage outstanding of the lenders to be eligible to initiate recovery action under SARFAESI Act 2002 from 75% to 60%

Insolvency and Bankruptcy Bill 2015

The judicial delays and a weak insolvency resolution procedure in the country also triggered the growth of NPAs with large number of borrowers taking shelter under the inefficiencies of the system thereby defeating even the best intended policies initiated by the Government/Regulator. The insolvency regime in the country is all set to undergo a sea change with the introduction of the Insolvency and Bankruptcy Bill 2015,(IBB) which is yet to be table before the Houses of the Parliament. As per the provisions of the IBB, the Financial Creditors of a defaulting borrower entity will call the shots in the entire proceedings. If the financial creditors are of the view that the entity can be revived then they may collectively (by a super majority) decided to restructure the dues and file a revival package before the adjudicating authority and if they decide otherwise, the entity will be liquidated. As such under the new rules of the game, it is the collective wisdom of the lenders which will prevail over the entire proceedings. The IBB also stipulates that any revival package, if envisaged, should be approved within a maximum of 180 days, extendable by another 90 days, failing which liquidation would be the only fate of the entity.

Conclusion:

Although the Government and the Regulator have taken several initiatives for creating an effective NPA management regime, but the success story is not very encouraging. As always said that `Prevention is better than Cure' so greater stress should be laid on developing in-house capabilities for an effective credit appraisal system and subsequent more efficient monitoring capabilities which should be able to raise a red flag upon observing signs of delinquency in any borrower account and as such the problem may be addresses at the nascent stage without waiting for it to assume huge proportions. It is always better to nip the problem in the bud itself.

On the remedial side, the ARCs mechanism should be to further strengthen to be more participative and productive in the overall management of NPAs. Looking to the availability of huge amount of NPAs which have been put on block by the lenders, for acquisition by the ARCs, the capital available with the ARCs is meagre. The ARCs should have higher accessibility to funds for investment in the SRs. Possibilities should be explored for the ARCs to have access to capital markets for raising funds. Further, there is a dire need for the banks to be more realistic while assigning a price to the NPA which are put on block. It is time for the banks to face the reality and `take the bull by its horns' by exiting from un-productive loans by quickly selling the distressed assets to ARCs at the competitive prices/ possession and sale under SARFAESI, even if that tantamount to increased losses in the short term. At least the monies locked up in such un-productive assets will be released which could be utilized for more effective usage in the medium and long term.

With robust systems in place, the growing NPAs can be managed effectively which would help in un-locking of good money blocked into un-productive assets and give a much needed boost to the sagging economy in general and the banking sector in particular.