Solving the NPA Crisis in India

This editorial is based on the article "Resolving India's banking crisis" which appeared in "The Hindu" on 11th May, 2019. The article talks about how the India's banking problems can be solved without privatising the PSBs.

India's banking sector is an unresolved problem.

To resolve this problem we will need clarity on how the problem arose in the first place. Also, we will need to discard simplistic and ideologically-driven solutions in favour of those that can be practical and effective.

Indian banks and NPAs

Here is why the NPA problem is such a big problem to Indian banks, especially PSBs.

- In March 2018, non-performing assets (NPAs) at commercial banks amounted to ₹10.3 trillion, or 11.2% of advances.
- Public sector banks (PSBs) accounted for ₹8.9 trillion, or 86%, of the total NPAs.
- The ratio of gross NPA to advances in PSBs was 14.6%.
  - **These are levels typically associated with a banking crisis.**
  - For example, in 2007-08, NPAs totalled only ₹566 billion (a little over half a trillion), or 2.26% of gross advances!
- The current trend is that the increase in NPAs since 2008 has been staggering.

How did this problem come about?

The answer lies partly in the credit boom of the years 2004-05 to 2008-09.

In that period, commercial credit (or what is called 'non-food credit') doubled. It was a period in which the world economy as well as the Indian economy were booming. **Indian firms borrowed furiously** in order to avail of the growth opportunities they saw coming.

- **Most of the investment went into infrastructure and related areas — telecom, power, roads, aviation, steel.**
- Businessmen were overcome with exuberance and they believed, as many others did, that India had entered an era of 9% growth.

But soon after, as the Economic Survey of 2016-17 notes, many things began to go wrong.

- There were problems in acquiring land and getting environmental clearances and several projects got stalled. Project costs soared.
- **At the same time, with the onset of the global financial crisis in 2007-08 and the slowdown in growth after 2011-12, revenues fell well short of forecasts.**
- **As a result, financing costs rose as policy rates were tightened in India in response to the crisis.**
- **Further, the depreciation of the rupee meant higher outflows for companies that had borrowed in foreign currency.**

This combination of adverse factors made it difficult for companies to service *(i.e maintain and repay)* their loans to Indian banks.

The year 2014-15 marked a watershed because of tightening of banking norms.

- The Reserve Bank of India (RBI), acting in the belief that NPAs were being under-stated, introduced tougher norms for NPA recognition under an **Asset Quality Review**.

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- **NPAs in 2015-16 almost doubled over the previous year as a result. It is not as if bad decisions had suddenly happened. It's just that the cumulative bad decisions of the past were now coming to be more accurately captured.**

  Higher NPAs mean higher provisions on the part of banks. *[A provision is an amount that you put in aside in your accounts to cover a future liability. The purpose of a provision is to make a current year's balance more accurate, as there may be costs which could, to some extent, be accounted for in either the current or previous financial year]*
- **Provisions rose to a level where banks, especially PSBs, started making losses.**
  - Their capital got eroded as a result.
  - Capital from the government was slow in coming and it was barely adequate to meet regulatory norms for minimum capital. Without adequate capital, bank credit cannot grow.

    Once NPAs happen, it is important to effect to resolve them quickly. Otherwise, the interest on dues causes NPAs to rise relentlessly.

Where is the solution to this problem?

Is the problem public ownership of banks?

Since the problem is more concentrated in PSBs, some have argued that public ownership must be the problem.

> Public ownership of banks, according to them, is beset with corruption and incompetence (reflected in poor appraisal of credit risk). **The solution, therefore, is to privatise the PSBs, at least the weaker ones**.

There are problems with this idea of privatising PSBs.

> First, there are wide variations within each ownership category (within Indian banks).
> - **In 2018, the State Bank of India's (SBI's) gross NPA/gross advances ratio was 10.9%. This was not much higher than that of the second largest private bank, ICICI Bank, 9.9%.**
> - **The ratio at a foreign bank, Standard Chartered Bank, 11.7%, was higher than that of SBI**.
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>   > *Moreover, private and foreign banks were part of consortia that are now exposed to some of the largest NPAs. Therefore the explanation lies elsewhere.*

A brief look at the state of PSBs show that they are not in as bad a shape as many make them out to be.

> **For example, PSBs had a higher exposure to the five most affected sectors — mining, iron and steel, textiles, infrastructure and aviation.**
> - These sectors accounted for 29% of advances and 53% of stressed advances at PSBs in December 2014. For private sector banks, the comparable figures were 13.9% and 34.1%.
> - **Rough calculations show that PSBs accounted for 86% of advances in these five sectors**. *(By an interesting coincidence, this number is exactly the same as the PSBs' share in total NPAs)*
> - **As mentioned earlier, infrastructure projects were impacted by the global financial crisis and environmental and land acquisition issues. In addition, mining and telecom were impacted by adverse court judgments. Steel was impacted by dumping from China. Thus, the sectors to which PSBs were heavily exposed were impacted by factors beyond the control of bank management.**

Wholesale privatisation of PSBs is thus not the answer to such a complex problem.

> We need a broad set of actions, some immediate and others over the medium-term and aimed at preventing the recurrence of such crises.

Way Forward

One immediate action that is required is resolving the NPAs.

- Banks have to **accept losses on loans** (or ‘haircuts’).
- They should be able to **do so without any fear of harassment** by the investigative agencies.
- The Indian Banks’ Association has set up a six-member panel to oversee resolution plans of lead lenders. To expedite resolution, more such **panels may be required**.
- An alternative is to **set up a Loan Resolution Authority**, if necessary through an Act of Parliament.
- Also, the government must **infuse at one go whatever additional capital is needed** to recapitalise banks — providing such capital in multiple instalments is not helpful.

Management of Concentration Risk

- One important lesson from the past decade’s experience with NPAs is that management of concentration risk — that is, excessive exposure to any business group, sector, geography, etc. — is too important to be left entirely to bank boards.
- The RBI has drawn this lesson to some extent.
- Effective April 1, 2019, **the limit for exposure to any business group has been reduced from 40% of total capital to 25% of tier I capital** (*which consists of equity and quasi-equity instruments*).
- The limit for a single borrower will be 20% of tier 1 capital (*instead of 20% of total capital*).

To conclude, **the task of accelerating economic growth is urgent. This is not possible without finding a solution to the problems that confront the banking system.**

- **There is ample scope for improving performance within the framework of public ownership.**
- What is needed is a concentrated focus on the part of the government.

Drishti Input

Discuss the crisis of non-performing assets (NPAs) in the context of Public Sector Banks (PSBs) in India. What are some of the ways in which we can overcome this crisis?