Evergreening of Loans

For Prelims: Reserve Bank of India (RBI), Stressed loans, ESG (Environmental, Social, and Governance) norms , Asset reconstruction company (ARC)
For Mains: Evergreening of Loans, Approaches Utilized for Evergreening Loans.

Why in News?

The Governor of the **Reserve Bank of India (RBI),** recently addressed bank boards and expressed concerns about **banks adopting over-aggressive growth strategies and engaging in the evergreening of loans.**

- The governor emphasized the need for robust **corporate governance** and highlighted instances of concealing the true status of stressed loans.

What is the Evergreening of Loans?

- **About:**
    - Evergreening loans, a **form of zombie lending,** is a practice of **extending new or additional loans to a borrower who is unable to repay the existing loans,** thereby **concealing the true status of the non-performing assets (NPAs)** or bad loans.
- **Approaches Utilised for Evergreening Loans**:
    - **Selling and buying back loans or debt instruments** between two lenders to avoid classifying them as NPAs.
    - **Persuading good borrowers to enter into structured deals** with stressed borrowers to hide their default.
    - **Using internal or office accounts to adjust the repayment obligations** of borrowers.
    - **Renewing or disbursing new loans to stressed borrowers** or related entities closer to the repayment date of earlier loans.
- **Impact:**
    - Evergreening loans can create a **false impression of the asset quality and profitability of banks and** delay the recognition and resolution of stressed assets.
    - It can also **undermine the credit discipline and moral hazard among borrowers,** and erode the trust and confidence of depositors, investors and regulators.

What is a Non-Performing Asset?

- NPA refers to a **classification for loans or advances that are in default or are in arrears on scheduled payments of principal or interest.**
- Banks are required to classify non-performing assets further into the following three categories based on the period for which the asset has remained non-performing and the realizability of the dues:
    - **Sub-standard Assets:** A substandard asset is an asset classified as an NPA for a **period less than or equal to 12 months**
    - **Doubtful Assets:** A doubtful asset is an asset that has been nonperforming for a **period**

exceeding 12 months.
    - **Loss Assets:** Assets that are **uncollectible and where there is little, or no hope of recovery and that needs to be fully written off.**

- **Loan write-off Vs. Evergreening:**
    - **Loan write-offs** are a **process of removing bad loans** from the books of banks after making adequate provisions for them. **Loan write-offs do not mean that the borrowers are relieved of their repayment obligations** or that the banks stop pursuing recovery from them. Loan write-offs are done to **clean up the balance sheet of banks and reflect their true financial position.**
        - Write-off exercise has **enabled banks to reduce their non-performing assets, or defaulted loans, by Rs 10,09,510 crore ($123.86 billion) in the last five years.**
        - Evergreening of loans, on the other hand, is a practice of extending new or additional loans to a borrower who is unable to repay the existing loans, thereby **concealing the true status of the non-performing assets (NPAs) or bad loans.**
- **Initiatives by RBI:**
    - The RBI has cautioned banks against adopting **over-aggressive growth strategies, underpricing or over-pricing of products**, concentration or lack of diversification in deposit or credit profile, which can expose them to higher risks and vulnerabilities.
    - The RBI has also implemented various measures to support the banking sector, including **providing liquidity support, regulatory forbearance, the establishment of an asset reconstruction company (ARC),** and the resolution framework.
        - However, the RBI has highlighted that these measures alone are insufficient if banks do not improve their risk management and governance practices.
    - Several banks have faced penalties imposed by the **RBI for violating various norms related to** KYC (Know Your Customer), customer grievance redressal, fraud reporting, etc.
        - Supervisory action has also been initiated by the RBI against some large private sector banks for governance lapses.

Note: An **Asset Reconstruction Company is a specialised financial institution that specialises in acquiring and resolving** non-performing assets (NPAs) of banks and other financial institutions. ARCs were introduced in India in the late 1990s as a response to the **increasing problem of NPAs in the banking sector.**

How can Evergreening of Loans be Controlled?

- **Enhanced Risk Assessment:** Financial institutions should adopt **robust risk assessment practices** to evaluate the creditworthiness of borrowers accurately.
    - This involves conducting thorough due **diligence, analyzing repayment capacity, and assessing the viability of the borrower's business model.** By accurately identifying potential risks, lenders can avoid the need for evergreening loans.
- **Transparent Reporting and Disclosure: Transparency** is crucial in preventing evergreening of loans. **Lenders should provide accurate and timely information on their loan portfolios,** including non-performing loans (NPLs) and loan restructuring.
    - Clear and transparent disclosure requirements enable regulators, investors, and other stakeholders to assess the financial health of banks and identify any potential evergreening practices.
- **Asset-liability Management:** There is a need to lay emphasis on the **importance of asset-liability management (ALM),**
    - ALM involves **assessing and monitoring the potential risks arising from the maturity mismatch between assets and liabilities,** interest rate fluctuations, and other market risks.
    - Banks have been advised to promptly **interact with the media in order to dispel any**

misinformation or rumours on social media that can trigger panic among depositors.

- **ESG (Environmental, Social, and Governance) Norms:** There is a **need for banks to comply with** **ESG (Environmental, Social, and Governance) norms** as they are becoming increasingly relevant for investors and stakeholders.
    - Banks should **adopt sustainable business practices, disclose their ESG performance,** and align their lending policies with national and international goals on climate change and social welfare.
    - ESG goals are a set of standards for a company's operations that force companies to follow **better governance, ethical practices, environment-friendly measures and social responsibility.**
- **Recommendations of P J Nayak Committee:**
    - According to the **Committee to Review Governance of Boards of Banks in India,** wherever significant **evergreening in a bank is detected by the RBI, penalties should be levied through cancellations of unvested stock options** and claw-back of monetary bonuses on officers concerned and on all whole-time directors, and the Chairman of the audit committee be asked to step down from the board.

UPSC Civil Services Examination Previous Year Question (PYQ)

Q. With reference to the governance of public sector banking in India, consider the following statements: (2018)

1. Capital infusion into public sector banks by the Government of India has steadily increased in the last decade.
2. To put the public sector banks in order, the merger of associate banks with the parent State Bank of India has been affected.

Which of the statements given above is/are correct?

(a) 1 only
(b) 2 only
(c) Both 1 and 2
(d) Neither 1 nor 2

Ans: (b)

Source: IE