NPAs: All talk and no action*

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The media are full of it. Viral Acharya, a recently inducted Deputy Governor of the Reserve Bank of India (RBI), has declared publicly that resolving the problem of bank stress resulting from large non-performing assets (NPAs) on their balance sheets is the RBI's priority, taking precedence over measures such as interest rate reduction to spur growth. The issue here is not just one of preventing bank insolvency, but of keeping the credit pipe open. Banks burdened with NPAs are likely to be less willing to expand their loan books, and if interest rates are too low, banks may be unwilling to offer loans to existing and potential borrowers characterised by even moderately above-average risk.

These factors have revealed themselves starkly during financial year 2016-17, when the policy of demonetisation disrupted banking activity during a large part of the year. An analysis by Business Standard (23 July 2017) of 32 listed public and private sector banks shows that advances in 2016-17 grew by just 1.7 per cent year-on-year, which was a 20-year low. It is indeed difficult to separate out the shorter-term, adverse effects of the demonetisation initiative on lending, from the long-term effects of overexposure to defaulting borrowers. But clearly bank appetite for lending large sums to corporates does seem to be satiated, when compared to the years after 2003 when bank lending boomed. The only positive thus far stems from the fact that most of the banks involved are public sector entities with the implicit backing of government. The perception that the liabilities of these banks are backed by a sovereign guarantee has prevented a bank run.

What is becoming clear now is that for reasons still to be fully explained, the NPA problem is extreme because due diligence was lacking at a systemic level. Nothing illustrates this better than the evidence that 12 of the largest corporate defaulters whose names are yet to be officially revealed accounted for around a quarter of the non-performing assets in the commercial banking system. The surprise does not lie in the fact that a few firms account for a large share of NPAs. There is no reason why NPAs should be more evenly distributed across sectors and firms unless it is presumed that the problem results from a generalised recession or that mismanagement is a systemic problem. What is surprising, however, is that when the ratio of stressed assets to gross advances in the banking system have crossed the double-digit mark, or stressed assets are a large proportion of outstanding advances, a few borrowers account for a large share of defaults. That suggests that banks have been willing to build their loan book with a large share of advances to some borrowers, who – it is now clear – were potential defaulters. Whether this was the result of just bad or fraudulent decision-making or pressures from outside the bank concerned is yet unclear.

As information on of the ways in which different groups of banks are grappling with the defaults by such borrowers emerges, as it did in the Kingfisher Airlines case for example, it is clear that banks have tried to retrieve themselves from this mess by lending even more to potential defaulters or converting part of their debt into equity. The crisis came when such resolution measures did not work. On the other hand, their pursuit meant that the deficits on the balance sheets of these firms were even larger.

In the event, when banks decide to make a case for liquidation as a way of recovering at least a part of their loans, the assets available prove to be inadequate to provide even a fraction of the value of their exposure, especially since resources have often been diverted out of the firms concerned.

It is in this background that Acharya’s claim that the RBI is focused on resolving the bad loan problem needs to be examined. Bank NPAs are not a new issue, though the magnitude of the problem was revealed when Raghuram Rajan, the previous RBI Governor, decided to impose new guidelines on identifying NPAs. This forced banks to declare as NPAs, assets that had been classified as standard because they had been through a debt restructuring process, even when the latter was not successful.

Having recognised the magnitude of the problem, the government and the RBI have been engaged with policy aimed at cleaning up bank balance sheets. Principal among these was an effort to infuse budgetary resources to recapitalise the public sector banks, where much of the NPAs were located. But what the government thought it could spare for the purpose was far short of what was required to clean up the balance sheets. So, for some time there was an attempt to use Asset Reconstruction Corporations (ARCs) to take over, at heavily discounted rates, and dispose of bad assets. That too did not work, as was the case with the idea of setting up bad banks to take over the bad assets, without specifying clearly how those banks would be financed. That seemed to leave only the possibility of shrinking the public sector either by selling off bank assets to help write off bad debt or by issuing new equity and diluting public ownership. But given that the public sector banks are already in poor shape, the price at which they could be privatised is likely to be indefensible.

Perhaps in preparation for all this, the government has decided to give the RBI a last chance to force banks to recover at least a part of their loans. To that end, a first set of 12 large defaulters has been identified by the RBI and the banks exposed to them advised to take them to the National Company Law Tribunal (NCLT), the body responsible for adjudicating insolvency proceedings under India's new bankruptcy law. Under the law, a settlement must be reached within 180 days (extendable in exceptional circumstances by 90 days), so an early resolution is also part of the objective. As noted earlier, these large defaulters account for around a quarter of NPAs in the books of the scheduled commercial banks. So the government’s expectation possibly is that a quick resolution of these NPAs would allow recovery of loans, even with a haircut or a discount that would significantly reduce recapitalisation requirements.

Since the names of the 12 defaulters being targeted for resolution in the first stage have not been officially disclosed, it is difficult to judge whether these expectations are warranted. But media speculation, based on information from unnamed sources, suggests that the 12 include firms that have been the target of debt restructuring, in the case of some of which the responsible individuals are absconding. Little is likely to be recovered, as has been the case with Kingfisher Airlines. So, as in the case of the ARCs and the bad bank idea, the secretive move against the 12 defaulters only serves to postpone the problem.

Concrete action requires two types of initiatives on the part of the government and the RBI. The first is for the government to make a clear assessment of recapitalisation requirements and invest money in the equity of public banks, financed if necessary with borrowing from the RBI. (Direct investment by the RBI in bank equity will be opposed because of the conflict of interest involved in the bank regulator being an owner of banks, which was the reason why ownership of the State Bank of India was transferred from the RBI to the central government.)Recapitalisation, however, would require dropping the neo-conservative ideas of how the government can use the fiscal lever it has at hand, which are at the core of the government fiscal reform and consolidation agenda. But even if the government is willing to modify its ideological outlook that abjures increases in debt financed spending, this can only be a first step.

In the medium- and long-term the source of the problem needs to be addressed: that is, the dependence on private investment for investments in capital intensive, long-gestation projects, and the dependence on banks for the financing of such projects. The former is the result of the reform-induced failure of the government to mobilise adequate resources, either through taxation or borrowing, to finance capital expenditure that is best undertaken by the public sector. In many such areas, profits have been volatile and difficult to come by, and firms have found themselves unable to service the debts they had incurred while making those investments. The latter is the result of the decision to do away with specialised development banking institutions with access to low cost, long maturity funding as part of financial liberalisation, and encourage banks to mobilise short-term capital that must be returned on demand to take on the task of financing large investments in steel and infrastructure, for example. The maturity and liquidity mismatch involved has led to the current mess in which defaults have been large and NPA stress is pushing sustainable limits.

In sum, neoliberal reforms, in the financial sector and outside, are the root of the current problem. They prevent the government from undertaking the large investments in infrastructure and capital intensive industries that are imperative for development, but are too difficult a responsibility for the private sector to shoulder. They encourage the commercial banking system to lend to private investors in such areas, especially when liberalisation-induced foreign capital inflows increase liquidity in the banking system. In an effort to facilitate private investment activity, they make it difficult to resolve the NPA problem when it first arises, by prescribing “restructuring of debt” as the better option. And finally, by refusing to use government money to recapitalise banks they make it near impossible to clean up bank balance sheets. This explains why a problem that has been recognised for long just will not go away.

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